Bloomberg Tax

Tax Management Estates, Gifts and Trusts Journal™

Domestic Asset Protection Trusts and Fraudulent Transfer Jurisdiction

By James P. Menton, Jr., Esq.[*]

The common law rule is that self-settled spendthrift trusts may be reached by creditors. Over the years, several domestic jurisdictions, including South Dakota, Nevada, and Alaska, have enacted statutory provisions to protect self-settled spendthrift trusts from creditors. These trusts, often called ''domestic asset protection trusts'' (DAPTs), may come under attack, however, and may ultimately not shield assets from creditors (and thus from bankruptcy trustees). In particular, a DAPT may not insulate a settlor from a claim that assets were fraudulently transferred into the trust. In *Toni 1 Trust v. Wacker*, the Alaska Supreme Court considered the issue of whether Alaska could prevent other state and federal courts from exercising subject matter jurisdiction over fraudulent transfer claims against an Alaska DAPT.[1] The court said no.

TONI 1 TRUST V. WACKER

After a Montana state court issued a series of judgments against Donald Tangwall, his wife Barbara, and mother-in-law Toni Bertran, Barbara and Toni transferred Montana real property to the Toni 1 Trust (Trust), a DAPT allegedly created under Alaska law. The judgment creditors filed a fraudulent transfer action under Montana law in Montana state court, alleging that the transfers were made to avoid the judgments. The Montana court entered default judgments against the Trust, Barbara, and Toni.

After the fraudulent transfer judgments were issued, the judgment creditors purchased Barbara's 50% interest in a parcel of property at a sheriff's sale. Before the judgment creditors could purchase Toni's remaining 50% interest in the parcel, Toni filed Chapter 7 bankruptcy in Alaska, resulting in her interest in the parcel becoming subject to the jurisdiction of the bankruptcy court. The Chapter 7 trustee later brought a fraudulent transfer claim under Bankruptcy Code §548 against Donald as trustee of the Trust and obtained a default judgment against him.

Donald, as trustee of the Trust, then filed a complaint in Alaska state court, arguing the state and federal judgments were void for lack of subject matter jurisdiction because Alaska state courts have exclusive jurisdiction over fraudulent transfer claims against the Trust under Alaska Stat. §34.40.110(k). Section 34.40.110(b)(1) creates a limited cause of action for fraudulent transfers — a creditor of a settlor of a spendthrift trust can reach trust property if the creditor can prove that the settlor's transfer of property to the trust ''was made with the intent to defraud that creditor.''[2] Alaska Stat. §34.40.110(k) purports to grant Alaska courts exclusive jurisdiction over fraudulent transfer claims against Alaska self-settled spendthrift trusts: ''A court of this state has exclusive jurisdiction over an action brought under a cause of action or claim for relief that is based on a transfer of property to a trust that is the subject of this section.''

Donald sought a declaratory judgment that all judgments against the Trust from other jurisdictions were void and that no future actions could be maintained against the Trust because the statute of limitations had run. The trial court dismissed the complaint. The Alaska Supreme Court affirmed.

In affirming, the Alaska Supreme Court relied on *Tennessee Coal, Iron & Rail Road Co. v. George* in determining that the full faith and credit clause of the Constitution does not compel states to acquiesce to

---

[*] James P. Menton, Jr. is a partner at Robins Kaplan LLP in Los Angeles. His practice is primarily focused on business litigation, bankruptcy, creditor's rights, and trust-related commercial disputes.

[1] 413 P.3d 1199 (Alaska 2018).

[2] Alaska Stat. §34.40110(b)(1) provides that creditors must also satisfy additional requirements set forth in Alaska Stat. §34.40.110(d).

ISSN 0886-3547

another state's attempt to circumscribe their jurisdiction over transitory actions even though that state created the right of action.[3]

In *Tennessee Coal*, an employee sued his employer in Georgia court based upon an Alabama statutory cause of action. The employer responded that Alabama state courts retained exclusive jurisdiction over the action under the Alabama Code, and that the full faith and credit clause required Georgia courts to respect Alabama's assertion of exclusive jurisdiction. The Supreme Court found that full faith and credit does not so require, stating ''jurisdiction is to be determined by the law of the court's creation and cannot be defeated by the extraterritorial operation of a statute of another State, even though it created the right of action.''[4]

The Alaska Supreme Court stated that Alaska Stat. §34.40.110(k) goes beyond the limit recognized by *Tennessee Coal* in purporting to grant Alaska courts exclusive jurisdiction over a type of transitory action, which includes fraudulent transfer actions, against Alaska trusts. Recognizing the analogy is ''imperfect'' because the Montana court's judgment against Donald was based on a cause of action under Montana law relating to an Alaska Trust, rather than on a fraudulent transfer cause of action created under an Alaska statute, the Alaska Supreme Court concluded that *Tennessee Coal* controls, and that ''[t]he clear implication is that the constitutional argument rejected in *Tennessee Coal* would be even less compelling were a state to assert exclusive jurisdiction over suits based on a causes of action it did **not** create.''[5]

In this case, the Alaska Supreme Court stated, ''[i]n seeking to void the Montana court's judgment for lack of jurisdiction, [Donald] effectively argues that AS 34.40.110(k) can deprive Montana courts of jurisdiction over cases arising under Montana law. This is simply a more extreme interpretation of the 'full faith and credit' principle than the interpretation considered and rejected in *Tennessee Coal*.''[6]

The Alaska Supreme Court concluded: ''The basic principle articulated in *Tennessee Coal* has not changed in the last century. As applied to this case, it means that AS 34.40.110(k)'s assertion of exclusive jurisdiction does not render a fraudulent transfer judgment against an Alaska trust from a Montana court void for lack of subject matter jurisdiction.''[7] The Alaska Supreme Court, therefore, could not grant Donald the relief sought from the Montana judgment.

The Alaska Supreme Court also found that Alaska Stat. §34.40.110(k) cannot limit the scope of a federal court's jurisdiction because a state cannot restrict federal courts' jurisdiction even though the state created the right of action, citing *Marshall v. Marshall*,[8] which the Alaska Supreme Court stated ''confirmed that the *Tennessee Coal* rule also applies to claims of exclusive jurisdiction asserted against **federal** courts.''[9] The Alaska Supreme Court also noted that Alaska Stat. §34.40.110(k), if attempting to limit federal jurisdiction, likely runs afoul of the Constitution's Supremacy Clause.

Accordingly, the court found the Chapter 7 trustee's fraudulent transfer judgment under Bankruptcy Code §548 was not void for lack of subject matter jurisdiction.

PRACTICAL CONSIDERATIONS

Toni 1 Trust evidences that you cannot necessarily rely on a DAPT state statute to establish jurisdiction in situations involving fraudulent transfer actions in a non-DAPT state. As a result, another state's fraudulent transfer law and/or the Bankruptcy Code may be able to be used to reach assets in a DAPT.

Further, providing for applicable law in a trust document may not prevent it from being disregarded. For example, in *Waldron v. Huber (In re Huber)*,[10] the bankruptcy court sitting in Washington (a non-DAPT state) disregarded the settlor's choice of Alaska law and applied Washington State law and found that the settlor's transfers of assets to an Alaska Trust were fraudulent under Bankruptcy Code §548 and Washington State fraudulent transfer law.

In *Huber*, Donald Huber (Huber) was a real estate developer in Washington State. Huber resided and had his principal place of business in Washington State, and most of his assets were located there. Huber established a self-settled asset protection trust (Trust), which adopted Alaska as the governing law. Huber's son, step-daughter, and Alaska USA Trust Company (AUSA) were the trustees. Huber transferred more than 70% of his assets to the Trust. Substantial distributions from the Trust were made to or for the benefit of Huber, and the record before the court ''indicates that AUSA did nothing to become involved with the preservation and/or protection of the assets of the Trust and was acting merely in the nature of a straw man.''[11]

In 2011, Huber filed for Chapter 11 bankruptcy protection. The case was later converted to Chapter 7.

---

[3] 413 P.3d at 1204. *See Tennessee Coal, Iron & R.R. v. George*, 233 U.S. 354 (1914).

[4] 233 U.S. at 360.

[5] 413 P.3d at 1204 (emphasis in original).

[6] *Id.*

[7] *Id.* at 1205–1206 (citation omitted).

[8] 547 U.S. 293 (2006).

[9] 413 P.2d at 1206 (emphasis in original).

[10] 493 B.R. 798 (Bankr. W.D. Wash. 2013).

[11] 493 B.R. at 806.

ISSN 0886-3547

The Chapter 7 trustee filed an adversary proceeding against Huber and was granted summary judgment invalidating the transfers to the Trust based on theories that the Trust was invalid under state law and the transfers fraudulent under federal bankruptcy law and Washington State law.

In determining the validity of the Trust, the bankruptcy court first addressed a choice of law issue, as Alaska recognizes self-settled asset protection trusts and Washington State does not. As the bankruptcy court was exercising federal bankruptcy jurisdiction, the bankruptcy court applied federal choice of law rules to determine whether Alaska or Washington State law applied. Federal choice of law rules follow the Restatement (Second) of Conflict of Law. The applicable section of the Restatement is §270, which provides that a trust is valid if valid ''under the local law of the state designated by the settlor to govern the validity of the trust, provided that this state has a substantial relation to the trust and that the application of its laws does not violate a strong public policy of the state with which, as to the matter of the issue, the trust has the most significant relationship . . . .''

In applying the Restatement, the bankruptcy court found that when the Huber Trust was created ''the settlor was not domiciled in Alaska, the assets were not located in Alaska, and the beneficiaries were not located in Alaska. The only relation to Alaska was that it was the location in which the Trust was to be administered and the location of one of the trustees, AUSA.''[12] Thus, Alaska had ''a minimal relation'' to the Trust when created. By contrast, the bankruptcy court found that Washington State had ''a substantial relation'' to the Trust when created: ''The Debtor resided in Washington; all of the property place into the Trust, except a $10,000 certificate of deposit, was transferred to the Trust from Washington; the creditors of the Debtor were located in Washington; the Trust beneficiaries were Washington residents; and the attorney who prepared the Trust documents and transferred the assets into the Trust were located in Washington.''[13]

Given Washington State's substantial relationship with the Trust and Washington State's ''strong policy against self-settled protection trusts,'' in accordance with Restatement §270, the bankruptcy court disregarded the settlor's choice of Alaska law and applied Washington State law. In applying Washington State law, the bankruptcy court found that Huber's ''transfers of assets into the Trust were void as transfers made into a self-settled trust,'' and that the Chapter 7 trustee ''is entitled to summary judgment as a matter of law to the extent the Trustee seeks to have the transfers invalidated.''[14]

The bankruptcy court then considered and found that Huber's transfers of assets into the Trust were fraudulent under Bankruptcy Code §548(e) and the Washington Uniform Fraudulent Transfers Act. The bankruptcy court found that Huber's fraudulent intent to hinder, delay, and defraud creditors was established by numerous badges of fraud, including threatened litigation against him; the transfer of all or substantially all of his assets into the Trust; the Trust was a self-settled trust; his substantial indebtedness; he continued to benefit from the transferred assets, including the granting of substantially all of his requests for distribution; he received no consideration for the transfer; and evidence that he feared losing his assets to creditors given the declining real estate market, the inability to secure financing, and mounting indebtedness. The bankruptcy court concluded the trustee was entitled to summary judgment as a matter of law on the fraudulent transfer claims.

In *Marine Midland Bank v. Portnoy (In re Portnoy)*,[15] the court stated that ''[w]hereas under normal circumstances parties are free to designate what state's or nation's law will govern their rights and duties, where another state or nation has a dominant interest in the transaction at issue, and the designated law offends a fundamental policy of that dominant state, the court may refuse to apply the foreign law.''[16] The court considered the public policy of New York against self-settled trusts and concluded equity would not countenance applying the law of the offshore trust situs: ''Portnoy may not unilaterally remove the characterization of property as his simply by incorporating a favorable choice of law provision into a self-settled trust of which he is the primary beneficiary. Equity would not countenance such a practice.''[17]

Practitioners would be well served to consider the implications of these decisions when advising clients on wealth transfer strategies, design plans keeping fraudulent transfer laws in mind, and stay current on legal developments.

---

[12] 493 B.R. at 808.

[13] 493 B.R. at 808–809.

[14] 493 B.R. at 809.

[15] 201 B.R. 685 (Bankr. S.D.N.Y. 1996).

[16] 201 B.R. at 699.

[17] 201 B.R. at 701.

ISSN 0886-3547