GUTTING THE RULE AGAINST SELF-SETTLED TRUSTS: HOW THE NEW DELAWARE TRUST LAW COMPETES WITH OFFSHORE TRUSTS

BY JOHN E. SULLIVAN III

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*John E. Sullivan III is a graduate of The University of Texas School of Law and is a member of the Cleveland, Ohio law firm of Sullivan & Sullivan, Ltd. Mr. Sullivan concentrates in debtor-creditor matters (including bankruptcy, collections, asset protection planning, and the use of U.S. and offshore trusts and companies), general business and personal planning, and business litigation. This article is a follow-up to an earlier article written by Mr. Sullivan in this journal, "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 (1997). The author thanks Ms. Julia Ryan Sullivan, the other member of Sullivan & Sullivan, Ltd., for her thoughtful editing assistance. All opinions expressed in the text, however, are strictly those of the author.
I. INTRODUCTION

On July 9, 1997, Delaware enacted House Bill 356, which added "a new subchapter" to title 12, chapter 35 of the Delaware Code. The bill created the "Qualified Dispositions in Trust Act," which "is similar to legislation recently enacted in Alaska . . . [and] is intended to maintain Delaware’s role as the most favored domestic jurisdiction for the establishment of trusts." The key feature of the Act, and its Alaska counterpart, is that trust settlors may now use self-settled spendthrift trusts as a tool to shelter assets from creditors. This represents a radical departure from the long-standing American rule against self-settled trusts. Moreover, by permitting the use of self-settled trusts as an asset protection tool, Delaware, along with Alaska, has joined the ranks of an ever growing number of offshore jurisdictions that permit creditor-resistant self-settled trusts. Therefore, it is apparent that Delaware has made a concerted effort to become an onshore version of an offshore trust situs.

1Synopsis, An Act to Amend Title 12, Delaware Code, Relating to Qualified Dispositions in Trust, H.B. No. 156, substitute no. 1 (July 9, 1997) (to be published in Del. BILLS & RES., but Synopsis not found in Del. LAWS).
2This is the short title of the law [hereinafter the Act or Delaware’s Act] as set forth in Del. CODE ANN. tit. 12, § 3576 (1997). All references to statutory code sections in this article are references to Delaware’s Act unless otherwise specified.
3See supra note 1.
The purpose of this article is to explore various asset protection issues related to self-settled trusts in general, and the new Delaware trust in particular. A brief historical review will show that other countries have, in varying degrees, allowed self-settled trusts as protective devices for some time. In contrast, the United States, until recently, has only allowed self-settled protective trusts in a few limited circumstances, most commonly being certain retirement plans. Delaware’s Act, though consistent with established practice elsewhere, still constitutes a significant development from a United States perspective. This article also reviews some of the intricacies of the Act and reaches two basic conclusions: first, that trusts settled under the Act are potent tools by which a settlor may shelter his own assets, and second, that the utility of Delaware trusts is limited compared to offshore trusts. These limitations arise from several points, such as uncertainties surrounding federal estate and gift tax concerns, uncertain evidentiary issues, and some unavoidable competitive disadvantages that would attach to any onshore trust structure. Finally, this article suggests some ways to improve the Act, and also makes some predictions about its impact on American trust law.

II. PRIOR LAW: THE RULE AGAINST SELF-SETTLED TRUSTS IN AMERICA AND LIMITED EXCEPTIONS

Before the enactment of the Delaware and Alaska trust statutes, American law routinely functioned under a canon known to practitioners as the "rule against self-settled trusts." The rule has long been recognized by leading commentators such as Scott, Bogert, and Griswold by the Restatement, and by a myriad of cases from virtually

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4See, e.g., In re Witwer, 148 B.R. 930, 937 (Bankr. C.D. Cal. 1992), aff’d, 163 B.R. 614 (B.A.P. 9th Cir. 1994) (referring to the "policy against . . . 'self-settled' trusts").


7In connection with self-settled trusts in which the settlor gave the trustee discretionary authority to pay trust income to the settlor during the settlor's lifetime, Griswold wrote, 'The courts have very properly held that in such a case creditors of the settlor may reach the entire income from the trust property during his life. A person cannot settle his own property so that it will be free from the claims of creditors and yet retain the right to receive the income, if it is paid to any one, during his lifetime.'


8See infra note 11.
every jurisdiction in the United States.9 Under the rule, whose origin can be traced to an ancient English statute,10 any interest a settlor retains in property transferred into trust is automatically subject to attachment by the settlor’s creditors.11 The basic principle of the rule is that a person may not settle his or her own assets into trusts, retain use and benefit of that property, and then prevent creditors from attaching that property on the grounds that it is now titled in the name of the trustee instead of the settlor. Courts feared that, without the rule, debtors would evade their "just debts."12 The rule applies to virtually all self-settled trust, including self-settled spendthrift trusts.13 Under the rule, the relevant transfer into trust can be undone even if there is no violation of the fraudulent transfers laws.14 Moreover, as long as the settlor retains an interest in

9See Ervin N. Griswold, Spendthrift Trusts Created in Whole or in Part for the Benefit of the Settlor, 44 HARV. L. REV. 203 (1931-1932), for a collection of earlier cases. See also Outwin, 76 T.C. at 163-64 (discussing additional cases applying the rule against self-settled trusts).

10See Griswold, supra note 9, at 204 (referring to England’s statute of 3 Hen. VII, adopted in 1487). Griswold’s article is a good survey of early cases applying the rule in the context of spendthrift trusts.

11Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit.” RESTATEMENT (SECOND) OF TRUSTS § 156(2) (1959). Note that:
[The rule adopted by the . . . Restatement . . .] refers only to amounts which the trustee could pay to the settlor; it makes no mention of amounts which the trustee would be required to pay in the event the settlor seeks judicial review of the trustee’s actions. None of the authorities we have consulted cite the existence of an enforceable right to discretionary distributions as the rationale for the Restatement rule.


12See, e.g., SCOTT & FRATCHER, supra note 5, § 156.2, at 179 (citing Greenwich Trust Co. v. Tyson, 27 A.2d 166, 173 (Conn. 1942) (referring to "just debts").

13Estate of Paxton v. Commissioner, 86 T.C. 785, 818 n.34 (1986) (collecting cases); see Griswold, supra note 9 (collecting cases). Further, a spendthrift trust is a trust containing language barring creditors from attaching or acquiring the interest of a debtor-beneficiary. See infra note 82.

14Estate of Paxton, 86 T.C. at 818 (quoting RESTATEMENT (SECOND) OF TRUSTS § 156(2) cmt. a (1959), for the proposition that whether the settlor intended to defraud creditors "is immaterial"); Vanderbilt Credit Corp., 473 N.Y.S.2d at 245 (citation omitted) ("The
trust, it is available to his creditors. This means there is virtually no statute of limitations on creditors’ rights under the rule because creditors can attach a retained interest regardless of how much time has passed since the date on which the trust was settled.

Self-settled trusts, while legitimate, were nonetheless ineffective against creditors on policy grounds. The reasoning was that a debtor’s property should be available to his creditors, even if the property was titled in the trustee’s name. Otherwise, debtors or prospective debtors could put their property beyond the reach of creditors without ever relinquishing the economic benefit of the property. This was deemed unfair.

Upon closer examination, certain things are apparent about the rule. To begin, the rule’s name is a misnomer: it always was, and still is, legally permissible for somebody to settle a trust for their own benefit. Indeed, many people routinely settle trusts for their own benefit as part of fairly traditional (and sensible) estate and financial planning. The settlor’s creditors need not allege or prove the trust is a fraudulent conveyance before they are permitted to reach the full amount of the beneficial interest retained by the settlor . . . “). Griswold, supra note 9, at 205 (stating that creditors rights under the rule against self-settled trusts "are not dependent upon the law relating to fraudulent conveyances").

The rule "was a prohibition of trusts for the benefit of the settlor on the ground that such a trust was against public policy. . . . [A]ll trusts to which it applies are invalid, whether the trusts are spendthrift trusts or not." Griswold, supra note 9, at 204. Accord Estate of Paxton, 86 T.C. at 815 (stating self-settled trusts are "against public policy"); Outwin v. Commissioner, 76 T.C. 153, 166 (1981) (noting "strong public policy"); Provident Trust Co. v. Banks, 9 A.2d 260, 262 (Del. Ch. 1939) (noting authorities holding self-settled trusts to "be contrary to public policy"); Vanderbilt Credit Corp., 473 N.Y.S.2d at 246 (noting self-settled trust are "against public policy").

"[I]f a man were setting up a trust of his own property and were naming the trustee . . . , it would be easy for him to select some person who would approve any demand for withdrawal that he made." Id. at 165 (quoting Deposit Guaranty Nat’l Bank v. Walter E. Heller & Co., 204 So. 2d 856, 861 (Miss. 1967)).

For instance, many people try to minimize probate costs by using trusts as a substitute for a will. Many of these trusts are settled well in advance of death and, therefore, require provisions regarding distribution of trust property during the settlor’s lifetime. Hence, the settlor, who often wants use, benefit and control of the property during the rest of his life, will retain various rights to receive or direct distributions of trust principal, income, or both.
rule is really a statement about creditors rights in self-settled trusts, and not a ban of self-settlements. More importantly, the rule is based on an unspoken but fundamental premise: the rule implicitly assumes that creditors have a legitimate entitlement to any assets that a debtor has placed into trust, and that society broadly shares this assumption.20 These assumptions may have been valid in an earlier era when courts and juries were more restrained, and when notions of liability were less expansive.21 Today, however, it is a different world, and many people perceive America to be synonymous with frivolous litigation and engulfed by statutes creating excessively broad liability. The rule, therefore, does not take into account the contemporary urge to shelter assets from vexatious lawsuits, bizarre verdicts, and judges who are often alarmlingly cavalier about their jobs.22

Even before Delaware's Act was created, the rule against self-settled trusts was not absolute, as U.S. law recognized certain exceptions. The most notable of these exceptions is in the area of pension and retirement trusts, such as retirement plans funded pursuant to the

Likewise, many older Americans, as part of their elder care planning, will settle large portions of their estate into trust and, in the text of the trust, instruct the trustee on how to use trust property in the event of the settlor's disability or incapacity. This is sensible advance planning for one's elder years. Another common historical use of a self-settled trust involves public officials: In order to reduce or eliminate the possibility of conflicts of interest between their public duties and their personal finances, office holders have often settled their assets into "blind trusts." These blind trusts are ostensibly administered by the trustee without any input from the public officials, who nonetheless retain broad rights to receive the principal or income of the trust fund. An example of a blind trust involves President Lyndon Johnson. In LBJ's case, however, one must question just how "blind" the trust really was because Johnson apparently had private phone lines installed in the Oval Office so that he could maintain almost daily contact with those responsible for administering his trust interests. I Robert A. Caro, The Years of Lyndon Johnson: The Path to Power at xxiii (1982).

20See, e.g., supra note 12 and accompanying text (referring to "just debts").

21For an example of courts ratifying expanded liability, see Owen v. City of Independence, Mo., 445 U.S. 622, 657 (1980). In that case, decided under the Civil Rights Act, 42 U.S.C. § 1983 (1996), the Court stated, "Doctrines of tort law have changed significantly over the past century... No longer is individual 'blameworthiness' the acid test of liability; the principle of equitable loss-spreading has joined fault as a factor in distributing the costs of official misconduct." Owen, 445 U.S. at 657.

22See, e.g., the infamous proclamation by Justice Richard Neely of the West Virginia Supreme Court of Appeals, who stated:

As long as I am allowed to redistribute wealth from out-of-state companies to injured in-state plaintiffs, I shall continue to do so. Not only is my sleep enhanced when I give someone else's money away, but so is my job security, because the in-state plaintiffs, their families, and their friends will reelect me.

Employee Retirement Income Security Act of 1974 (ERISA) and Individual Retirement Accounts (IRAs).

ERISA plans are retirement trust accounts that are maintained by employers for the sake of employees and are funded by employer contributions. These employer contributions are made in exchange for an employee’s labor. Hence, ERISA contributions are ultimately generated by the employee, who, in turn, is also a beneficiary of the ERISA trust. This indirect method placing the employee’s money into trust is technically considered a form of self-settled trust. Pursuant to both Congressional mandate and at least two U.S. Supreme Court decisions, however, the general rule is that contributions to an ERISA trust are beyond the reach of creditors, at least while those contributions are held in the trust fund. This contravenes the rule against self-settled trusts.

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24 See, e.g., 29 U.S.C. § 1082(b)(3)(A) (1994) (referring to "amount considered contributed by the employer to or under the plan").

25 See RESTATEMENT (SECOND) OF TRUSTS § 156, cmt. f (1959). The rule against self-settled trusts generally applies to trust settlements made by third parties at the behest of, or pursuant to arrangement with, a debtor-beneficiary. In other words, it is aimed at persons who would indirectly settle trusts for their own benefit. This aspect of the rule is designed to prevent circumvention by diverting into trust property paid or delivered to the trustees by third persons when, in fact, that property really belongs to the beneficiary.

Pursuant to 29 U.S.C. § 1056(d)(1) (1998), "Each [ERISA] pension plan shall provide that benefits provided under the plan may not be assigned or alienated." In other words, ERISA plans have spendthrift clauses. See infra note 82, explaining more on spendthrift clauses. As a result of such spendthrift clauses, the beneficial interest in an ERISA trust is, generally speaking, off limits to a beneficiary's creditors. See, e.g., Patterson v. Shumate, 504 U.S. 753, 759 (1992) (imposing a "restriction on the transfer" of a debtor’s 'beneficial interest’") (quoting 29 U.S.C. § 1056(d)(1) (1998)); Guidry v. Sheet Metal Workers Nat’l Pension Fund, 493 U.S. 365, 369 (1990) (referring to § 1056(d) as an "anti-alienation" device).

ERISA’s spendthrift provision is not absolute, however, as there are a series of exceptions to it. One exception, which is by far the least controversial, is for persons who benefit from Qualified Domestic Relations Orders (QDRO), which are basically child or spousal support orders. The holder of a QDRO is entitled to attach assets held in an ERISA trust. 29 U.S.C. § 1056(d)(3) (1998). This exception reflects a clear policy judgment by Congress: the immediate support needs of ex-spouses and children have priority over future retirement needs. This policy judgment can be justified by the fact that many ERISA plan participants may not retire until many years after their ERISA interest is attached, thereby giving them time to replenish their retirement funds.

A second exception is for tax claims by the federal government. Pursuant to 28 U.S.C. § 3205(a) (1994), the government’s right to satisfy a tax debt takes priority over a debtor-beneficiary’s rights under a plan spendthrift clause. United States v. Sawaf, 74 F.3d 119, 122 (6th Cir. 1996).

A third exception exists for plan trustees who steal or embezzle from an ERISA pension fund. A majority of courts hold that the interest of such trustees can be attached to
Similarly, the interplay of federal law and state law has, in many

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states, made IRAs a form of self-settled trust that is resistant to creditor claims. Under federal law, a person who opens an IRA is actually settling a retirement trust fund that is administered by a bank or other institution approved as trustee by the Treasury Department.\(^2\) The exemptibility of IRAs under state law will also vary from state to state. In some states, IRAs are wholly exempt, while other states exempt IRAs only to the extent "reasonably necessary" for the maintenance and support of the debtor and his dependents.\(^2\) Still other states do not exempt IRAs at all.\(^3\) Nonetheless, those states that wholly or partially exempt IRAs have repealed the rule against self-settled trusts as it applies to this narrow category of retirement trust. In states that apply the "reasonably necessary" standard, the extent of the exemption is within the sound discretion of the courts.\(^5\) In states that wholly exempt IRAs, however, the rule is fully contravened for IRAs.

Between possible exemptions for IRAs, which vary from state to state, and the general federal rule that creditors may not attach ERISA funds while they are still held in trust, it is evident that the rule against self-settled trusts has been substantially eroded within the limited category of retirement assets. Taken together, these exceptions represent a transparent policy judgment that the overall societal interest in secure

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\(^2\)Under 26 U.S.C. § 408(a) (1997), an IRA is "a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries." An IRA trust must be maintained at all times as a domestic trust in the United States. \(\text{Id.}\) Further, "the written governing instrument creating the trust [must] meet[\text{\textit{a}}}^\) six specific criteria listed in § 408(a)(1)-(6), one of the criteria is that "[t]he trustee is a bank (as defined in subsection (n)) or such other person who demonstrates to the satisfaction of the Secretary [of the Treasury] that the manner in which such other person will administer the trust will be consistent with the requirements of this section." 26 U.S.C. § 408(a)(2) (1997); see also 26 C.F.R. §§ 1.408-2(b)(2)(i), 408-2(e) (1997) (establishing detailed requirements for a nonbank "other person" to act as an IRA trustee).

\(^3\)See PETER SPERO, ASSET PROTECTION: LEGAL PLANNING AND STRATEGIES ¶ 10.04[3]-[4] (1994), for a general summary of the varying state law approaches to exempting IRAs. See also In re Herbert, 140 B.R. 174, 178 (N.D. Ohio 1992), for an example of how the "reasonably necessary" standard might be employed. Moreover, whether a state's IRA exemption applies in federal bankruptcy court turns on whether that state opted out of the federal scheme of exempt property and invoked its right to apply state exemptions in bankruptcy proceedings within its borders. See 11 U.S.C. § 522(b)(1) (1994) (giving states the ability to opt against federal exemptions set forth in § 522(d)). If a state did not opt out, then the federal exemption for IRAs applies, which is based on the "reasonably necessary" standard. 11 U.S.C. § 522(d)(10)(E)(iii) (1994).

\(^5\)See, e.g., In re Swenson, 130 B.R. 99, 100-01 (Bankr. D. Utah 1991) (finding that IRAs are not exempt under Utah law).

\(^6\)See supra note 29 (example of how the "reasonably necessary" standard might be employed).
private retirement funds outweighs the interests of a handful of private creditors. Congress and the various state legislatures apparently do not want to see hordes of elderly retirees and their dependents suddenly become wards of the state.\(^{32}\) Despite these exceptional inroads for retirement plans, however, the rule against self-settled trusts, including spendthrift trusts, was still very much the norm in America until passage of the Act and its Alaskan counterpart.

### III. ENGLISH LAW AND OFFSHORE STATUTES:
**A DIFFERENT APPROACH TO SELF-SETTLED TRUSTS**

The American approach to self-settled trusts is prudish when compared to the approach of other common law jurisdictions. For example, England and those nations that follow its precedents, have long recognized common law trusts known as the "protective trust"\(^{33}\) and the "discretionary trust."\(^{34}\) As its name implies, the protective trust is a trust device that allows protection of assets and is the forerunner of contemporary offshore asset protection trust legislation.\(^{35}\) The

\(^{32}\)As to ERISA, see Guidry v. Sheet Metal Workers Nat’l Pension Fund, 493 U.S. 365, 376 (1990) (noting interest of debtor’s dependents in preserving debtor’s ERISA pension); Boggs v. Boggs, 117 S. Ct. 1754, 1762 (1997) ("The principal object of the statute is to protect plan participants and beneficiaries"). As to state law exemptions in general, see Boggs v. Boggs, 82 F.3d 90, 97 (5th Cir. 1996), rev’d on other grounds, 117 S. Ct. 1754 (1997) ("purpose of the spendthrift provision is to prevent plan participants from recklessly divesting themselves of plan benefits before retirement"); In re Johnson, 880 F.2d 78, 83 (8th Cir. 1989) (discussing how the Minnesotah homestead exemption should be "liberally construed," regardless of the "moral character of the debtor," and there is no reason to be less liberal with "the vicious, the criminal, or the immoral. All must live, and right consideration should contemplate not only the living but the next generation... [This] sounds in hope for the future both as to the debtor and his children.") (quoting Ryan v. Colburn, 241 N.W. 388, 389 (Minn. 1932)); Public Health Trust of Dade County v. Lopez, 531 So. 2d 946, 948 (Fla. 1988) (stating that the purpose of exemption is to allow the debtor to “live beyond the reach of financial misfortune and the demands of creditors”); Frase v. Branch, 362 So. 2d 317, 318 (Fla. App. 1978) (commenting that the exemption statute is liberally construed in favor of debtor, "even at the sacrifice of just demands").

\(^{33}\)See generally GRAHAM MOFFAT ET AL., TRUSTS LAW (TEXT AND MATERIALS) 203-04 (2d ed. 1994) (explaining the development of the protective trust in England).

\(^{34}\)In describing a discretionary trust, one court explained:

> A discretionary trust is one in which “by the terms of a trust it is provided that the trustee shall pay to or apply for a beneficiary only so much of the income and principal or either as the trustee in his uncontrolled discretion shall see fit to pay or apply.”


\(^{35}\)MOFFAT ET AL., supra note 33, at 201.
discretionary trust is simply a variant of the common law protective trust. In addition, other common law jurisdictions have more recently enacted "asset protection trust" statutes that go even further in allowing the protection of assets. Each of these devices — the common law protective trust, the discretionary trust, and the asset protection trust — can be self-settled and, to one degree or another, are effective against the settlor's creditors. Hence, America stands virtually alone in its rigid and virtually absolute adherence to the rule against self-settled trusts.

The English protective trust (sometimes called the "common law protective trust") can be settled for the sake of anybody and has three key characteristics:

1. **Determinable Interest:** The trust beneficiary has a determinable interest (i.e., an interest that terminates upon the occurrence of a certain event, date or other objectively identifiable factor). The interest can be defined so that it is a clear entitlement before the event of termination, such as a life interest in income, to be paid quarterly.

2. **Forfeiture Clause:** The beneficiary's interest is forfeited pursuant to a forfeiture provision that activates upon the occurrence of the determinable event.

3. **Springing Discretionary Trust:** Upon forfeiture, a discretionary trust springs into existence. The forfeited interest is held by the trustee for the benefit of the principal beneficiary and others. The trustee has discretion as to making distributions.

Under this time-honored English structure, a beneficiary's original interest in trust distributions terminates and is forfeited upon the occurrence of the determinable event; thereafter, the trust becomes discretionary in

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36Id. at 210-12.
37Note, however, that England does not recognize spendthrift trusts. Id. at 213-14; see also Nichols v. Eaton, 91 U.S. 716, 725-27 (1875) (rejecting the English view that settlors cannot place life interests of beneficiaries beyond the reach of creditors and recognizing the right of U.S. settlors to make trust funds inaccessible to creditors of non-settlor beneficiaries).
38MOFFAT ET AL., supra note 33, at 205.
39Id. at 206.
40See generally id. at 208 (explaining the events causing a discretionary trust to spring into existence).
nature. Moreover, the determinable event can be some financial misfortune, such as the settlor's bankruptcy or efforts at attachment by a beneficiary's creditors. The discretionary nature of the ensuing trust is the key to protecting the assets from the beneficiary's creditors. A trustee has broad discretion to determine if, when, to whom, and how much to distribute; and that discretion may typically be exercised free of any judicial interference. This means a beneficiary has, in Bogert's words, a "mere expectancy" of future distributions. As a result, a beneficiary generally has no right to compel distributions by the trustee, either for his sake or for the sake of others, and similarly, a beneficiary's creditors are also unable to compel distributions by the trustee. Occasionally, however,

41"The effect of forfeiture is to activate the discretionary trust." Id.
42Bankruptcy is the primary example given by Moffat, although the determining event could be other events, such as divorce, Moffatt et al., supra note 33, at 206-07, or attempted attachments of earnings, see Edmonds v. Edmonds, 1 All E.R. 381 (1965) (holding that debtor-husband's pension interest was held in trust and rendered unattachable by the issuance of an order of attachment), or the issuance of a charging order against a beneficiary's interest. See also Re Richardson's Will Trusts, 1 All E.R. 540 (1958) (noting that when the beneficiary of a testamentary protective trust suffers forfeiture in advance of bankruptcy, the resulting discretionary trust is not available to the trustee-in-bankruptcy). A protective trust, however, is not as effective against a trustee-in-bankruptcy if the bankrupt beneficiary was also the settlor.
43See, e.g., Re Bullock, 64 L.T.R. 736, 738 (Ch. 1891), in which Kekewich, J., states: I am unwilling to fetter the trustees' discretion, which was intended to be and ought to be construed as large. . . . [T]hey certainly may . . . spend the whole or any part of the income in maintenance, using that word in its most general and widest sense; and I doubt whether I was right in saying in the course of the argument that they could not properly pay Mr. Bullock's debts. The discretion is vested in them, and . . . they must exercise it, and so long as they exercise it honestly — that is, as men of ordinary business habits and prudence, and with due regard to all the circumstances of the case — the court will not interfere with them. Id. See also Edmonds, 1 All E.R. at 381 (discussing trustee's discretion to pay or withhold).
44Bogert, supra note 6, § 228, at 525.
45Where there is a trust under which trustees have the discretion as to applying the whole or part of a fund to or for the benefit of a particular person, that particular person cannot come to the trustees, and demand the fund; for the whole fund has not been given to him but only so much as the trustees think fit to let him have." In re Smith, 1 Ch. 915, 918 (1928). Accord Re Bullock, 64 L.T.R. 736, 738 (Ch. 1891) (noting that beneficiary "has no control over the fund when the trustees resolve to exercise their discretionary power," and that "[h]e cannot, and no one claiming through him can, make a claim against the trustees for payment"). Insofar as nonsettlor beneficiaries are concerned, America shares this view. See, e.g., Herzog v. Commissioner, 116 F.2d 591, 594 (2d Cir. 1942) (explaining that "where a trust has been created by a third person, the income of which may be applied to the use of some person in the discretion of a trustee, . . . the trustee cannot be compelled to exercises his discretion in
even the trustee of a discretionary trust may be obligated to make distributions. For example, a beneficiary may be financially distressed and in dire need of aid. If creditors are simultaneously hounding the beneficiary, there is a risk that funds may be attachable once distributed. English law, however, provides a long-standing solution to this problem. Even though assets will be attachable if directly distributed to a beneficiary, they will often be unattachable if distributed to third parties on behalf of a beneficiary.  

The protective trust as described above is a device that can be used by persons settling trusts for the sake of others and also for the sake of themselves. In general, protective trusts are highly effective against

favor of the person in question or [his] creditors); accord Bogert, supra note 6, § 228, at 524-25 (noting trustee of discretionary trust may "withhold payments at his will"); see also Vanderbilt Credit Corp. v. Chase Manhattan Bank, 473 N.Y.S.2d 242, 245 (N.Y. App. Div. 1984) (stating that "[w]here there is a discretionary trust, the law is clear that a creditor of a beneficiary, who is not the settlor, cannot compel the trustee to pay any part of the income or principal to the beneficiary").

46Once the discretionary trust is activated, trustees "are not entitled, regardless of the needs of the beneficiaries, to retain in their hands the income of the trust estate." In re Gourju's Will Trusts, 1 Ch. 24, 34 (1943).

47See infra note 48. A similar view prevails in America. Cf. In re Cesare, 170 B.R. 37, 38-39 (Bankr. D. Conn. 1994) (stating general rule regarding distributions of exempt property); Guidry v. Sheet Metal Workers Nat'l Pension Fund, 39 F.3d 1078, 1082-83 (10th Cir. 1994) (stating that ERISA funds lose spendthrift protection upon distribution to plan beneficiary but will be "exempt from garnishment to the extent provided by . . . [state] law").

48On attachability of direct payments, see In re Smith, 1 Ch. 915, 919 (1928) (stating that debtor-beneficiary's assignee or trustee-in-bankruptcy may say to beneficiary that "[a]ny money which the trustees do in the exercise of their discretion pay to you, passes by the assignment or under the bankruptcy"); Re Bullock, 64 L.T.R. 736, 738 (Ch. 1891) (explaining that direct payments would be "wrongful" and would render trustee of trust "accountable to the trustee in bankruptcy"). On the unattachability of distributions made to third parties, see In re Smith, 1 Ch. 915, 919 (1928) (noting creditors' inability to get to trust property distributed in such a way that no money or goods ever gets into the hands of the debtor); Bullock, 64 L.T.R. at 738 (discussing "application" of funds for sake of beneficiary and stating that "[i]t is clear . . . [that] the trustee in bankruptcy... can take no interest in income thus applied"). See also Edmonds, 1 All E.R. at 381 (opining that creditor wife could not attach distributions "if the trustees make payments not to but for the benefit of the [debtor]-husband — such as discharging his hotel bills or his accounts with shopkeepers").

49Persons who settle protective trusts in which they are beneficiaries frequently name other persons as well, such as present or prospective family members. See, e.g., Edmonds v. Edmonds, 1 All E.R. 379, 381 (1965) (involving settlor and family on protective trust); Moffat et al., supra note 33, at 203 (referring to settlements "in favour of the beneficiary and his family"). The other beneficiaries, however, do not actually need to be alive at the time of settlement. It will suffice if they are hypothetical persons who might be born or otherwise come into existence later. Such hypothetical persons are sometimes referred to as members of an "open-ended class" that has not yet been irrevocably "closed." See In re Trafford's Settlement, 1 Ch. 32, 33 (1985) (settlor who never married or had children self-settled a
creditors of nonsettlor beneficiaries. Self-settled protective trusts are even considered to be effective against the settlor's own individual creditors, but are often ineffective against a settlor's trustee-in-

discretionary trust for the benefit of himself and his future wife and children). By naming others as well as himself, the settlor creates an argument that creditors cannot attach the trust because any retained interest is not necessarily the settlor-beneficiary's, but instead potentially belongs to the other beneficiaries as well. This argument has been rejected in the United States, which instead allows attachment of the maximum amount that might be distributed to the settlor-beneficiary. American courts reasons that the other beneficiaries had no entitlement to the trust fund because distributions, if any, were discretionary with the trustee and may never have yielded any actual distribution. Consequently, the other beneficiaries do not suffer any real loss if the settlor-beneficiary's creditors attach the whole of the trust fund. See, e.g., Greenwich Trust Co. v. Tyson, 27 A.2d 166, 173 (Conn. 1942); Ware v. Gulda, 117 N.E.2d 137, 138 (Mass. 1954) (explaining that the settlor must never keep property away from his creditors by holding it in trust). This argument, however, carries greater weight in England. See, e.g., In re Trafford's Settlement, 1 Ch. at 38-41 (stating that "open-ended" class of beneficiaries caused decedent's interest in self-settled discretionary trust to be excluded from his estate for death tax purposes as decedent "did not have an interest in possession"). See also infra note 54 (regarding limited availability of trust funds to trustee-in-bankruptcy in cases involving multiple beneficiaries).

It is probably advisable to use an open-ended class of beneficiaries in connection with a simple discretionary trust under English common law. "Under the rule of Saunders v. Vautier, a beneficiary of full age (18 or over) and sound mind and entitled to the entire equitable interest can require the trustees to transfer the trust property to him and thus terminate the trust." Moffat et al., supra note 33, at 235 (citing Saunders v. Vautier, 4 Beav. 115 (1841)); see also In re Smith, 1 Ch. 915, 918 (1928) (extending rule to cases in which all beneficiaries jointly demand trust property). Consequently, a lone beneficiary is exposed to the risk that his or her creditors can indirectly attach the trust fund by forcing a beneficiary to demand the trust fund pursuant to Saunders. However, if an open-ended class is added, there is little risk of this happening because the class is not yet closed, and the trustees will have full authority to withhold money from the one known beneficiary in order to conserve trust assets for other prospective beneficiaries. See In re Trafford's Settlement, 1 Ch. 32, 38-41 (1985); Moffat et al., supra note 33, at 238 (stating that "where there are beneficiaries who are under age, unborn or even whose identity is unknown then the rule cannot be used to terminate a trust"). Therefore, beneficiaries under English protective trusts will generally not be at risk under Saunders because the statute potentially provides for the issue of a beneficiary's unknown spouse or unborn. England's Trustee Act, 1925, ch. 19, § 33(1)(ii).

Note that the approach of Saunders has been rejected in the United States for many years, see, e.g., Claflin v. Claflin, 20 N.E. 454 (Mass. 1889), and that the Cook Islands has expressly repealed the rule of Saunders as part of its APT legislation. See Cook Islands International Trust Act § 10 (1984 as amended) (discussing the application of the rule in Saunders v. Vautier).

See, e.g., Re Bullock, 64 L.T.R. 736 (Ch. 1891) (stating that testamentary protective trust is for the sake of decedent's heirs).

See In re Detmold, 40 Ch. D. 585, 587-88 (1889). See also Edmonds, 1 All E.R. at 381 (holding that interest of debtor husband in pension fund could not be attached by creditor wife while funds were held by trustee; attachment order in favor of wife caused a forfeiture of husband's right to pension distributions). Edmonds involved a self-settled trust in that the trust fund consisted of pension assets settled into trust by the debtor-beneficiary's employer in
bankruptcy.\textsuperscript{52} Protective trusts, however, may even be effective against a settlor’s own trustee-in-bankruptcy if the act of forfeiture occurs in advance of a bankruptcy petition.\textsuperscript{53} Also, if a trust has beneficiaries other than the settlor, the trustee in bankruptcy may be limited to recovering only that portion of the trust fund that is not used for the sake of the nonsettlor beneficiaries.\textsuperscript{54} This differs from the general American rule

exchange for labor and services. \textit{Id.} This trust, therefore, fell within the rule announced in \textit{Restatement (Second) of Trusts} § 156, \textit{cmnt. f} (1959). \textit{Id.} See also supra note 25 (explaining the \textit{Restatement} position).

\textsuperscript{52}British courts distinguish between the rights of an individual creditor and the rights of the trustee in bankruptcy; the latter is vested with greater rights on the view that they represent all creditors and therefore, because they protect a potentially broad class, should be given greater rights to attach the debtor’s assets. Hence, it has been said:

In general property cannot be put into protective trusts so as to protect settlers against the consequences of their own bankruptcy. The attempted limitation against bankruptcy will be void as against the trustee in bankruptcy (\textit{Re Burroughs-Fowler} [1916] 2 Ch 251 is but one of many cases affirming this proposition). This does not mean, however, that the settlement itself is void or that the limitation will be ineffective against an individual creditor as opposed to the generality of creditors represented by the trustee in bankruptcy.

\textbf{Moffat et al., supra} note 33, at 216. See also \textit{Detmold}, 40 Ch. D. at 587-88, in which the court stated:

A settlement by a man of his own property upon himself for life, with a clause forfeiting his interest in the event of alienation, or attempted alienation, has never, so far as I know, been defeated in favour of a particular alienor; it has only been defeated in favour of the settlor’s creditors generally, on the ground that it would be a fraud on the bankrupt law.

\textsuperscript{53}\textbf{Moffat et al., supra} note 33, at 216-17 (noting that a forfeiture “took place before the commencement of the bankruptcy, and, therefore, the forfeiture is valid as against the trustee in bankruptcy”) (quoting \textit{Detmold}, 40 Ch. D. at 588); see also \textit{Re Richardson’s Will Trusts, 1 All E.R. 540} (1958) (stating that the beneficiary of another person’s testamentary protective trust suffered forfeiture in advance of bankruptcy; resulting discretionary trust unavailable to trustee-in-bankruptcy); \textit{Trafford’s Settlement, 1 Ch. at 36} (discussing efficacy of self-settled discretionary trusts vis-à-vis trustee-in-bankruptcy).

\textsuperscript{54}See, e.g., \textit{Wallace v. Anderson, 51 E.R. 885, 16 Beav. 533} (1853) (similar); \textit{Page v. Way, 49 E.R. 8, 9, 3 Beav. 20, 21} (1840) (holding that assignees of a bankrupt husband’s interest in a self-settled trust “take everything subject to what is proper to be allowed for the maintenance of the wife and children”).

In \textit{Kearsley v. Woodcock, 3 Hare’s 185} (1843), the beneficiary of a testamentary trust went bankrupt. Under the terms of the trust, the beneficiary was entitled to periodic income payments. Upon doing any act whereby his share would become payable to any other person, however, the beneficiary’s interest was to "absolutely cease and determine, and . . . become absolutely forfeited," and thereafter the trust would become a discretionary trust for the sake of the beneficiary and his wife and family. \textit{Id.} at 185. The beneficiary experienced financial difficulty and made an assignment for the benefit of creditors. \textit{Id.} at 187. The court, following \textit{Page v. Way}, directed that the bankrupt’s creditors could receive “any interest of [the bankrupt] . . . under the trusts of the said will, not required for the support and maintenance of the plaintiffs, his wife and children.” \textit{Id.} at 190. The court also noted that separating the
which permits any creditor to attach any interest that might conceivably be paid to or for a settlor-beneficiary, regardless of any other beneficiary's potential interest in a trust.\textsuperscript{55}

Consequently, and despite a potential weakness in favor of trustees in bankruptcy, the English protective trust has become so popular and widespread over the years that Parliament long ago adopted a "short form" version, whereby a settlor can merely declare a settlement to be "on protective trusts."\textsuperscript{56} The self-settled protective trust is, therefore, recognized as a valid instrument in England and other common law jurisdictions with statutes modelled after the English version.\textsuperscript{57}

The discretionary trust is even more protective because it is believed to be capable of frustrating even the settlor's trustee-in-bankruptcy.\textsuperscript{58} The trust document omits the first two elements of the bankrupt's interest in the discretionary trust from the interest of his wife and children would be difficult, especially since some of the money spent on the wife and children might also benefit the bankrupt at no extra cost to the trust. Id. at 189-90.

To the extent that Kearsley allowed creditors to attach the interest of a nonsettlor bankrupt, this aspect of Kearsley is called into question by later cases such as Re Bullock, 64 L.T.R. 736 (Ch. 1891). See supra note 48 and the terms of England's Trustee Act, 1925, ch. 19, § 33(1)(ii). For more on the Trustee Act, see supra note 49 and infra note 56.

\textsuperscript{59}See supra note 49.

\textsuperscript{50}MOFFAT ET AL., supra note 33, at 204 (quoting England's Trustee Act, 1925, ch. 19, § 33(1)(ii). Note that the determinable event under the statutory short form is quite broad, and also that a trust instrument can create express conditions of determination that vary from the statutory provision that applies in default of more express language. MOFFAT ET AL., supra note 33, at 205-06; Trustee Act, 1925, ch. 19, § 33(1)(i) (stating broad terms, including "any act or thing . . . whereby . . . [the beneficiary] would be deprived of the right to receive" trust income); Trustee Act, 1925, ch. 19, § 33(2) (making statutory terms "subject to any variation . . . in the instrument creating the trust"). Upon forfeiture, § 33(1)(ii) results in a discretionary trust that may be held for the sake of one or more beneficiaries. Trustee Act, 1925, ch. 19, § 33(1)(ii).

\textsuperscript{51}See, e.g., Trusts (Jersey) Law § 31(4) (1984 as amended) (referring to "property to be held upon a spendthrift or protective trust"); Nevis International Exempt Trust Ordinance § 6(2) (1994 as amended) (similar).

\textsuperscript{52}For example:

[I]f property-owners wish to protect themselves effectively against the consequences of a bankruptcy a determinable interest will not suffice but in principle a discretionary trust will. . . . [C]ounsel in Re Trafford's Settlement [1985] Ch 32 could point to standard conveyancing works which showed that "a settlor to protect his own income against loss under a future bankruptcy was advised to create an immediate discretionary trust" (at 36). . . . [T]he basic principle still holds that where statute does not intrude, a discretionary trust can provide an effective means of protecting a person's property [i.e., the settlor's property] from creditors.

MOFFAT ET AL., supra note 33, at 217.

Moffat's reference to "statute" was to §§ 339-341 and §§ 423-424 of England's
protective trust structure (i.e., a determinable interest and the occurrence of a determinable event) and instead immediately creates a trust consisting of only the third element (i.e., a purely discretionary trust).\(^5\)

The efficacy of the discretionary trust in a bankruptcy stems from the fact that the transfer, and hence the settlor’s forfeiture of property, occurs in advance of a bankruptcy, and not as a result of a bankruptcy, thereby eliminating any concern regarding bankruptcy abuse.\(^6\)

English creditors are not defenseless, as transfers into discretionary trusts are subject to fraudulent transfers claims.\(^6\)

Short of that, however, the discretionary trust settlement stands,\(^6\) and the trust structure can deflect claims raised by the settlor’s creditors, even though the settlor may yet benefit from discretionary distributions by the trustee.\(^6\) As a result, self-settled discretionary trusts are a valid asset protection tool under English law, contrary to the U.S. view that prevailed before the Delaware Act.\(^6\)

The asset protection trust (APT) is the most modern device permitting the creation of self-settled trusts that are effective against the settlor’s creditors.\(^6\) Nevis, the Cook Islands, the Bahamas, and Jersey are

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5. In effect the settlor must omit the first stage of the protective trust, moving straight to the second stage discretionary trust . . . ." MOFFAT ET AL., supra note 33, at 217.

6. Id. at 216-17; see also In re Detmold, 40 Ch. D. 585, 588 (1889) (holding that a forfeiture clause in a settlement was valid against the trustee in bankruptcy if forfeiture occurs before bankruptcy).

6. See supra notes 52, 58.

6. See supra note 48 on indirect benefits and payments to third parties.

6. See supra note 58. See also SCOTT & FRATCHER, supra note 5, § 156.2, at 175, which states:

Where the settlor creates a discretionary trust of which he is himself a beneficiary, his creditors may be able to reach his interest, even though the trustee in the exercise of his discretion wishes to pay nothing to the beneficiary or to his creditors, and even though the beneficiary could not compel the trustee to pay him anything.

Id.; BOGERT, supra note 6, § 228, at 531 ("The rules which limit the effectiveness of spendthrift trust in some cases may well be applied to the discretionary trust, for example, the doctrine that the beneficiary is denied protection if he created the trust for himself.").

6. The terms of such legislation can vary considerably from one jurisdiction to the next. However, Nevis and the Cook Islands are generally regarded as the two leading offshore jurisdictions. This is primarily because their statutes are comprehensive and make clear that self-settled spendthrift or protective trusts are permissible when not tainted by a fraudulent
among the offshore jurisdictions that have some type of APT legislation. Like traditional English law, some APT regimes provide for a statutory "short form" version of the protective trust. These jurisdictions also allow the draftsman to create more tailored restraints on alienation differing from the short form. Further, APT legislation will often impliedly or expressly state that the spendthrift or protective provisions of a trust may be applied for the benefit of a settlor-beneficiary. Under

transfer. See infra note 192. Indeed, in many regards, the Nevis and Cooks statutes are nearly identical to each other. For reference, the Nevis statute is the Nevis International Exempt Trust Ordinance (1994 as amended), while the Cook's statute is the Cook Islands International Trust Act (1984 as amended). The provision of the Nevis statute expressly allowing self-settled spendthrift trusts is Nevis International Exempt Trust Ordinance § 6(4) (1994 as amended). In the Cooks, this result is accomplished by the interplay of two provisions: Cook Islands International Trust Act § 13C(g) (1984 as amended) (allowing settlers to be beneficiaries) and § 13F (allowing beneficiary's interest to be protected by a spendthrift clause).

The author has had various conversations over the years with members of both the private and public sectors in Nevis, the Cooks, and other offshore jurisdictions. These conversations reveal a fairly consistent explanation for the sudden growth of APT legislation. Many people both inside and outside America have come to view the United States as an overly litigious society where an increasing number of Americans seek a safe harbor from litigation. The relevant offshore jurisdictions, which are willing to cater to the American wish for a safe harbor, have, in response, enacted APT legislation in order to spur development of their financial services sectors to help generate revenue for their treasuries. Like Delaware, these jurisdictions require a trustee to have some sort of nexus with their jurisdiction. Cf infra note 200 (reviewing Act § 3570(8) and its definitional requirement that a "trustee" have economic ties with Delaware) with Nevis International Exempt Trust Ordinance § 2 (1994 as amended) (stating that the definition of "international trust" requires trustee to be a Nevis corporation or a corporation doing business in Nevis, which is an effort to boost local employment and the local economy). Also, just as Delaware has for years reaped substantial revenues from incorporation and other fees, APT jurisdictions frequently require trust registration fees. See, e.g., Nevis International Exempt Trust Ordinance §§ 37-38 (1984 as amended) (regarding initial and annual trust registration fees). Consequently, APT statutes are in many ways an exercise in competitive free market economics and good old-fashioned economic development.


68Nevis International Exempt Trust Ordinance § 6(1) (1994 as amended) (allowing trust to make beneficiary's interest subject to termination); Trusts (Jersey) Law § 31(a) (1984 as amended) (similar).

69See supra note 65, regarding Cooks and Nevisian statutes. Jersey, like the Cooks, takes an indirect approach, allowing spendthrift and protective trusts to protect the interests of beneficiaries, and also stating that settlers may be beneficiaries. This implies that settlers may benefit from protective trusts and all the protections conferred by those trusts. Trusts (Jersey) Law § 31 (1984 as amended) (recognizing spendthrift and protective trusts); § 9(12) ("A settlor
many APT statutes, the primary remedy of a creditor is to sue under the local (i.e., offshore) law of fraudulent transfers.\(^7^0\) If a plaintiff succeeds, the trust is not typically voided, but is instead made liable, and then only to the extent of the particular property that was fraudulently transferred.\(^7^1\) Because foreign situs APTs allow settlors considerable opportunity to shelter their assets, both for their own benefit and for the sake of other beneficiaries, these trust devices have become increasingly popular with Americans in recent years.\(^7^2\) The popularity of APTs is enhanced by the fact that most of the jurisdictions with APT legislation are English common law nations. Some jurisdictions still remain under the English flag or use the Privy Council in London as their final court of appeal, thereby conferring legitimacy on these venues.\(^7^3\)

Hence, between the traditional English common law protective trust, the related statutory short form, the English discretionary trust, and the contemporary APT statutes of many other common law nations, much of the world allows self-settled trusts as a way to shelter assets from the settlor’s creditors, provided that the settlement did not violate fraudulent transfer laws.

IV. AN OVERVIEW OF THE DELAWARE ACT

Delaware has joined the offshore world in a key respect, permitting self-settled discretionary trusts that are effective against many of a

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\(^7^0\)See infra note 84. There are some significant differences between offshore and domestic fraudulent transfers law. See infra text accompanying notes 191-97.

\(^7^1\)See, e.g., Nevis International Exempt Trust Ordinance § 26 (1994 as amended) ("An international trust shall be declared invalid only to the extent necessary to satisfy the obligation of a creditor at whose instance the trust was declared invalid together with such costs as the Court may allow."); id. § 24(1)(b) (stating that trust "liability shall only be to the extent of the interest that the settlor had in the property prior to settlement"); accord Cook Islands International Trust Act § 13B(1) (1984 as amended) (similar effect).

\(^7^2\)See, e.g., Alaska H.B. 101 Sponsor Statement, Rep. Vezey, which states: Throughout the United States there is a strong demand for means of preserving assets for future generations. The vehicle for doing this is called a trust. Across the U.S. there is a lack of strong trust law. As a result, we are seeing literally billions of dollars being transferred offshore to foreign countries where laws provide for strong trusts that can preserve assets for future generations.

\(^7^3\)For instance, Bermuda is still a crown colony and voted in 1995 to continue its colonial status. See Empire in the Americas: And Forget George Washington, ECONOMIST, Oct. 4, 1997, at 40. Likewise, the Privy Council has served for many years as the final appellate court for many jurisdictions across the globe, including a number in the Caribbean. See The Caribbean: A Relic of Empire, ECONOMIST, Feb. 8, 1997, at 43.
As demonstrated below, the Act preserves the rule against self-settled trusts insofar as present creditors are concerned but has repealed the rule in connection with future creditors. Assuming a settlor does not violate UFTA when settling a discretionary trust, a qualified disposition will generally be safe from attack by persons with claims arising after the date of settlement. The Act, therefore, legitimizes the contemporary urge to shelter assets from future lawsuits and to protect wealth from a litigation system that many Americans deem to be both excessive and illogical.

Under the Act, the key legal objective is to create a trust settlement that satisfies the criteria for a "qualified disposition." A trust can easily meet these criteria if the drafter understands a few central terms and follows some basic ground rules set forth in the definitional provisions of the Act. First, the term "disposition" is broadly defined as "a transfer, conveyance or assignment of property, or the exercise of a power so as to cause a transfer of property, to a trustee." Second, a "qualified disposition" is any "disposition by or from a transferor to a trustee, with or without consideration, by means of a trust instrument." "Trust instrument" is defined in pertinent part as "an instrument appointing a trustee for . . . property that is the subject of a disposition," provided that the relevant instrument contains certain mandatory terms. In particular, a trust instrument must:

74 The Act places certain restrictions on what "transferors" may do, or what powers "transferors" may retain, in connection with a trust settled pursuant to the Act. See, e.g., DEL. CODE ANN. tit. 12, § 3570(7) (1997) (defining "transferor"); id. § 3570(9)(b) (discussing powers and interests that may be retained by a "transferor"); id. § 3571 (allowing solely discretionary distributions to a "transferor"); id. § 3573 (creating preferential treatment for certain creditors of a "transferor"). Thus, the Act technically applies to any "transferor" involved in a trust transaction, and not just to settlors, who are a sub-set of persons who might transfer property into a trust. Because this article focuses on the right to self-settle a protective trust and related issues, however, the text will refer to "settlers" instead of "transferors."

75 Persons whose claims arose on or before the date of a transfer are referred to as "present creditors" for Uniform Fraudulent Transfers Act (UFTA) purposes, whereas persons whose claims arise after the date of a transfer are referred to as "future creditors." 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, 966 (1997).


77 Id.

78 Id. § 3570(6).

79 Id. § 3570(9).
1. expressly state that the trust is governed by Delaware law,

2. create an irrevocable settlement, and

Specifically, the Act states that the trust instrument must "[e]xpressly incorporate[] the law of this State [i.e., Delaware] to govern the validity, construction and administration of the trust." CODE ANN. tit. 12, § 3570(9)(a) (1997). In other words, Delaware law must govern all aspects of the trust. This requirement of total governance differs from the laws of other jurisdictions. For instance, under the laws of Nevis, it is permissible for some aspects of a trust to be governed by one jurisdiction's law while other aspects may be governed by the laws of different jurisdictions. Nevis International Exempt Trust Ordinance § 4(3) (1994 as amended) ("The terms of an international trust may provide for a severable aspect of the trust (particularly the administration of the trust) to be governed by a different law from the proper law of the trust."). The Nevisian approach comports with Article 9 of the Hague Convention on the Law Applicable to Trusts and on Their Recognition (1985) (stating that "a severable aspect of the trust, particularly matters of administration, may be governed by a different law").

Section 3570(9)(b) requires a qualified disposition to be "irrevocable." DEL. CODE ANN. tit. 12, § 3570(9)(b) (1997). A transferor, however, can retain certain powers and the trust can still be considered irrevocable. Specifically,

a trust instrument shall not be deemed revocable on account of its inclusion of 1 or more of the following: A transferor's power to veto a distribution from a trust, a testamentary special power of appointment or similar power vested in the transferor, or the transferor's potential or actual receipt of a distribution of income, principal or both, in the sole discretion of a trustee who is neither the transferor nor a related or subordinate party of the transferor within the meaning of 26 U.S.C. § 672(c) . . . .

Id.

Section 672 is part of the "grantor" trust rules contained in §§ 671-679 of the Internal Revenue Code (IRC). 26 U.S.C. § 672 (1995). Under the grantor trust rules, the IRC deems a person to be an "owner" of a trust if that person retains certain powers over the trust's principal or income. See generally 26 U.S.C. § 671-679 (1995) (discussing grantor trust rules). Since the person who most often retains the relevant powers is the grantor of the trust, the relevant IRC provisions have been dubbed "grantor trust" rules. The primary consequence of "owner" status is that some or all of trust income will be attributed to the "owner," even if funds were not actually distributed to the "owner." See, e.g., id. § 674 (declaring grantor to be owner of any portion of trust subject to the grantor's power to control beneficial enjoyment thereof). Hence, for income tax purposes only, the IRC has created a theory of "transparency" that disregards any transfers to a trustee.

The basic theory behind the grantor trust rules is that the retained powers of the grantor (or other relevant person) are so broad that the grantor should, for tax purposes, be treated as if he or she is the outright owner of the relevant property, and that any income derived from that property should therefore be taxable to the owner. See, e.g., Helvering v. Clifford, 309 U.S. 331, 336 (1940) (referring to retained powers that "blend so imperceptibly with the normal concepts of full ownership"); Vercio v. Commissioner, 73 T.C. 1246, 1254-55 (1980) (stating that "the choice of the taxable person turns on who in fact controls the income"); see also Helvering v. Horst, 311 U.S. 112, 118 (1940) ("The power to dispose of income is the equivalent of ownership of it."). Further, the IRC recognizes that powers can be retained and exercised indirectly as well as directly. One form of indirect retention of powers is to name a trustee who is a "related or subordinate party," 26 U.S.C. § 672(c) (1995), which can include a spouse. Id. § 672(c).
3. have a spendthrift clause.\textsuperscript{52}

It is important to note that the IRC's willingness to disregard a trusteeship is limited to tax issues only, and is not at all binding on state law matters regarding the validity of a trust. The courts have often noted the distinction between tax law concerns and state law issues. See, e.g., Estate of Sanford v. Commissioner, 308 U.S. 39, 42-43 (1939) ("When the gift tax was enacted Congress was aware that the essence of a transfer is the passage of control over the economic benefits of property rather than any technical changes in its title."); id. at 43 (stating that "'taxation is not so much concerned with the refinements of title as it is with the actual command over the property taxed'") (quoting Corliss v. Bowers, 281 U.S. 376, 378 (1930)); Outwin v. Commissioner, 76 T.C. 153, 166-67 (1981) (noting that a grantor's spouse may qualify as an adverse party for gift tax purposes if he or she has a direct legal or equitable interest in the trust property but this may not be relevant in determining the rights of creditors under state law). Consequently, the IRC's conclusions as to "ownership" under the grantor trust rules are not binding on state trust law issues. Granted, settlers who retain excessive powers may also, under some circumstances, run the risk of having a trust deemed a "sham" trust or of the trustee being deemed the settlor's agent or "alter ego" for state law purposes. While the IRC's concerns are similar to state law concerns, however, state law claims ultimately differ from grantor trust issues and must be analyzed under the appropriate standards of controlling state law.

\textsuperscript{52}Section 3570(9)(c) requires a trust instrument to "[p]rovide[] that the interest of a beneficiary in the trust property or the income herefrom may not be transferred or assigned, whether voluntarily or involuntarily, before the trustee distributes the property or income to the beneficiary.". DEL. CODE ANN. tit. 12, § 3570(9)(c) (1997). The Act's mandatory spendthrift provision for "qualified dispositions" is similar in concept to the Congressional mandate that all ERISA-qualified pension and retirement trusts must have a spendthrift provision. 29 U.S.C.A. § 1056(d) (West Supp. 1998) ("Each pension plan shall provide that benefits provided under the plan may not be assigned or alienated."). As a result of such spendthrift clauses, the beneficial interest in a trust is generally off limits to a beneficiary's creditors. See, e.g., Patterson v. Shumate, 504 U.S. 753, 758 (1992) (allowing an ERISA disqualified pension plan to be excluded from the bankruptcy estate); Guidry v. Sheet Metal Workers Nat'l Pension Fund, 493 U.S. 365, 376 (1990) (refusing to carve out an exception to ERISA's prohibition on the assignment or alienation of pension benefits); Scott v. Bank One Trust Co., 577 N.E.2d 1077, 1084 (Ohio 1991) (holding that spendthrift trusts, which impose a restraint on the voluntary or involuntary transfer of the beneficiary's interest in the trust property, are enforceable under Ohio law). The basic theory underlying spendthrift trusts is that the settlor of a trust is under no compulsion to transfer property to his intended beneficiary. Therefore, if the settlor may withhold property from his beneficiary, then he may also make conditional transfers to a beneficiary via a trustee. Moreover, the relevant conditions may include an instruction to the trustee to refrain from distributions if the property would be lost to the beneficiary due to claims and attachments by the beneficiary's creditors. Id. at 1078. Consequently, creditors have no right to the beneficiary's interest in trust property because the trust property, while still in trust, does not yet belong to the beneficiary. Id. ("The beneficiary of a spendthrift trust has no interest that is liable to the execution of a judgment"); but see Bank One Ohio Trust Co. v. United States, 80 F.3d 173, 176 (6th Cir. 1996) (noting that federal tax lien can attach beneficial interest in a spendthrift trust).

Depending upon local law, it is also possible that a creditor may not be entitled to attach trust fund property even after it is distributed to a beneficiary. For instance, rather than distribute cash, a trustee might choose to distribute tangible personal property that is exempt from attachment by a creditor under a state's exempt property laws.
If the basic rules are followed, the exclusive means by which a
general creditor can invalidate a trust settlement is to show that the
settlor's transfer into trust violated the Delaware Uniform Fraudulent
Transfers Act (UFTA). This is very similar to offshore legislation.

Section 3572(a) states:
Notwithstanding any other provision of this Code, no action of any kind,
including, without limitation, an action to enforce a judgment entered by a
court or other body having adjudicative authority, shall be brought at law or
in equity for an attachment or other provisional remedy against property that
is the subject of a qualified disposition or for avoidance of a qualified
disposition unless such action shall be brought pursuant to the provisions of
§ 1304 or § 1305 of Title 6.

DEL. CODE ANN. tit. 12, § 3572(a) (1997). Sections 1304-1305 are provisions of the Delaware
UFTA and correspond to §§ 4 and 5 of the model act.

The Act exempts certain classes of creditors from the operation of § 3572(a). See id.
§ 3573; see also infra notes 101-29 and accompanying text. Apart from these preferred
creditors, however, section 3572(a) makes UFTA the sole remedy for all other creditors. DEL.
CODE ANN. tit. 12, § 3572(a) (1997). For reference, nonpreferred creditors will be called
"general creditors" in this article.

Note that the Alaska statute allows only that type of fraudulent transfer claim known
as "actual fraud," and does not allow "constructive fraud" claims, whereas the Act allows both.
Compare ALASKA STAT. § 34.40.010 (Michie Supp. 1997) with DEL. CODE ANN. tit. 6, § 1304
(1993 & Supp. 1996). Actual fraud is a transfer made with intent to hinder, delay or defraud
a creditor. Intent, and intent alone, is the key to actual fraud. See ALASKA STAT.
§§ 34.40.010, 34.40.110(b)(1) (Michie Supp. 1997) (referring to intent to hinder, delay or
defraud); Sullivan, supra note 75, at 963-64 (defining actual fraud). Constructive fraud is,
generally speaking, unconcerned with intent, and looks only to the economic effect of a
transfer. In particular, the plaintiff must prove (1) that the transferor did not receive
"reasonably equivalent value" in exchange for the property transferred, and (2) that the transfer
left the transferor insolvent, either on a cash flow, balance sheet, or thin capital basis. Id. at
965-66. Hence, mere negligence in financial planning can be deemed constructive fraud.
Alaska eschews the constructive fraud theory, as demonstrated by its statutory phrasing. In
contrast, the remedies section of the Act expressly refers to Delaware's version of UFTA,
including those UFTA provisions regarding constructive fraud. DEL. CODE ANN. tit. 12,
§ 3572(a) (1997) (referring to DEL. CODE ANN. tit. 6, § 1304 (1993 & Supp. 1996), which
contains both actual and constructive fraud provisions).

The distinction between the Alaska and Delaware remedies is potentially significant,
but probably only in a handful of cases, particularly if good planning is followed. Many
instances of constructive fraud are also cases of actual fraud: transfers that result in insolvency
and which also lack an exchange of reasonably equivalent value are often exchanges that were
meant to hinder, delay, or defraud creditors. Indeed, insolvency or lack of reasonably
equivalent value are often signs of fraudulent intent, thus showing the potential for considerable
overlap between the two species of fraud. See Sullivan, supra note 75, at 968-71 (describing
the use of "badges of fraud" in proving actual fraud cases). When overlap occurs, the adverse
economic effects associated with constructive fraud often arise by design. Thus, the distinction
between Alaska and Delaware is limited to only the remaining cases of constructive fraud, i.e.,
those cases that are not also instances of actual fraud. Fortunately, transferees can avoid
constructive fraud if they do not render themselves insolvent or if they receive reasonably
equivalent value in exchange for property. Id. at 967 n.32. Note, however, that reasonably
Moreover, a general creditor can avoid a transfer into trust "only to the extent necessary to satisfy the transferor's debt to the creditor at whose instance the disposition had been avoided." The transfer is not equivalent value exists only if the interest received in exchange for the transferred property has utility or value to the transferor's creditors. Id. at 1013 n.195. Since the purpose of a qualified disposition is to put assets beyond the reach of creditors, it is highly unlikely that a settlor's retained interest in a Delaware trust will count as reasonably equivalent value. This means the settlor of a qualified disposition must remain solvent in order to avoid constructive fraud. However, is something the settlor of an Alaska trust should also strive for, as staying solvent will avoid an inference of fraudulent intent under Alaska law whereas post-transfer insolvency would jeopardize the safety of an Alaska structure. Thus, this difference between the Alaska and Delaware statutes is really more theoretical than practical.

See, e.g., Nevis International Exempt Trust Ordinance § 24 (1994 as amended). Note, however, that Delaware's Act makes UFTA an exclusive remedy for general creditors, whereas offshore venues may allow for other means of attack, such as a claim that the trust is "immoral or contrary to . . . public policy." Id. § 23(1)(b). The entire purpose of offshore trust law, however, is to create a public policy entitling settlers, within limits, to put their own property beyond creditors while still retaining use, benefit, and control. One must, therefore, question how many cases will actually be held to be immoral or against public policy.

Del. Code Ann. tit. 12, § 3574(a) (1997). Additionally, qualified dispositions can be avoided to the extent needed to pay "such costs, including attorneys' fees, as the court may allow" in cases involving a successful UFTA challenge to a qualified disposition. Id. This last provision can be taken as authorizing discretionary awards of attorneys' fees to compensate plaintiffs who successfully allege that the Act has been abused by a transferor. Indeed, many fraudulent transferors rely upon the extra cost and expense of UFTA litigation to deter collection suits by creditors who might otherwise levy and execute upon the property which has been improperly conveyed. They simply hope that their improper transfers will never be challenged because it is cost-prohibitive for a creditor to sue. To counter this result, it is good policy to award fees and costs to plaintiffs who prove, for instance, that a transfer was intentionally designed to improperly thwart a creditor. Otherwise, the cost-prohibitive nature of challenging wrongful settlements would, in fact, discourage many injured creditors, thereby providing practical incentive for a strategy of deliberate fraudulent transfers.

Without § 3574(a)’s authorization of attorneys’ fees, the American Rule of legal fees would usually bar the court from shifting legal fees to losing transferors. See Alyeska Pipeline Serv. Co. v. Wilderness Society, 421 U.S. 240, 257 (1975) (holding that the rule has long been that attorneys’ fees are not ordinarily recoverable). Under the American Rule, each side to a lawsuit side generally bears its own legal fees, regardless of who wins, unless there is express statutory or contractual authorization to award fees. Id. There are exceptions to this general rule, one of which provides for awarding fees against parties who have "acted in bad faith, vexatiously, wantonly, or for oppressive reasons." Id. at 258-59 (quoting F.D. Rich Co. v. United States ex rel. Indus. Lumber Co., 417 U.S. 116, 129 (1974)); Slavik v. State of Del., 480 A.2d 636, 639 n.5 (Del. 1984) (same). This exception, however, does not automatically translate into an award of fees against a losing defendant, even one who is ultimately found liable for intentional misconduct. The bad faith in question is the bad faith, if any, found in the course of litigation. This does not include the alleged misdeeds giving rise to a suit. "The intent of this exception is not to compensate worthy litigants but to 'deter abusive litigation in the future, thereby avoiding harassment and protecting the integrity of the judicial process.'" Schlank v. Williams, 572 A.2d 101, 108 (D.C. App. 1990) (quoting Synanon Found., Inc. v. Bernstein, 517 A.2d 28, 37 (D.C. 1986), cert. denied, 498 U.S. 938 (1990). Since many UFTA
automatically avoided as to any other creditor. This, too, is similar to the law of at least two other offshore jurisdictions.\(^8\)

Most importantly, Delaware now permits self-settled spendthrift trusts, which are a key pillar of contemporary offshore APT legislation.\(^9\) The Act also harkens back to traditional English law, as a qualified disposition must be a discretionary trust. It is, in fact, this discretionary nature of English trusts that gives them their ability to shelter assets from the settlor's own creditors.\(^8\) Delaware has embraced these concepts in section 3570(9)(b), which imposes the irrevocability requirement, and states that "a trust instrument shall not be deemed revocable on account of . . . the transferor's potential or actual receipt of a distribution of income, principal, or both, in the sole discretion of . . . [the] trustee."\(^9\)

Additionally, section 3571 states:

A qualified disposition that requires a trustee to distribute all or any part of the trust's income or principal,

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claims will be defensible on numerous grounds, see Sullivan, supra note 75, at 975-1042, awards of fees are not justified based on this exception, even if the defendant transferor ultimately loses. Cf Weinberger v. UOP, Inc., 517 A.2d 653, 656 (Del. Ch. 1986) (holding that "fact that . . . [defendant corporation] failed in its obligation to deal fairly with the minority stockholders does not, without more, warrant" an award of attorney fees). Consequently, courts need § 3574(a) as authority to shift fees.

In determining whether to award fees, and how much an award should be, courts may tread cautiously. Many UFTA claims are defensible. Therefore, courts may hesitate to award fees against losing defendants in such circumstances for fear of creating a chilling effect that would deter transferors and trustees from raising valid or good faith defenses. The urge to avoid a chilling effect could be especially strong because a successful defense effort will often redound to the benefit of innocent trust beneficiaries, who have an interest in preserving a trust fund. Additionally, UFTA claims of constructive fraud can be based on acts or omissions that result from mere negligence by the transferor. Sullivan, supra note 75, at 962-963 n.20. Thus they may be devoid of any ill intent. The impetus, then, to award fees in a negligence setting is diminished. Although the plaintiff was still forced to incur legal fees to avoid a transfer, the defendant did not maliciously try to make attachment of assets cost prohibitive. Fee awards to successful plaintiffs, however, may also become routine. The precautionary concerns noted here may ultimately be overcome by the judiciary's desire to internalize the cost of litigation on the transferor who wrongly settled a trust, even if the wrongful conduct was negligent or debatable. In other words, courts may view a fee award as a normal part of compensation for any plaintiff who was forced to sue in order to get property held in trust.

\(^8\)See supra note 71.

\(^9\)See supra text accompanying notes 59-75 (regarding self-settled trusts in offshore jurisdictions).

\(^8\)See supra note 36 (defining and explaining discretionary trusts); see also supra text accompanying notes 40-44 (reviewing English discretionary trusts).

\(^8\)Del. CODE ANN. tit. 12, § 3570(9)(b) (1977). Further, the trustee must not be a "related or subordinate party of the transferor within the meaning of 26 U.S.C. § 672(c)." Id. For the significance of § 672(c), see supra note 81.
or both, to the transferor shall not be entitled to any rights or benefits arising under § 3572 of this title, but a qualified disposition shall remain subject to § 3572 of this title notwithstanding that the trustee has the sole discretion, exercisable without regard to any ascertainable standard, to distribute trust income or principal, or both, to the transferor if such trustee is neither the transferor nor a related party or subordinate party of the transferor within the meaning of 26 U.S.C. § 672(c).  

Accordingly, in addition to the three mandatory clauses needed to create a "qualified disposition" (i.e., Delaware law, irrevocability, and a spendthrift clause), the Act allows for an optional fourth clause. Under this fourth clause, the settlor may retain a discretionary interest in any part of a qualified disposition.  

So long as an independent trustee has unfettered discretion over possible distributions to the settlor, a qualified disposition can, as a general rule, be avoided only on grounds of a fraudulent transfer. If, however, the trustee is obligated to make payments to the settlor, if the settlor has a legal right to compel distributions, or if the trustee is not

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90 Del. Code Ann. tit. 12, § 3571 (1977) (emphasis added). Section 3572 states the general rule that "qualified dispositions" can be avoided only pursuant to the Delaware UFTA. Id. § 3572. See supra note 83 (quoting the language of § 3572(a)). For the significance of 26 U.S.C. § 672(c) (1996), see supra note 81.

91 Del. Code Ann. tit. 12, § 3572(a) (1977). Note that a Delaware qualified disposition need not be self-settled. A settlor can make a qualified disposition for the sake of others and, assuming that the three mandatory features of a qualified disposition are present, the enhanced protections of the Act will safeguard the beneficial interests of nonsettlor beneficiaries.

92 Section 3572 states the general rule that qualified dispositions may be avoided only if they violate Delaware's UFTA. Del. Code Ann. tit. 12, § 3572 (1977). This general rule is subject to exceptions for certain preferred creditors, specifically, the payees named in certain domestic relations orders or agreements, creditors who relied upon certain written representations regarding the trust fund, and personal injury victims whose injuries arose on or before the date of the qualified disposition. For more, see infra Part V.

93 See Del. Code Ann. tit. 12, § 3571 (1997) (disallowing protection for "[a] qualified distribution that requires a trustee to distribute" property to a transferor) (emphasis added). Note that the Act does not prohibit mandatory or scheduled distributions to nontransferors, except to the extent that distributions might be prohibited by a § 3570(9)(e) spendthrift clause. Consequently, the only beneficiary of a qualified disposition who must be subject to purely discretionary distributions is a settlor-beneficiary.

94 See id. § 3571 (referring to "ascertainable standards"). "Ascertifiable standard" is a term of art within the estate and gift tax field. It refers to standards governing the trustee’s conduct that are so definite that a beneficiary could sue a trustee for failing to conform to those standards. Explained differently, it is "[a] clearly measurable standard under which the holder of a power is legally accountable." 26 C.F.R. § 25.2511-1(g)(2) (1997). In connection with
independent from the settlor, then general creditors are not confined to
UFTA as their sole remedy against a self-settled qualified disposition.
This presumably means that general creditors can invoke all other
remedies that might exist in addition to UFTA, including the rule against
self-settled trusts. If a settlor is willing to part with substantial control
over trust property, however, the Act creates a vast safe harbor in which
to shelter assets. If a settlor names himself as a beneficiary of a qualified
disposition, the mandatory spendthrift clause should protect trust assets
from the collections efforts of the settlor’s creditors. This is the true
import of section 3572(a), which relegates general creditors to UFTA as
their sole remedy. This result is also the clear implication of making a
spendthrift clause mandatory in a qualified disposition.

Moreover, to at least some degree, a settlor-beneficiary can fulfill
the proverbial wish of having his cake and eating it too: while the Act
requires settlor-beneficiaries to part with much control over trust assets,
settlor-beneficiaries need not suffer a total loss of control. Indeed, the
Act allowssettors to reserve certain important powers over trust affairs
without losing creditor protection. For instance, a settlor may veto a
trustee’s distributions to other beneficiaries. Consequently, even if the
settlor cannot compel the trustee to distribute funds to the settlor, the
settlor is nonetheless able to prevent the trustee from spending trust assets
on anyone else. Any ensuing distributions would thereby be limited to
only the settlor during his lifetime. Further, the settlor can exercise "a
testamentary special power of appointment or [other] similar power,\footnote{See Del. Code Ann. tit. 12, § 3571 (1997) (referring to subordinate or related
parties). This comports with traditional spendthrift trust law, which denies spendthrift
protection to any trust in which the beneficiary has dominion and control over the trust. See,
e.g., In re Gallagher, 101 B.R. 594, 600 (Bankr. W.D. Mo. 1989) (noting that a trust that
concerns a spendthrift provision cannot be a spendthrift trust if the beneficiary has dominion
or control over the trust).}

\footnote{See Del. Code Ann. tit. 12, § 3570(9)(c) (1997).}

\footnote{Section 3570(9)(b) states, "[A] trust instrument shall not be deemed revocable on
account of its inclusion of . . . [a] transferor’s power to veto a distribution from a trust." Id.
§ 3570(9)(b).}

\footnote{Id. A special power is typically defined by reference to a general power of
appointment. A general power of appointment is "a power which is exercisable in favor of the
individual possessing the power . . . , his estate, his creditors, or the creditors of his estate,"
subject to certain limited exceptions. 26 U.S.C. § 2514(c) (1994); accord id. § 2041(b)(1);}

\footnote{Id.}
thereby vesting in the settlor considerable power to control distributions
upon his or her death. These reserved powers bring with them significant
estate and gift tax implications. Moreover, this ability to retain some
degree of use, benefit and control while still shielding assets from
creditors is a concept very similar to key offshore legislation.

In sum, the Act is something of a hybrid between the traditional
English discretionary trust and the more contemporary APT. It allows
settlers to self-settle discretionary spendthrift trusts that are effective
against future creditors, while allowing the settlor to retain some limited
but potentially significant powers. Therefore, the Act is a radical
departure from prior American law, which, apart from retirement plans,
shunned self-settled trusts of any type.

V. PREFERRED CREDITORS WITH PRIORITY CLAIMS

A. In General and Domestic Relations

Certain creditors are given preferred status under the Act, thereby
giving their claims a priority interest in a trust fund. The particular
creditors in question are payees named in certain domestic relations

DELIB. CODE ANN. tit. 30, § 1304(f) (1997). A special power of appointment is typically
considered any power that is not a general power. John R. Price, Price on Contemporary

99See infra Part VII.B.1.

100See Nevis International Exempt Trust Ordinance § 47(a)-(f) (1994 as amended)
(stating that an international trust will not be declared invalid or affected in any way if the
settlor retains power or control); Cook Islands International Trust Act § 13C, (1984 as
amended). The powers a settlor may reserve under the Act, however, are much more narrow
than those retainable under offshore legislation. See infra notes 211-13, 247, & 263-64 and
accompanying text. Therefore, there may be a considerable difference of degree. Further, the
settlor's retention of any power is a potential conflict with UFTA, which holds that retained
control can be a badge of fraud. UFTA § 4(b)(2), 7A U.L.A. 653 (1996); DEL. CODE ANN.
tit. 6, § 1304(b)(2) (1996). The retention of use, benefit and control, however, is not
conclusive under UFTA. See UFTA § 4, cmt. 6, 7A U.L.A. 654 (1996) (stating that a court
should "take into account all indicia negating as well as those suggesting fraud"). Further
still, the limited scope of the Act's retainable powers divests the settlor of the ability to
maintain day-to-day control over the trust corpus, thus doing much to eliminate UFTA
provisions related to excessive retained control. Finally, the significance of this badge of fraud
must be viewed as minimal when the settlor is retaining powers that are expressly permitted
by the Act, which is a more recent statute than UFTA, and which deals with a particularized
subject matter in contrast to UFTA's general application. See, e.g., United States v. Smith, 831
F. Supp. 549, 551 (E.D. Va. 1993) (stating the "later statutes receive precedence over earlier
statutes and specific statutes receive precedence over more general statutes").
orders or agreements,101 creditors who relied upon certain written representations regarding the trust fund,102 and personal injury victims whose injuries arose on or before the date of the qualified disposition.103 Each of these preferential exceptions is carefully tailored to address certain public policy concerns that the General Assembly plainly thought warranted special consideration.

For instance, the preference given to obligees of child support, spousal support, and marital property awards is a clear attempt to protect the financial interests of dependent children and ex-spouses, and also to prevent obligors from using qualified dispositions to evade their debts to such persons. In this regard, the Act resembles ERISA, which also allows the beneficiaries of domestic relations orders to pierce the veil created by its spendthrift provisions.104 This preference also comports with longstanding Delaware law, which previously gave obligee spouses a right to attach the spendthrift interests of obligor spouses in connection with domestic support orders.105

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101Section 3573(1) states:
Notwithstanding the provisions of § 3572 . . . , this subchapter shall not apply in any respect . . . [t]o any person to whom the transferor is indebted on account of an agreement or order of court for the payment of support or alimony in favor of such transferor’s spouse, former spouse or children, or for a division of distribution of property in favor of such transferor’s spouse or former spouse, to the extent of such debt . . . .


102Section 3573(2) states:
Notwithstanding the provisions of § 3572 . . . , this subchapter shall not apply in any respect . . . [t]o any creditor who became a creditor of the transferor in reliance upon an express written statement of the transferor that any property that was the subject of the qualified disposition thereafter remained the property of the transferor and was available to satisfy any debt to such creditor incurred by the transferor.


103Section 3573(3) states:
Notwithstanding the provisions of § 3572 . . . , this subchapter shall not apply in any respect . . . [t]o any person who suffers death, personal injury or property damage on or before the date of a qualified disposition by a transferor, which death, personal injury or property damage is at any time determined to have been caused in whole or in part by the act or omission of either such transferor or by another person for whom such transferor is or was vicariously liable.


104See 29 U.S.C. § 1056(d)(3) (1998) (regarding Qualified Domestic Relations Orders (QDROs)).

105Garretson v. Garretson, 306 A.2d 737, 740-41 (Del. 1973) (reasoning that obligee spouses are not really "creditors" as that term is commonly understood). This is another area in which the Act differs from its Alaska counterpart. Under the Alaska law, a trust settlement
B. Relying Creditors

The exception for relying creditors is narrowly crafted to protect those who extend credit due to a settlor’s misrepresentations as to his or her financial resources. This is nothing more than saying that a settlor cannot practice fraud.\textsuperscript{106} To that extent, this exception is a rather unremarkable public policy concern aimed at deterring financial fraud and promoting truth in commerce.

If anything deserves comment about the relying creditor exception, it is the fact that the Act diminishes a fraud victim’s rights. This is demonstrated by breaking down the relevant statutory phrase into its component parts.\textsuperscript{107} In connection with qualified dispositions, a creditor must show each of the following elements to prove fraud by the settlor:

1. The settlor presented the creditor with a written statement.

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\textsuperscript{106}Delaware recognizes at least two types of fraud: common law fraud and equitable fraud.

\textsuperscript{107}See supra note 102 for the text of § 3573(2).

\textsuperscript{[T]he elements of common-law fraud . . . [are]: 1.) a false representation, usually one of fact, made by the defendant; 2) the defendant's knowledge or belief that the representation was false, or was made with reckless indifference to the truth; 3) an intent to induce the plaintiff to act or to refrain from acting; 4) the plaintiff's action or inaction taken in justifiable reliance upon the representation; and, 5) damage to the plaintiff as a result of such reliance.}

Zirn v. VLI Corp., 681 A.2d 1050, 1060-61 (Del. 1996) (original emphasis deleted). The difference between common law fraud and equitable fraud is that the latter omits the second prong. "Thus, equity provides a remedy for negligent or innocent misrepresentations." Id. at 1061.
2. The written statement expressly asserted that property held by the trustee was instead the settlor's property.

3. The written statement also expressly asserted that property held by the trustee was available to satisfy any debts the settlor might incur to the creditor.

4. The creditor became a creditor in reliance upon the written statement.

This test substantially tightens the evidentiary requirements for proof of fraud. Before the Act, a plaintiff could prove fraud with evidence of verbal misrepresentations\(^{108}\) or by showing material omissions, including omissions by silence and concealment.\(^{109}\) Now, however, only written misrepresentations are actionable. The Act prohibits lawsuits based on potentially flawed memories of verbal statements, or on ambiguous omissions or failures to act. Plaintiffs will not be able to force jury trials based on disputed, undocumented reconstructions of events. A plaintiff must now have written proof, which is inherently more reliable than testimony regarding verbal exchanges or interpretations of omissions or inactions.\(^ {110}\) Moreover, not just any writing will sustain a claim. The writing must expressly misrepresent the true state of the legal title and the availability of the assets. Unless both express written misrepresentations exist, the plaintiff


\(^{110}\) Professor Tribe, in an article focusing on hearsay issues, referred to "the four testimonial infirmities of ambiguity, insincerity, faulty perception, and erroneous memory." Lawrence Tribe, Triangulating Hearsay, 87 Harv. L. Rev. 957, 958 (1974). Although these infirmities make witness testimony "particularly suspect," id., in connection with hearsay, "when the act or utterance is not one made in court, under oath, by a person whose demeanor at the time is witnessed by the trier, and under circumstances permitting immediate cross-examination," id., these infirmities can also befall any effort to reconstruct relevant conversations between actors, even if those actors are the only parties and witnesses to a lawsuit. Moreover, the ability to cross-examine a witness is no guaranty that the truth will come out. Some people are accomplished liars and can fool anybody, including a judge or jury. Some people are nervous wrecks under oath and, thus, appear evasive and dishonest when they are really only scared and apprehensive. Other people, by the time they testify, have utterly convinced themselves that they are recalling events with 100% accuracy, no matter what the case may really be; in the absence of documentary evidence, there may be nothing to refute such erroneous testimony except more inherently suspect testimony. In such cases, the fact finder is left with the virtually impossible task of deciding which of two conflicting, uncorroborated and unverifiable stories is the truth.
loses and the qualified disposition stands. The "express written statement" requirement will also give a settlor room to argue that a writing is not "express" enough. Such arguments could easily defeat all fraud claims save those based on very clear misrepresentations, thereby insulating settlers from claims based on unclear or inconclusive writings. These elevated evidentiary hurdles are undoubtedly designed to reduce claims based on weak evidence, which in turn is the legislature's way of showing its determination to make qualified dispositions resistant to all but the most provable of fraud claims.

Finally, there is the question of reliance. Interestingly, the statute is silent as to whether a creditor's reliance must be reasonable or justified. This silence could arguably mean that any degree of reliance would suffice, but this is not likely: an unqualified reliance standard would be contrary to the overwhelming body of American tort law, which requires "reasonable" or "justifiable" reliance in virtually every other context; including bankruptcy discharge cases regarding the extension of credit. In addition, any interpretation of section 3573(b) that

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111 As an aside, note that evidence of other misrepresentations is probably irrelevant and hence inadmissible in connection with the limited question of whether the plaintiff is a preferred creditor. This is because the only misrepresentations that matter are writings regarding the title to, and availability of, the trust property. See Del. Code Ann. tit. 12, § 3573(2) (Supp. 1997); see also FED. R. EVID. 401-402 (defining relevance and governing admissibility); Del. R. Evid. 401-402 (similar). Evidence of other misrepresentations, however, may be admissible in connection with other issues that arise in a suit, such as the defendant's state of mind and the availability of punitive damages, see, e.g., Jardel Co. v. Hughes, 523 A.2d 518, 527-31 (Del. 1987) (reviewing standards for punitive damages); Cummings v. Pinder, 574 A.2d 843, 845 (Del. 1990) (stating that "intentional or willful conduct" may sustain award of punitive damages), or whether a "pattern" exists for RICO purposes. Columbia Natural Resources, Inc. v. Tatum, 58 F.3d 1101, 1107-08 (6th Cir. 1995).


113 Indeed, for relying creditors, the only good thing regarding the Act's limitations on fraud claims is that the Act appears to allow claims for "equitable" fraud as well as common law fraud. See supra note 106. The statutory elements do not seem to require that the misrepresentation be intentional; negligent misrepresentations may suffice. Cf. Zirm v. VLI Corp., 681 A.2d 1050, 1061 (Del. 1996) (noting that "equity provides a remedy for negligent or innocent misrepresentations").


115 See, e.g., Huddleston v. Herman & MacLean, 640 F.2d 534, 543, 548 (5th Cir. 1981), reh'd denied, 650 F.2d 815 (5th Cir. 1981) (discussing reasonable reliance as an element of Rule 10b-5 securities claim); Zirm, 681 A.2d at 1061 (requiring justifiable reliance); Gaffin v. Teledyne, Inc., 611 A.2d 467, 472 (Del. 1992) (same); Burr v. Board of County Comm'r's of Stark County, 491 N.E.2d 1101, 1105, Syl. ¶ 2 (Ohio 1986) (justifiable reliance); Restatement (Fifth) of Torts § 105, at 728 (5th ed. 1984) (justifiable reliance);

endorses an unqualified reliance standard and, thus, lessens a plaintiff's burden, would be inconsistent with the legislature's plain intent to increase a plaintiff's burden, as shown by the Act's "express written statement" requirement.

Moreover, an unqualified reliance standard simply does not make sense. The same policy reasons that commend a "reasonableness" or "justifiability" standard in other contexts also apply to qualified dispositions. At some point, one person's decision to rely upon another's representations, whether written or verbal, becomes so alarmingly inept as to be a careless assumption of risk. This is true whether the relevant conduct involves the sale of goods, the provision of services, or, as here, the extension of credit. An unqualified reliance standard would reward people for such reckless self-endangerment. The law, though, should discourage people from dangerous and foolish acts, and not reward them.

This is especially true today in connection with matters involving extension of credit. A growing body of evidence suggests that creditors have become too aggressive in extending credit, and actively encourage loans to people who simply are not creditworthy. Such overly liberal credit policies are ultimately dangerous for all persons involved: a weak borrower can easily become mired in debt, incur a bad credit history, and often be forced into bankruptcy. The lender then ultimately suffers avoidable losses, hurting both itself and its shareholders; and bankruptcy courts become unduly crowded by debtors who should never have been given credit in the first place. To help mitigate these problems, Delaware courts should require reliance to be justified or reasonable before a creditor is given preferential access to funds held in qualified dispositions.

119See, e.g., Williams v. Rank & Son Buick, Inc., 170 N.W.2d 807, 810 (Wis. 1969), in which the court stated:

"It is an unsavory defense for a man who by false statements, induces another to act to assert that if the latter had disbelieved him he would not have been injured. . . . Nevertheless courts will refuse to act for the relief of one claiming to have been misled by another's statements who blindly acts in disregard of knowledge of their falsity or with such opportunity that by the exercise of ordinary observation, not necessarily by search, he would have known. He may not close his eyes to what is obviously discoverable by him."

Id. at 810 (quoting Jacobsen v. Whitely, 120 N.W. 285, 286 (Wis. 1909)).

Fortunately, such an interpretation of section 3573(b) does not contravene legislative intent. Given the overwhelming prevalence of reasonableness or justifiability standards in other matters requiring proof of reliance, it can be legitimately argued that the legislature knew of such standards and assumed that they would be applied in connection with this reliance provision of the Act. As previously noted, such an interpretation is consistent with the General Assembly's desire to "weed out" weak claims, as evidenced by the "express written statement" requirement. 121

C. Priority for Certain Present Creditors

In addition, the Act confers preferential treatment on certain pre-settlement claimants, specifically being "person[s] who suffer[] death, personal injury or property damage on or before the date of a qualified disposition." 122 This preference applies whenever the settlor is directly responsible for the pre-transfer injury, 123 and also when the settlor is "vicariously liable" for the victim's injury. 124 The rights of these preferred creditors survive a trust settlement. 125

This preference is important for several reasons. First, it preserves the rule against self-settled trusts in connection with claims by present creditors. This limited preservation of the rule is an obvious prophylaxis: Delaware does not want its statute abused by debtors trying to shelter assets from known creditors, as sometimes happens when American settlers move assets offshore to an APT jurisdiction. 126 By keeping the

121 Del. Code Ann. tit. 12, § 3573(2) (Supp. 1997) (requiring "express written statement"). Note that Alaska's statute is arguably more debtor friendly in connection with relying creditors. Unlike the Act, the Alaska statute does not give an express preference to relying creditors, see Alaska Stat. §§ 34.40.010, 34.40.110 (Michie Supp. 1996), but, at first blush, seems to confine all claimants to fraudulent transfers relief. This initial impression could be misleading, though.


123 Id. (referring to "damage . . . hav[ing] been caused in whole or in part by the act or omission of . . . such transferor").

124 Id.

125 Id. (allowing this preference "any time" it is "determined" that the settlor, or one for whom the settlor is vicariously liable, was a causative agent).

126 See, e.g., 515 S. Orange Grove Owners Ass'n v. Orange Grove Partners, Plaint No. 208/94 (High Ct. Rarotonga, Civil Div., Nov. 6, 1995), more fully summarized in Bruce & Wojewodzki, supra note 121, at 41. To the credit of the Cook Islands, their bench acted against this obvious fraud. Hence, the problem is not so much with the Cooks as it is with settlers who try to abuse the system.
rule in place for present creditors, prospective settlors will have no incentive to replicate such abuse in Delaware.

Second, by implication, this priority verifies the Act's repeal of the rule in connection with claims by future creditors. The preference is given only to present creditors, thereby confirming the legislature's intent to give future creditors fewer rights, including no rights under the rule against self-settled trusts. In this regard, the Act again patterns itself after offshore venues, which in many cases have gone so far as to abolish the rights of future creditors altogether and to confer rights on present creditors only. Delaware has not gone as far in limiting the rights of future creditors, as it has preserved their rights under UFTA. Nonetheless, it remains true that Delaware has substantially curtailed the rights of future creditors.

VI. NASTY SURPRISE NO. 1: THE INNOCENT BENEFICIARY CLAUSE AND SOME RELATED QUESTIONS

A. General Concerns

The Act contains at least two nasty surprises for those who might challenge a qualified disposition. The first is what can be called the "innocent beneficiary" clause.

Under this provision, beneficiaries will generally be able to retain property distributed to them in advance of a lawsuit, even if the plaintiff eventually proves that the relevant transfer into trust was fraudulent. Only those beneficiaries who accept property in bad faith will be concerned about returning a distribution. This is expressly set forth in section 3574(c) of the Act, which states:

If the court is satisfied that a beneficiary of a trust has not acted in bad faith, the avoidance of the qualified disposition shall be subject to the right of such beneficiary to retain any

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127See infra note 193 for more on this point.
128Present creditors, however, are often confronted with sterner evidentiary and procedural hurdles in offshore venues. See infra note 196.
129Del. Code Ann. tit. 12, § 3572(a) (Supp. 1997) (referring to Del. Code Ann. tit. 6, § 1304 (1996), which is Delaware's version of UFTA § 4, and which confers rights on future creditors). Future creditors, however, have limited rights under UFTA. See generally Sullivan, supra note 75 (discussing future creditor rights). Further, the more time that has elapsed between the date of a transfer and the date on which a claim arose, the more difficult it will be for a future creditor to succeed, particularly if all intervening creditors have been paid. See id. at 1026-30.
distribution made upon the exercise of a trust power or discretion vested in the trustee of such trust, which power or discretion was properly exercised prior to the creditor's commencement of an action to avoid the qualified disposition. 120

This innocent beneficiary clause, which is very similar to a provision of Bahamian law, 131 raises some questions that will need answering by the courts. For instance, what is meant by the phrase "properly exercised" in connection with trust powers and trustee discretion? One plausible answer is that a "proper exercise" is a good faith exercise of powers and discretion in keeping with the terms of the relevant trust; this possibility has the advantage of being able to draw upon established tests for good faith. 132 Likewise, how will courts measure a beneficiary's "bad faith"? Presumably, the courts will rely upon established definitions to gauge this factor. Because the Act is new, however, these are unresolved issues that case law will ultimately mold and develop. 133

131 Section 5(1)(b) of the Bahamian Fraudulent Disposition Act (1991), states: In the event that any disposition shall be set aside pursuant to this Act, then . . . unless the court is satisfied that a beneficiary of a trust has acted in bad faith the disposition shall only be set aside subject to the right of such beneficiary to retain any distribution made consequent upon the prior exercise of a trust, power or discretion vested in the trustee of such trust or any other person, and otherwise properly exercised.

Id. It is unclear whether the similarity between the two statutes is intentional or inadvertent. There are, however, differences as well. The Bahamian statute treats "trust, power or discretion" as a disjunctive listing of three separate items, id.; Delaware law refers to a "trust power or discretion," thus referring to only two items. The ultimate question is also phrased differently. The Bahamas require proof that a beneficiary acted in bad faith, thus apparently putting the evidentiary burden on creditors. Id. § 5(1)(b). In contrast, Delaware arguably requires a beneficiary to prove an absence of bad faith.


133 "Bad faith" is an imprecise term that has been defined or expressed in countless different formulations. Most cases seem to focus on the presence or absence of dishonesty, deceit, ill will or similar traits. See 7A C.J.S. Bad Faith § 929-33 (1997), and cases cited therein.
B. *Mandatory Distributions and Powers in Third Parties*

The innocent beneficiary provision also raises an extremely serious question: does this clause protect only discretionary distributions by a trustee, or will it also cover distributions made pursuant to a schedule of mandatory payments? This question is of little relevance to settlor-beneficiaries, as the Act’s protections are lost in cases of mandatory distributions to a settlor.\(^{134}\) This does, however, remain an important question in connection with distributions to beneficiaries who have not contributed property to the trust. Since many settlors want their beneficiaries to receive certain minimum distributions of corpus or income at regular intervals, this question is apt to appear early in the Act’s life.\(^{135}\)

The lack of clarity stems from a simple grammatical question: What is meant by the phrase "exercise of a trust power or discretion vested in the trustee"? More specifically, does the phrase "vested in the trustee" modify just the term "discretion," or does it also modify the term "trust power"? If "vested in the trustee" modifies only "discretion," then it is quite possible that the innocent beneficiary clause will protect only discretionary distributions by the trustee. If, however, the term also modifies "trust power," then it is at least possible that the innocent beneficiary provision will also protect distributions made by the trustee pursuant to a mandatory payment schedule. Whether such protection would actually be extended would turn on whether "trust power" includes the act of simply writing checks or disbursing assets pursuant to a timetable set forth in the trust.

Either interpretation may cause problems. If innocent beneficiary protection fails to extend to mandatory payments, then beneficiaries may be forced to disgorge property they received in good faith. This situation may not be a problem if the transaction is immediately reversed, but it is not likely that most beneficiaries will be told to disgorge the day after they receive assets. To the contrary, a more likely scenario is that creditors will seek disgorgement sometime after a beneficiary has spent,


\(^{135}\)This whole question assumes that the Act allows mandatory distributions to persons who have not transferred property into trust. The Act, however, is silent on this question. Because the Act nevertheless expressly states that a trust is not protected if the settlor is entitled to mandatory distributions, see Del. Code Ann. tit. 12, § 3571 (1997), quoted in supra text accompanying note 90, the Act’s silence about mandatory payments to other beneficiaries indicates that the legislature was aware of the concept of mandatory payouts and chose to vitiate protection only if payouts were mandated for the settlor. It is, thus, plausible to conclude that the legislature approves of payment schedules for anybody but the settlor.
pledged or otherwise consumed some or all of a distribution. In other words, a reliance interest will have arisen; depending upon the amount of money involved, that interest could be significant. Moreover, some creditors may seek more than disgorgement of property still held by a beneficiary; these creditors may also try to make a beneficiary compensate for assets already consumed. These scenarios could prove highly inequitable to beneficiaries.

If, however, innocent beneficiary protection extends to mandatory payments by the trustee, then there is the potential for abuse. A transferor could settle a trust with a rapid (or even immediate) mandatory payout schedule, thereby putting assets beyond the reach of creditors because assets would have been transferred to innocent third parties through use of a trustee middleman. In effect, the innocent beneficiary clause could become a means to improperly convert attachable assets into unattachable ones.\(^\text{136}\)

Presently, the Act does not pose a clear answer to this issue; and it will be interesting to see how the courts resolve this potential problem.

A related issue is whether the term "trust power" encompasses powers held by persons other than the trustee. This will also turn on whether "vested in the trustee" modifies "trust power" or just "discretion." If "vested in the trustee" only modifies "discretion," then "trust power" is not necessarily a power vested in the trustee, and somebody other than the trustee might hold a power to compel distributions to an innocent beneficiary.\(^\text{137}\) The power holder could be a close friend of the settlor, or somebody who is under the settlor's control. Indeed, a possibility is that the holder of such a "trust power" could be the settlor, although this may not be permissible.\(^\text{138}\) Moreover, if powers can be held by somebody

\(^{136}\)If a payout schedule was immediate or rapid, however, one could question whether the trustee acted in good faith, especially if there were facts indicating that the settlor might try to "launder" money through a trust. Careless trustees might find themselves liable to creditors injured by such tactics, but that will be relief to creditors only if a trustee has enough assets to satisfy a creditor claim, and even then a creditor would have to first endure the costs and risks of litigation to get a recovery.

\(^{137}\)The reserved power could be in the form of a special or general power of appointment exercisable in favor of persons other than the settlor. A power exercisable in favor of the settlor would not make sense, as it would probably cause the trust to lose the protections of a qualified distribution. Sections 3570(9)(b) and 3571 give independent trustees "the sole discretion" to control distributions, if any, to the settlor. \textit{Id.} §§ 3570(9)(b), 3571. If anybody else were given a power exercisable in favor of the settlor, then it is likely that the trustee's "sole discretion" will have been lost, and with it, the protections of the Act similarly vanish.

\(^{138}\)The Act is silent on whether the settlor can retain lifetime powers in favor of persons other than himself. The Act, however, has expressly enumerated three rights that the settlor
other than the trustee, the power holder could order a distribution and undercut the trustee’s authority over the trust. In some cases, if the power holder is controlled by the settlor, then the settlor may again be able to convert attachable assets into unattachable ones. The settlor could instruct the power holder to distribute property to innocent beneficiaries before creditors can prevent dissipation of trust assets. This is another way to achieve the same result that might accrue if settlors could require rapid payout schedules knowing that innocent beneficiaries can keep such distributions.

Hence, no matter which way courts go, there is a risk that somebody might wrongly suffer. Innocent beneficiaries might be severely harmed if they cannot keep distributions that are made pursuant to mandatory payment schedules or, alternatively, if they cannot keep distributions that are made pursuant to the exercise of powers vested in somebody other than the trustee. On the other hand, creditors may likewise suffer if funds could be funnelled through trustees to innocent beneficiaries. In all, this is perhaps a conundrum.

C. Possible Interpretive Solutions

Fortunately, there is a solution to this potential set of problems, and it consists of several elements of statutory interpretation.

The Act envisions trustees with a vast degree of discretion over trust affairs. Consequently, the Act should be interpreted in ways that enhance, rather than restrict, the powers of trustees. That means that "vested in the trustee" should be held to modify both "discretion" and "trust power." Employing this interpretation, the innocent beneficiary clause would only apply to distributions by trustees, and not to distributions made by other persons holding trust powers. This would eliminate the risk that settlors could use powers vested in third parties to control the timing or amount of distributions.

As to the meaning of "trust powers," this phrase should also be broadly construed in favor of trustees. This could extend to innocent beneficiary protection to distributions made by trustees pursuant to set schedules, which could result in some abuse. The practical reality, however, is that the overwhelming bulk of trust funds subject to the Act...
are apt to be held by professional trustees at banks, brokerage houses, trust companies, or other similar businesses. Such trustees will be motivated to defend against abusive settlors because accepting such business could create trustee liability to a creditor.\textsuperscript{140} This implication will cut down on the likelihood of abuse.

Moreover, it is easy to see why the legislature might want to put the risk of loss on creditors rather than on innocent beneficiaries. Beneficiaries will often be sympathetic individuals or charities, whereas creditors will, in many cases, be larger entities that are more capable of absorbing a loss. Creditors will also be able to control the risk of abuse in many cases. An innocent beneficiary may keep only those distributions received "prior to the creditor's commencement of an action to avoid the qualified disposition."\textsuperscript{141} Creditors, therefore, can preempt the beneficiary's protection by quickly filing suit. This may not be a perfect arrangement from a creditor's viewpoint, but it was acceptable to the legislature, which was obviously more concerned about issues other than creditor's rights. Accordingly, the courts should respect the balance struck by the legislature, and give innocent beneficiaries wide protection, even in cases involving mandatory payouts by a trustee.

D. Does Protection Extend to Settlor-Beneficiaries?

Another interesting issue involves settlors who are also good faith beneficiaries in receipt of discretionary distributions. A settlor can be an innocent transferee, even if his settlement is ultimately deemed a fraudulent transfer. Not all fraudulent transfers are acts of actual fraud; UFTA also targets constructive fraud, in which a transfer can be voided simply because a transferor negligently left himself unable to pay legitimate creditors.\textsuperscript{142} Moreover, the negligent injury caused by such a transfer may not be discovered for many years thereafter. Under these circumstances, it is quite conceivable that a trustee could make a discretionary distribution to a settlor-beneficiary "prior to [a] creditor's

\textsuperscript{140} A trustee is exposed to money damages if it receives fraudulently transferred assets. Del. Code Ann. tit. 6, § 1308(b) (1996). A careless trustee may also be exposed to civil "aiding and abetting" liability, see, e.g., Halberstam v. Welch, 705 F.2d 472, 477-78 (D.C. Cir 1983), as well as other forms of liability. See also supra note 136 (discussing ways trustee can be held liable to creditors).


\textsuperscript{142} See Del. Code Ann. tit. 6, § 1304(a)(2)(b) (1997) (asking whether the debtor "[i]ntended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due") (emphasis added).
commencement of an action to avoid the qualified disposition,\textsuperscript{143} and before the settlor-beneficiary or the trustee was aware of a creditor grievance. On these facts, the question is whether the settlor-beneficiary may keep the distributed assets.

At this early stage, there is no clear answer. One option is that the debtor may keep the property because the Act recognizes "the right of such beneficiary to retain any distribution . . . [i]f the court is satisfied that a beneficiary . . . has not acted in bad faith."\textsuperscript{144} A second choice is to adhere to the general rule that a debtor's assets are subject to collection unless state or federal law exempts that property from levy and execution,\textsuperscript{145} and to also conclude that the Act does not by itself exempt distributions from claims by the distributee's creditors.

The second choice is the better reasoned answer. The innocent beneficiary clause only protects distributees from the consequences of "avoidance of the qualified disposition."\textsuperscript{146} This means that most beneficiaries will not have to give up their distributions to the settlor's creditors. The clause does not, however, protect against any other legal consequences. One normal consequence of a distribution is that formerly exempt assets, once in the hand of a distributee, may be attached by the distributee's creditors unless the distribution is itself independently exempt.\textsuperscript{147} Every distributee is, therefore, at risk to claims by his or her own creditors. This risk arises from the fact that the distributee is in debt, and not from any "avoidance of the qualified disposition."\textsuperscript{148} Consequently, in the absence of a state law exemption covering the distributed property, a settlor-distributee should not be able to keep distributions from his own creditors, regardless of how innocent the settlor may be.

E. Summary of the Innocent Beneficiary Clause

The upshot of these concerns is that the innocent beneficiary clause is not likely to shelter all beneficial distributions from creditors trying to

\textsuperscript{143}\textsc{Del. Code Ann. tit. 12, § 3574(b)(2) (1997).}
\textsuperscript{144}\textsc{Id.}
\textsuperscript{145}See Sullivan, supra note 75, at 973 n.53 (discussing exempt property).
\textsuperscript{146}\textsc{Del. Code Ann. tit. 12, § 3574(b)(2) (1997).}
\textsuperscript{147}See In re Cesare, 170 B.R. 37, 39 (Bankr. D. Conn. 1994) (stating general rule regarding distributions of exempt property); Guidry v. Sheet Metal Workers Nat'l Pension Fund, 39 F.3d 1078, 1082-83 (10th Cir. 1994), cert. denied, 514 U.S. 1063 (1995) (remark ing that ERISA funds lose spendthrift protection upon distribution to plan beneficiary but will be "exempt from garnishment to the extent provided by . . . [state] law").
\textsuperscript{148}\textsc{Del. Code Ann. tit. 12, § 3574(b)(2) (1997).}
attach disbursed assets. Distributions made to a bad faith beneficiary, pursuant to an improper exercise of power or discretion, or to an innocent settlor-beneficiary, are all likely to be fair game for the settlor's creditors. Likewise, any distribution will, in general, be exposed to claims by the distributee's creditors.

Despite these limits, the settlor's creditors are nonetheless confronted with a difficult problem. The garden variety beneficiary who receives assets from a trustee will, in many instances, be able to keep those assets despite later claims by the settlor's creditors. This, in turn, means that plaintiffs who wait too long to sue may find the trust fund irretrievably dissipated, either in whole or in part. The Act's innocent beneficiary clause is, therefore, a potent constraint on creditor remedies and a commensurately strong form of asset protection.

VII. NASTY SURPRISE NO. 2: THE "FIRST AND PARAMOUNT LIEN"

A. The General Terms of the Clause

As if the innocent beneficiary clause and its attendant risk of dissipation were not enough, the Act presents yet another practical problem for the settlor's creditors: many trustees involved in litigation will be entitled to recover their costs and attorneys' fees out of the trust fund before even one cent is distributed to a successful plaintiff. Indeed, there is an express presumption that trustees shall have a priority claim on trust assets. This result flows from section 3574(b)(1), which states:

(1) If the court is satisfied that the trustee has not acted in bad faith in accepting or administering the property that is the subject of the qualified disposition:

a. [t]he trustee shall have a first and paramount lien against the property that is the subject of the qualified disposition 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; [and]
b. [t]he qualified disposition shall be avoided subject to the proper fees, costs, preexisting right, claims and interests of the trustee (and of any predecessor trustee that has not acted in bad faith); and,

c. [f]or purposes of this subdivision (1), it shall be presumed that the trustee did not act in bad faith merely by accepting such property.\(^{149}\)

This provision, which can be thought of as an "innocent trustee" clause, and which is also substantially similar to Bahamian law,\(^{150}\) is


\(^{150}\)See Bahamian Fraudulent Disposition Act § 5 (1991), which states:

(a) unless the court is satisfied that the transferee has acted in bad faith —

(i) the transferee shall have a first and paramount charge over the property, the subject of the disposition, of an amount equal to the entire costs properly incurred by the transferee in the defence of the action or proceedings to set aside (and not merely such costs as might otherwise be allowed by the court), and

(ii) the relevant disposition shall be set aside subject to the proper fees, costs, preexisting rights, claims and interests of the transferee, (and of any predecessor transferee which has not acted in bad faith).

Other offshore statutes raise the possibility of similar treatment for trustees in still other jurisdictions. Article 22(2) of the Trusts (Jersey) Law (1984) (as amended by the Trusts (Amendment) (Jersey) Law (1989)), states, "A trustee may reimburse himself out of the trust for or pay out of the trust all expenses and liabilities reasonably incurred in connexion with the trust." Section 31 of the Nevis International Exempt Trust Ordinance (1994 as amended) gives the court broad discretion to award fees and expenses payable by the trust fund ("The Court may order the cost and expenses of and incidental to an application to the Court under this Ordinance to be paid from the trust property or in such manner and by such persons as it thinks fit."). Nevis International Exempt Trust Ordinance § 31 (1994 as amended).

In one sense, the Delaware Act's protection of trustees is nothing new: it merely codifies prevalent United States law, which generally gives a trustee a priority lien on the trust estate as security for reimbursement of proper expenses. See Scott & Fratcher, supra note 5, § 244.1. Still, the similarity in phrasing between the Act and the Bahamas statute (i.e., "first
clearly designed to safeguard the interests of Delaware trustees. First, unless the fact finder concludes that the trustee acted in bad faith, the trustee's claims are "first and paramount" over those of all other persons, including beneficiaries and creditors. This phrasing unequivocally places the interests of local trustees above those of all other persons and connotes a strong legislative policy to protect all but the most wayward of trustees. The governing legal standard reinforces this policy. The test is whether the trustee acted in bad faith, and not whether he acted in good faith. In close cases, this means that the trustee will get the benefit of the doubt, as an absence of good faith is not automatically the same thing as proving that the trustee acted in bad faith. Indeed, one can easily envision cases in the proverbial "gray area," and in those instances the trustee should emerge with its lien intact.

The innocent trustee clause also has the effect of encouraging trustees to fight, which in turn means that the Act is more likely to deter

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131 Trustees under the Act will have Delaware ties to one degree or another. See infra note 200; see also supra note 65, for a comparable approach under Nevis law.


133 This conclusion is illustrated by the following hypothetical: a trustee undertook due diligence in advance of settlement and found no reason to refuse a proposed trust settlement. In particular, as a pre-condition to settlement, the trustee required the settlor to sign an affidavit attesting to the settlor's solvency and the lack of pending claims against him. The trustee also reviewed public records in the settlor's home county and county of employment and found no judgments or pending claims against the settlor. Further, the proposed beneficiaries seemed entirely innocent, such as minor children or bona fide charities. Based on these facts, the trustee agreed to take the trust business. Either by design or inadvertence, however, the settlor did not disclose that he was recently involved in a transaction that would likely result in a substantial, but disputed, claim and that, due to this trust settlement, the settlor might not be able to fully satisfy the liability that could arise from his transaction. If, thereafter, a plaintiff takes a large judgment against the settlor, and if the plaintiff seeks to void the settlement in order to satisfy the judgment, then the plaintiff would inevitably sue the trustee as part of any suit under UFTA: the transferee is a necessary party, especially if he still holds title to the transferred property. In re Schneider, 99 B.R. 52, 56 (Bankr. W.D. Wash. 1989) (applying rule to trustees); Simmons v. Clark Equipment Credit Corp., 554 So.2d 398, 401 (Ala. 1989) (applying rule to trustees); Fraley Ins. Agency v. Johnston, 784 P.2d 430, 431 (Okla. Ct. App. 1989); see also Fed. R. Civ. P. 19(a) (discussing persons to be joined if feasible); Del. R. Civ. P. 19(a) (discussing persons to be joined if feasible). The trustee, however, may feel compelled to fight the plaintiff's claim in order to protect the interests of its innocent beneficiaries, see SCOTT & FRATCHER, supra note 5, §§ 176, 178 (discussing trustee's duties to preserve trust property and to defend against claims), particularly because there is legitimate room to contest whether the settlement violated UFTA due to the contingent or uncertain nature of the plaintiff's claims. See Sullivan, supra note 75, at 1012-14 (regarding discounting of liabilities). On these facts, one might criticize the adequacy of the trustee's due diligence or the wisdom of fighting the UFTA claim, but it would be difficult to demonstrate that the trustee acted in bad faith. Accordingly, the trustee's lien should be left intact.
challenges or lead plaintiffs to settle for less than might otherwise be the case. Trustees are under a general duty to preserve trust property for the sake of their beneficiaries. 154 This provision includes a duty to defend against claims to trust assets. 155 Despite these duties, many trustees will inevitably feel the urge to settle more quickly and generously if they fear that their legal fees might come out of their own funds. The Act, however, mitigates this economic consideration and, so long as the trust fund is adequate, confers on trustees the security and comfort of knowing that somebody else — the trust fund — will usually pay their legal fees. This psychological and financial advantage could easily become a considerable practical factor in litigation. A large trust fund could give a trustee substantial staying power and the ability to overwhelm a plaintiff with motions, discovery proceedings, and other tactics. Indeed, other than a finding of bad faith, the only limits to a trustee's ability to finance litigation are the size of the trust fund itself and the question of whether the trustee's fees and expenses were "properly incurred." 156

B. Standing to Challenge a Lien

An initial issue to examine is who has standing to challenge a trustee's lien. 157 Presumably, a plaintiff will lack standing to challenge a trustee's lien if the plaintiff loses a suit to avoid a transfer. The Act is silent on this point, but it seems to be a sensible conclusion. A losing plaintiff has no right to any trust assets and, therefore, should have no right to complain about the size of a lien on those assets. It is, however, less certain whether a successful plaintiff has standing to challenge the size of a lien. If sufficient funds exist to satisfy a plaintiff after a lien is attached, then presumably this plaintiff also lacks standing even if the dollar amount of the trustee's lien is arguably excessive. Once again, the

154 See SCOTT & FRATCHER, supra note 5, § 176, at 482.
155 Id. § 188.4, at 62.
156 DEL. CODE ANN. tit. 12, § 3574(b)(1)(a) (1997) (referring to "the entire cost, including attorneys' fees, properly incurred . . . in the defense of the action or proceedings to avoid the qualified disposition"). For more, see infra notes 157-86.
157 Standing has been called one of "the most amorphous (concepts)" in the law. Flast v. Cohen, 392 U.S. 83, 99 (1968) (referring to "public law" questions). "The 'gist of the question of standing' is whether the party seeking relief has 'alleged such a personal stake in the outcome of the controversy as to assure that concrete adverseness which sharpens the presentation of issues upon which the court so largely depends for illumination of difficult . . . questions." Id. "In essence the question of standing is whether the litigant is entitled to have the court decide the merits of the dispute or of particular issues." Warth v. Seldin, 422 U.S. 490, 498 (1975).
rationale is that the plaintiff suffers no harm because his judgment can be fully satisfied. Consequently, a successful plaintiff should have standing to challenge a trustee's lien only when the trustee's lien consumes so much of the trust fund that a plaintiff cannot fully satisfy his judgment. Additionally, trust beneficiaries should always have standing to challenge a lien: every dollar saved on litigation expenses is, all things being equal, another dollar available for distribution to those beneficiaries, thus giving them a concrete stake in this issue and standing to object.

Apart from beneficiaries and successful-but-unsatisfied plaintiffs, however, nobody should have standing to challenge a trustee's lien. Furthermore, in the absence of objections by persons with standing, the court should conserve its resources by abstaining from disputes over whether liens were "properly incurred."

C. Were Fees "Properly Incurred"? Remedies, Merits, Procedures and Abstention

If a lien is challenged, a court might write down or even wholly disallow a trustee's claim against a trust fund on the grounds that fees and expenses were not properly incurred. Because the Act, however, intends to protect trustees, the legislative policy indicates that courts should tread cautiously before disallowing fees.

The question of whether fees are "properly incurred" raises the spectre of considerable attorney fees litigation reminiscent of proceedings under the Civil Rights Act or the Bankruptcy Code. A common judicial approach in these cases is the "lodestar" method, which starts with the number of hours worked by attorneys multiplied by appropriate

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158 This, in turn, creates ancillary questions. For instance, if the judgment creditor cannot immediately satisfy a judgment due to the size of the trustee's lien, but the judgment debtor is likely to receive attachable assets from other sources in the near future, does this mean that the court should wait before ruling on any challenge to a lien?

159 A beneficiary may have difficulty in successfully challenging a lien due to trust language that confers contractual lien rights on trustees, that gives trustees very broad discretion to incur expenses, or that otherwise limits the viability of a beneficiary's challenge. This, though, speaks to the merits of an objection and not to whether beneficiaries have standing to object.

160 For instance, a court might find that the costs of certain motions should be disallowed because they were patently frivolous, excessive, or cumulative of prior motions. A court might also find that the hourly rates charged by the trustee's attorneys were too high, or that the fees were inadequately documented due to deficient time-keeping records. Likewise, certain trial expenses might be disallowed.
