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Opinion No. 11-79

Creditors' Claims under the Tennessee Investment Services Act of 2007

QUESTION

Whether the Tennessee Investment Services Act of 2007 requires a creditor to prove fraud in order to prevail on an action for attachment or other provisional remedy against property that is a qualified disposition to an investment services trust, or to avoid a qualified disposition to such a trust?

OPINION

Yes. If the creditor's claim arises before a qualified disposition, the creditor may prevail by proving actual or constructive fraud. However, if the creditor's claim arises after a qualified disposition, the creditor must prove actual intent to defraud.

ANALYSIS

The Tennessee Investment Services Act of 2007 ("the Act"), codified at Tenn. Code Ann. §§ 35-16-101 to 112, permits a person to establish an irrevocable "investment services trust" that shields trust assets from the transferor's future creditors. *See* Tenn. Code Ann. § 35-16-102(7) & (14); Tenn. Code Ann. § 35-16-104. Prior to the passage of this Act, Tennessee law did not permit a person to create a spendthrift trust for his or her own protection. *See Citizens' Nat'l Bank v. Watkins*, 126 Tenn. 453, 150 S.W. 96, 97 (Tenn. 1912); *J.S. Menken Co. v. Brinkley*, 94 Tenn. 721, 31 S.W. 92, 94 (Tenn. 1895); *State v. Nashville Trust Co*., 28 Tenn. App. 388, 190 S.W.2d 785, 790 (1945). *See also* 2007 Tenn. Pub. Acts Ch. 144, § 13.

Under Tenn. Code Ann. § 35-16-102(7) of the Act, a trust instrument must meet four requirements before it will qualify as an "investment services trust." First, the instrument must appoint a "qualified trustee," as defined by Tenn. Code Ann. § 35-16-102(12). Second, the trust must expressly incorporate Tennessee law regarding the validity, construction, and administration of the trust. Third, the trust must be irrevocable. Finally, the trust instrument must provide that "the interest of the transferor or other beneficiary in the trust property or the income from the trust property may not be transferred, assigned, pledged or mortgaged, whether voluntarily or involuntarily, before the qualified trustee or qualified trustees actually distribute the property or income from the property to the beneficiary." Tenn. Code Ann. § 35-16-102(7)(C).

Tenn. Code Ann. § 35-16-104 of the Act addresses creditors' claims against property subject to a "qualified disposition,"[1] stating in pertinent part:

> (a) Notwithstanding any law to the contrary, no action of any kind, including, but not limited to, 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 to an investment services trust or for the avoidance of a qualified disposition to an investment services trust, unless the action is brought pursuant to the provisions of the Uniform Fraudulent Transfer Act, compiled in title 66, chapter 3, part 3, and, in the case of a creditor whose claim arose after a qualified disposition, unless the qualified disposition was also made with actual intent to defraud such creditor.
>
> (b) A creditor's claim under subsection (a) shall be extinguished unless:
>
> (1) The creditor's claim arose before the qualified disposition to an investment services trust was made, and the action is brought within the limitations of § 66-3-310 in effect on the date of the qualified disposition; or
>
> (2) Notwithstanding § 66-3-310, the creditor's claim arose concurrent with or subsequent to the qualified disposition and the action is brought within four (4) years after the qualified disposition is made.

Tenn. Code Ann. § 35-16-104(a)&(b).

Accordingly, pursuant to Tenn. Code Ann. § 35-16-104(a), a creditor must bring his or her action for attachment or other provisional remedy against property in the qualified disposition pursuant to the Uniform Fraudulent Transfer Act ("UFTA"). The UFTA contains two sections addressing creditors' claims seeking to avoid and recover fraudulent transfers. The first section addresses the avoidance and recovery of fraudulent transfers by existing and future creditors, and provides:

> (a) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:
>
> (1) With actual intent to hinder, delay, or defraud any creditor of the debtor; or
>
> (2) Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:

[1] A "qualified disposition" is "a disposition by or from a transferor with or without consideration, to an investment services trust after the transferor executes a qualified affidavit." Tenn. Code Ann. § 35-16-102(11).

> (A) Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
>
> (B) Intended 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.

Tenn. Code Ann. § 66-3-305(a).

In short, subsection (a)(1) requires the creditor to prove actual fraud by the debtor in order to avoid and recover the transfer of property by the debtor as a fraudulent transfer. Subsection (a)(2) requires only a showing of constructive fraud, meaning the property at issue may be avoided and recovered as a fraudulent transfer by a creditor without proving an actual intent to defraud. *In re Webb Mtn*., *LLC*, 420 B.R. 418, 431 (Bankr. E.D. Tenn. 2009); *In re Silvey*, 378 B.R. 186, 189 (Bankr. E.D. Tenn. 2007).

The second section of the UFTA addressing creditors' claims is Tenn. Code Ann. § 66-3-306. It addresses avoidance and recovery of fraudulent transfers by existing creditors, stating:

> (a) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation.
>
> (b) A transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made if the transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent.

Tenn. Code Ann. § 66-3-306.

Like Tenn. Code Ann. § 66-3-305(a)(2), Tenn. Code Ann. § 66-3-306 requires a showing of constructive fraud. *In re Webb Mtn*., *LLC*, 420 B.R. at 18; *In re Silvey*, 378 B.R. at 190-91. Accordingly, if a creditor's claim arises before a qualified disposition, pursuant to Tenn. Code Ann. § 35-16-104(b) the creditor will prevail on an action for attachment or other provisional remedy against property that is a qualified disposition to an investment services trust, or for the avoidance of a qualified disposition to such a trust, if the creditor establishes either actual or constructive fraud by the transferor of the property.

The aforementioned UFTA provisions govern any actions by an existing creditor to attach or pursue any other provisional remedy against property in a qualified disposition. However, with respect to a creditor's claim arising after a qualified disposition, Tenn. Code Ann. § 35-16-104(a) grafts an additional limitation on the UFTA's provisions by requiring such a creditor to show that the qualified disposition was made with the actual intent to defraud the

creditor. Thus, if a creditor's claim arises after a qualified disposition, the creditor must prove actual fraud in order to prevail on an action for attachment or other provisional remedy against property that is a qualified disposition to an investment services trust or for the avoidance of a qualified disposition to such a trust.

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