Asset Protection Planning
With Third Party Trusts

- *Wall Street Journal, Bloomberg*
- 12 years ago – HEMS & Age Vesting
- Bill Gates
- Grandma Nancy

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Mark is also a national speaker. He is past President of the Stanford Place Toastmasters with CTM and ATM designations. Mark received one of the highest evaluations that a speaker has ever received from WealthCounsel, the Better Business Bureau, the International Association of Financial Planners, and the Chartered Life Underwriters. In addition to numerous publications on estate planning, asset protection planning, and international law, Mark Merric is also co-author of the following three treatises:

- **Asset Protection Strategies**, American Bar Association (two chapters)
- **Asset Protection Strategies Volume II**, American Bar Association to be published Apr. 2005 (MM responsible for 1/5 of the text).
Derivations of the Discretionary Dynasty Trust

- Beneficiary Controlled Trust
- Inheritor’s Trust
- Mega Trust

For purposes of this outline –
- Discretionary Dynasty Trust

A. Derivations of Discretionary Dynasty Trusts

The term “beneficiary controlled trusts” and “inheritor’s trusts” were coined and is trademarked by Richard Oshins, Steven Oshins, and Noel Ice. Many times these trusts are also referred to as discretionary dynasty trusts, and have been frequently discussed by such prominent speakers as John Blatmachr and Roy Adams.
B. Benefits of Gifts and Trusts

The above slide details many key benefits of gifting property through the use of trusts. While many of the above benefits are either benefits to the settlor or the benefits save estate tax, there is one key benefit to the beneficiaries – the protection of his or her inheritance from future creditors, misfortunes, and estranged spouses.
C. Keys to a Discretionary Dynasty Trust

As used in this outline, a discretionary dynasty trust is a trust where a beneficiary receives his or her inheritance in trust, but has a large amount of influence over the trust due to holding a removal/replacement power.

1. Removal/Replacement Power

Until the death of the settlor (or possibly the later of the death of the settlor or the settlor’s spouse), the settlor retains the right to remove and replace a trustee who is independent within the meaning of IRC §672(c). However, upon the death of the settlor (or the latter death of the settlor or settlor’s spouse), this removal/replacement power vests in the child (assuming the child is over a certain age such as 30 or 35).

2. Discretionary Trust

The trust provides that the trustee may make distributions to anyone of the beneficiaries in the trustee’s sole and absolute discretion. Further, the trustee may make unequal distributions among the beneficiaries and may distribute all of the trust to one of the beneficiaries.

3. Spouse as a Safety Valve - Defined as a Variable

The “settlor’s spouse” is named as a beneficiary. The trustee may now borrow the assets from the insurance policy and make distributions to the settlor’s spouse. These distributions may be used for family purposes. Naturally, if the settlor’s spouse is named in the trust as a beneficiary, problems may easily arise in the event of a divorce. No client would want an estranged spouse suing for distributions from a trust that was funded with his or her assets. Therefore, rather than naming the spouse, the spouse should be defined as a variable – “the person the settlor is currently married to.” Please note that if husband and wife both settle separate trusts, due to the doctrine of reciprocal trusts only one spouse should only be a beneficiary of one trust.

There should be no estate tax inclusion issue by naming a spouse as a safety valve, because divorce is considered an “act of independent significance.” PLR 88190001; PLR 9141027; Rev. Rul. 80-255; Estate of Tully, 528 F.2d 1401 (Ct. Cl. 1976). Also see GCM 36681 where remarriage is also an “act of independent significance.”
4. Options & Mistakes

The issue of “who may be a trustee,” becomes particularly very important with discretionary dynasty planning. As will be discussed in detail later, the safest option is the use of an independent trustee. On the other hand, under current law a distribution trustee combined with a managing trustee should also work.

Many problems arise when the drafting attorney attempts to get the best of both worlds such as a sole trustee/beneficiary of a discretionary trust under local law. Also, if a support trust is drafted under local law.
a. **Limited Liability Company or FLP**

   i. **Minority/Marketability Discounts**

   With a well drafted operating agreement, the following percentage minority/marketability discounts are common based on the underlying assets:

   1. 30%-40% Marketable Securities
   2. 45%-50% Real Estate
   3. 50%-55% Operating Business Interests

   ii. **Control**

   The client typically retains control over the assets held by the LLC in his or her capacity as manager of the LLC or general partner of the FLP.

   iii. **Internal Control**

   Since the trustee does not have direct access to the assets of the limited liability company, the risk of misappropriation of assets is greatly reduced.
b. Managing / Distribution Trustees

Some estate planners have proposed an alternative to the upper tier LLC (or FLP). These estate planners recommend using the following two co-trustees with different functions:

(1) Managing Trustee – The managing trustee typically will be the settlor’s spouse or child. The managing trustee will have signature authority over investments and make all investment decisions. The managing authority will have absolutely no authority to make any distribution decisions. Many times the managing trustee will have a removal/replacement power over the distribution trustee.

(2) Distribution Trustee – The distribution trustee’s only function is to make distribution decisions. To avoid any possible estate tax inclusion issues, almost always, the distribution trustee is independent within the meaning of IRC § 672(c).

As discussed later in this outline, from an asset protection perspective, this design option is weaker than the tiered structure on the proceeding page. How much weaker is in a large part determined by who serves as the independent trustee on either structure. For example, if mom’s best friend serves as trustee and mom holds a removal power over such person, many estate planners argue that mom has dominion and control over the structure.
Distribution Trustee Provisions
(Complements of WealthDocs, LLC)

Definitions Section of Document

Distribution Trustee

The term “my Distribution Trustee” or “Distribution Trustee” refers to a person or a corporate fiduciary who is qualified to serve as an Independent Trustee and is appointed as Distribution Trustee in one or more trusts under this agreement. A Distribution Trustee’s authority is limited to participating in discretionary distributions specifically assigned to the Distribution Trustee, and has no other powers or responsibilities.

(a) Distribution Trustee Succession Upon My Death

I appoint Independent Bank Trustee to serve as the Distribution Trustee upon my death.

(b) Distributions of Income and Principal

The Distribution Trustee may distribute to the beneficiary or the beneficiary’s descendants, or both, as much of the income and principal of the trust as discussed in the following distribution provisions. No other Trustee may make discretionary distributions from the beneficiary’s trust. The distribution trustee has no authority to make any trustee decisions other than distribution decisions.

All distribution language and distribution guidelines are modified to state “the distribution trustee” instead of “my trustee.”
5. Trust Splits Into Separate Trusts

Upon the settlor’s death (or, if a first marriage, possibly the latter of the settlor’s death or the settler’s spouse’s death), the trust is split into separate trusts for each child. While some planners use a multiple beneficiary (i.e., a “pot trust”) when they create dynasty trusts, this author recommends against such an approach. If a multiple beneficiary trusts is used, the trustee of this discretionary trust will need to determine who should get what between children at the same generational level. The children will each have different opinions on what investments assets should be held by the trust. Finally, which child is going to have the removal/replacement power over the trustee? If the trust is divided into separate dynasty trusts, one for each child of the settlor, the sibling arguments are minimized.
6. Each Child Now Holds a Removal/Replacement Power

Assuming the child has reached a specified age of maturity (age 30, 35, or 40), each child receives a removal/replacement power over the trustee. Since each child has a separate trust, different trustees may serve on each separate dynasty trust, and each trustee may make investment decisions independently of the other trustee(s) on the other child trusts.
7. Trustee Must Be Able to Distribute All Assets to the Primary Beneficiary

One of the fundamental keys to a discretionary dynasty trust is that the beneficiary is willing to receive their inheritance in trust, rather than outright. During the beneficiary’s life, if a beneficiary must share the trust assets with their children by the terms of the trust, then the beneficiary would most unlikely be unwilling to receive the assets in trust. Therefore, a trustee must have the power to distribute all of the assets of the trust to the primary beneficiary, should the trustee choose to do so. In addition to the asset protection benefits, this is why the trust must be drafted as a “discretionary trust” under common law, because the trustee in his or her sole and absolute discretion must have the ability to make distributions to one beneficiary and exclude all others.

Please note as discussed later in this outline, the UTC and the Third Restatement most likely destroy this feature of most discretionary dynasty trusts.
8. Upon the Death of the Child

Upon the death of the child assuming the trust has not been consumed, the trust splits again so that each grandchild trust has a separate dynasty trust. If the grandchild has reached a specified age of maturity, then each grandchild holds a removal/replacement power over the trustee.

9. Dynasty Trusts and the Rule Against Perpetuities

As related to the children, it does not matter whether or not the trust is created in a jurisdiction that has abolished the rule against perpetuities. If a trust must vest twenty-one years plus a life in being, it will automatically survive to the grandchild level, maybe the next generation. In this respect, the child does not hold any vested remainder which may be considered a property interest or an enforceable right under state law.
Summary of Nine Keys

1. Settlor holds removal/replacement power over the trustee

2. Discretionary distribution standard

3. Spouse as a safety valve

4. Tiered FLP & LLC structure

5. Trust splits on death of the Settlor

6. Beneficiary receives removal/replacement power

7. Trustee may distribute all assets to the primary beneficiary

8. Upon the death of the primary beneficiary (i.e., the child), the trust again splits

9. The trusts are dynasty trusts

10. Summary of the Nine Keys

   a. Nice Options, But Not Necessary

      The following two of the nine keys are nice options that turbo charge the discretionary dynasty trust; however, they are not essential:

      (1) Spouse as a beneficiary serves as a safety valve;
      (2) Tiered FLP and LLC structure.

   b. Helps Keep Children From Fighting

      Most children would prefer not participating in a beneficiary controlled trust if such child might possibly end up sharing part of his or her inheritance with another child. Therefore, the following elements are regarded as essential, but not absolutely essential:

      (1) Trust splits on the death of the settlor into a separate trust for each child;
      (2) Upon the death of the child (i.e., primary beneficiary) of the separate child trust, the trust splits again – one separate trust for each grandchild;
      (3) The settlor holds a removal/replacement power over the trust until death;
      (4) After the settlor’s death, each child holds a removal/replacement power over each separate trust.

   c. Absolutely Essential For a Beneficiary Controlled Trust

      Each of the following three keys are absolutely essential for a discretionary dynasty trust:

      (1) Discretionary distribution standard;
      (2) Trustee may distribute all of the assets to the primary beneficiary; and
      (3) Trusts are dynasty trusts.
D. Self Settled Trusts

Almost all of this outline focuses on third party trusts - generally trusts that are created for the benefit of child or grandchild. However, prior to discussing third party trusts, a brief discussion regarding the lack of asset protection for most self settled trusts follows.
The general rule for self-settled trusts is a creditor may reach the maximum amount that the trustee could distribute to the settlor.\(^1\) With a fully discretionary trust as to income and principal, this would be the entire trust corpus.\(^2\) With a support trust, this may well be the entire trust corpus or possibly a lesser amount.\(^3\)

1. **Revocable Trust**

   In this respect, a revocable trust (also known as a living or loving trust) provides no asset protection whatsoever – even if the trust contains spendthrift provisions.

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\(^1\) Restatement (Second) Trusts, Section 156 (1959), and comments d. and e. Hughes v. Commr. or Internal Revenue Service, 104 F.2d 144 (9th Cir. 1939); Byrnes v. Commr., 110 F.2d 294 (3rd Cir. 1940); Nelson v. California Trust Company, 202 P.2d 1021 (1949); Greenwich Trust Co. v. Tyson, 27 A.2d 166 (1942).


2. **Retained Mandatory Distribution**

   a. **Attachment of a Mandatory Distribution**

   A mandatory interest is a distribution that is required to be made by the terms of the trust. There is absolutely no discretion. Examples of retained mandatory interests by a settlor are charitable remainder unitrusts, grantor retained annuity trusts, and qualified personal residence trusts. Under the Restatement (Third) of Trusts and the Uniform Trust Code any creditor may attach a mandatory interest. Naturally, this would include a settlor retaining a mandatory interest in a trust. Please note that state case law may disagree with the Restatement Third and UTC position. See *Brasser v Hutchinson*, 549 P.2d 801 (Colo. App. 1976); *In re Marriage of Guinn*, 93 P.3d 568 (Colo. App. 2004).

   b. **Self-Settled Interest Retained**

   Further, it should be noted that charitable remainder trusts, grantor retained income trusts, and qualified personal residence trusts are also self-settled trusts, and a creditor should be able to reach the settlor/beneficiary’s interest in such trust.

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ii UTC § 506.

iii *In Re Mack*, 269 B.R. 392 (D. Minn. 11/2/01) and *In re Brown*, 303 F.3d 1261 (11th Cir. 2002) are both charitable remainder trust cases where the creditor reached the settlors’ income interests. In re *Frangus*, 132 B.R. 723 (N.D. Ohio Bkrtcy 1991) and 132 B.R. 272 (N.D. Ohio Bkrtcy 1992), the trust was not a qualified personal residence trust in conformity with the Internal Revenue Code. However, the settlors did transfer their house into trust with the life interest in the house remaining in the settlors and the remainder interest going to their children. The court held the entire residence could be reached by the creditors, rather than just the life interest.
E. Drafting Beneficial Interests In Trust

1. Definitions

The time line is divided into two components for purposes of discussion: (1) distribution period to current beneficiaries; and (2) the beneficial interest after the event date.

a. Current Beneficial Interest

The distribution to current beneficiaries is the time period where a trustee may or shall make distributions to any beneficiaries until some event happens. The following is a list of examples of distributions to the current beneficiaries:

- During my spouse’s life, the trustee shall make distributions of all income on a quarter-annually basis (e.g., this is a mandatory distribution standard).
- During my life, the trustees shall make distributions to my children based on health, education, maintenance, and support (e.g., this is a support distribution standard).
- For so long as either my spouse or I are alive, the trustee may make distributions in the trustee’s sole and absolute discretion to the current beneficiaries. In determining whether a distribution shall be made and the amount of any distribution, the trustee may exclude any beneficiary from a distribution (e.g. this is a discretionary distribution standard).
For purposes of this article, “a current period of time” is the period of time before the event date, where during this period of time, the trustee has either a mandatory distribution standard, a support distribution standard, or a discretionary distribution standard. Further, for purposes of this chapter, all references to distributions means income or principal or both.

b. Event Date and the Beneficial Interest After the Event Date

The event date is where something happens on an event upon which property is either distributed to beneficiaries in the form of a remainder interest or the trust property continues in trust (e.g. a dynasty trust). Many planners may refer to the second time period of trust as the remainder interest. However, as discussed below, there are certain interests in trust that do not vest in any one or a certain class of beneficiaries.

Regarding the situations where a planner drafts a remainder interest, examples of remainder interests are detailed below.

- Upon my death, the trustee shall divide the trust property equally and distribute it to my then surviving children free and clear of trust (i.e., outright distribution).
- Upon the later of my death or my spouse’s death, the trustee shall distribute one-third of the trust property to my child when she reaches age 25, one-half of the balance when she reaches age 30, and the remaining trust property when she reaches age 35 (i.e., age vesting).
- At the end of ten years, the trustee shall distribute the property to my spouse free and clear of trust (i.e., term of years vesting).

As noted below, occasionally a drafter will combine some of the above distribution standards and a court may refer to this as a “hybrid distribution standard.” It should be noted, for the reasons discussed later in this article, the author strongly recommends not drafting a trust with a hybrid distribution standard (i.e., conflicting distribution language).
In the above examples, the event dates are “upon my death,” “upon the latter of my death or my spouse’s death,” and “at the end of ten years.” After the event date, the remainder interest was distributed either outright or pursuant to an age vesting option. Before the event date, the trustee had the power to make distributions to the current beneficiaries based on the distribution standard.

On the other hand, after the event date, there may not be any immediate remainder interest. Rather, the trust property may continue to be held in trust. This is the case with either a dynasty trust or a next generation vesting trust.

- Upon my death, the trustee shall divide the trust property equally between my children. However, each share of the child’s trust property shall be held in trust for his or her life. Upon my child’s death, the trustee shall divide the trust property equally between my grandchildren. However, each share of the grandchild’s trust property shall be held in trust for his or her life. This continues for generation to generation until the trust assets are extinguished or the rule against perpetuities is violated.

- Upon my death, the trustee shall make distributions to my children for their health, education, maintenance, and support. Upon the last of my children’s deaths, the trustees shall distribute the trust assets to my grandchildren by right of representation.

In the first example, there is no designated remainder interest that vests in anyone. On the other hand, with the second example, the children do not possess a remainder interest, but the grandchildren do have remainder interests.

From the above discussion it is easy to visualize that a beneficiary may be given a current distribution interest, a remainder interest, or both. However, the type of distribution interest and whether the beneficiary receives a remainder interest will determine whether he or she has one, two, or no property interest under state law.

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i The actual language of a dynasty trust is substantially different than that given in the example. This was done to conserve space and more adequately explain how a dynasty trust works.
2. Common Law Distribution Standards
   a. Mandatory Distribution Standard

   A mandatory distribution standard is found in the marital trust (i.e., the QTIP trust or power of appointment trust), a grantor retained annuity trust, a charitable remainder annuity trust, or a charitable lead annuity trust. With these types of trusts, the trustee must make the distribution required by the terms of the trust agreement; the trustee may not withhold or accumulate a mandatory distribution.

   Typically, a mandatory distribution standard is imposed on certain trusts for them to qualify for certain benefits under the Internal Revenue Code. For example, certain marital trusts (i.e., either a QTIP or power of appointment trust) require that all income be paid at least annually to the surviving spouse in order for the trust to qualify for the marital deduction.\(^i\) A grantor retained annuity trust (i.e., GRAT) requires that a certain amount be paid annually for the GRAT annuity term, so that the gift will be only of the remainder interest.\(^ii\) A charitable remainder trust (i.e., CRUT) generally requires that the annuity interest be paid annually, so that the CRUT will be classified as a tax exempt entity.\(^iii\)

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\(^i\) IRC Sections 2056(b)(5); IRC 2056(b)(7).
\(^ii\) IRC Section 2702(b).
\(^iii\) IRC Section 664.
Magical Language
Support Trust

- Mandatory Language – “Shall”
- Standard for distribution – HEMS
  - Comfort and welfare may reclassify the trust as a support trust.

b. Support Trust

A support trust under common law was created by the settlor to support one or more beneficiaries. A support trust directs the trustee to apply the trust’s income and/or principal as is necessary for the support, maintenance, education, and welfare of a beneficiary. The beneficiary of a support trust can compel the trustee to make a distribution of trust income or principal merely by demonstrating that the money is necessary for his or her support, maintenance, education, or welfare.

The magical language for a support trust is something similar to:

“The Trustee shall make distributions of income or principal for the beneficiary’s health, education, maintenance, and support.”

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i. First National Bank of Maryland v. Dept. of Health and Mental Hygiene, 399 A.2d 891 (Md. 1979); Restatement (Second) Trusts Section 154 (1959)

ii. Chenot v. Bordeleau, 561 A.2d 891 (R.I. 1989), Eckes v. Richland County Social Services, 621 N.W. 2d 851 (ND 2001); Restatement (Second) Trusts Section 128 comments d and e (1959); Id.
Implicit in this support language are two components: (1) a command that the trustee “shall” make distributions; and (2) under what standard or circumstances (i.e., health, education, maintenance, and welfare) distributions are to be made.

i. Mandatory Language

A support trust typically includes mandatory language that the trustee “shall” make distributions.\(^1\) The trustee is not given any discretion over whether a distribution is to be made. However, as pointed out below, there are few cases when a trust has been classified as a support trust even though the discretionary word “may,” or the words, “discretion,” and even “sole discretion” were used instead of the mandatory word, “shall.”

ii. Standard For Distribution

In addition to the mandatory language of distribution, the trustee is also given a standard for making distributions, which may be reviewed by a court for reasonableness. Typically, the standard contains words such as “health, education, maintenance, and support.” However, such standard may also include terms such as “comfort and welfare.”\(^\text{ii}\) Further, a support trust gives the trustee discretion only on the time, manner, or size of distributions needed to achieve a certain purpose, such as support of the beneficiary.\(^\text{iii}\)

iii. Examples

Courts have determined the following language to create a support trust:

- “[T]he Trustee shall use a sufficient amount of the income to provide for the grandchild’s support, maintenance and education” [emphasis added] was held to be a support trust.\(^\text{iv}\)

\(^1\) Lineback by Hutchens v. Stout, 339 S.E.2d 103 (NC App. 1986).

\(^\text{ii}\) It should be noted that for estate tax purposes, the “welfare” standard would result in the trust failing the definition of ascertainable standard. However, for the definition of a support trust, it is included within the ascertainable standard. Further, in some cases, language such as “comfort and general welfare” will also take the trust language outside that of a general support trust. Lang v. Com., Dept of Public Welfare, 528 A.2d 1335 (PA 1987); Restatement (Second) Trusts, Section 154 (1959) and comments thereto. But see, Bohac v. Graham, 424 N.W.2d 144 (ND 1988).

\(^\text{iii}\) Eckes v. Richland County Social Services, 621 N.W.2d 851 (ND 2001).

• “[T]he trustee shall pay…[to the settlor’s] daughters such reasonable sums as shall be needed for their care, support, maintenance, and education” [emphasis added] was determined to be a support trust.\textsuperscript{i}

• “[T]he trustee shall administer the trust estate for the benefit of my wife and my said daughter, or the survivor of either, and the trustee shall apply the income in such proportion together with such amounts of principal as the trustee, in its discretion, deems advisable for the maintenance, care, support and education of both my wife and my said daughter” [emphasis added] created a support trust.\textsuperscript{ii}

\textsuperscript{i} \textit{In re Carlson’s Trust}, 152 N.W.2d 434 (SD 1967).

\textsuperscript{ii} \textit{McNiff v. Olmsted County Welfare Dept.}, 176 N.W. 2d 888 (Minn. 1970).
c. Discretionary Trust

i. No Property Interest or Enforceable Right

The fully discretionary trust allows the trustee complete and uncontrolled discretion to make allocations of trust funds if and when it deems appropriate.\(^i\) If the beneficiary does not have a property interest or an enforceable right\(^ii\) a creditor cannot stand in the shoes of the beneficiary and has no right of recovery.\(^iii\) A beneficiary has nothing more than a mere expectancy.\(^iv\)

An “expectancy is the bare hope of succession to the property of another, such as may be entertained by an heir apparent. Such a hope is inchoate. It has no attribute of property, and the interest to which it relates is at the time nonexistent and may never exist.” \textit{Dryfoos v. Dryfoos}, 2000 WL 1196339 (Conn. Super. 2000) unreported case.

\(^i\) \textit{First National Bank of Maryland v. Dept. of Health and Mental Hygiene}, 399 A.2d 891 (Md. 1979).

Rather than using a property analysis, some courts will find that the beneficiary’s interest has no ascertainable value. *Miller v. Department of Mental Health*, 442 N.W.2d 617 (Mich. 1989); *Henderson v. Collins*, 267 S.E.2d 202 (Ga. 1980); *In re Dias*, 37 BR 584 (D. Idaho 1984). In essence, the analysis is the same - there is no interest or enforceable right that a creditor may attach because under this analysis the beneficial interest has no value.

Second Restatement Analysis

- Sec 155(1) – Discretionary Trust
  - A transferee or creditor of the beneficiary cannot compel a distribution

- Sec Comment (1) b.
  - Distinguished from a spendthrift trust
  - Nature of the beneficiary’s interest, rather than spendthrift provision that prevents transfer
  - Creditor cannot compel the trustee to pay anything, because beneficiary could not

ii. Second Restatement Analysis

  § 155(1) states “[Except for a self-settled trust], if 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, a transferee or creditor of the beneficiary cannot compel the trustee to pay any part of the income or principal.”

  Comment (1) b. “. . . a discretionary trust is to be distinguished from a spendthrift trust. In a discretionary trust, it is the nature of the beneficiary’s interest rather than a provision forbidding alienation which prevents the transfer of a beneficiary’s interest. The rule stated in this section is not dependent upon a prohibition of alienation which prevents the transfer of the beneficiary’s interest; but the transferee or creditor cannot compel the trustee to pay anything to him because the beneficiary could not compel payment to himself or application for his own benefit.”

  Also see, Tyler v. Preston Ridge Financial Services Corp., 1999 WL 33744315 (Tex. App. 1999) unreported case where the trust did not include a spendthrift provision. Rather, it was the nature of the discretionary nature of the beneficiary’s interest that protected the beneficial interest from creditor attachment.
Nothing
More than a Mere Expectancy?

Judicial Review Standard
Limited to
– Improper Motive;
– Dishonesty; or
– Failure to Act - Restm. 2nd 187 e. and j.
– Scott Classification of Discretionary Trust Cases
– Bogert Adds
  ■ Arbitrary and Capricious
  ■ Scott classifies these cases under failure to act.

iii. Judicial Review Standard

Restatement (Second) Section 187 – “Where discretion is conferred upon
the trustee with respect to the exercise of a power, its exercise is not subject to
control by the court, except to prevent an abuse by the trustee of his
discretion.”

Comment e – “... the court will not interfere unless the trustee in
exercising or failing to exercise the powers acts dishonestly, or with an
improper even though not dishonest motive, or fails to use his judgment, or
acts beyond the bounds of a reasonable judgment.

Comment j. – “The mere fact that the trustee is given discretion does not
authorize him to act beyond the bounds of a reasonable judgment. The settlor
may, however, manifest an intention that the trustee’s judgment
need not be exercised reasonably, even when there is a standard by which
the reasonableness of the trustee’s conduct can be judged. This shall be
indicated by a provision in the trust instrument that the trustee shall have
“absolute” or “unlimited” or “uncontrolled” discretion. These words are not
interpreted literally but are ordinarily construed as merely dispensing
with the standard of reasonableness.

When comment e and comment j are combined, the judicial review
standard for a discretionary trust becomes (1) dishonesty; (2) improper motive;
or (3) failure to act. In fact, this is the classification system used by Scott on
Trusts.
Also see the detailed analysis of *Scott on Trusts*, Section 187 at Page 15 where it is noted that if the distribution standard includes enlarged or qualifying adjectives such as “sole and absolute discretion” combined with “no fixed standard by which the trustee can be determined is abusing his discretion…the trustee’s discretion would generally be deemed final.” Furthermore, Section 187.2 provides, “[e]ven though there is no standard by which it can be judged whether the trustee is acting reasonably or not, or though by the terms of the trust he is not required to act reasonably, the court will interfere where he acts dishonestly or in bad faith or where he acts from an improper motive.” This analysis by *Scott on Trusts* remains consistent through the 2003 supplemental volume.

*George Taylor Bogert* also seems to hold relatively the same definitional analysis as *Scott* in *The Law of Trusts and Trustees*, 2nd Edition 1980, Supplement through 2003. Section 560 of the Supplement at Page 183 provides that if a settlor has given a discretionary power (without qualification), the court is reluctant to interfere with the trustee’s use of the power…Hence, in the absence of one or more of the special circumstances mentioned hereinafter, the court will not upset the decision of the trustee. These special circumstances (at Page 196) are (1) a trustee fails to use his judgment; (2) an abuse of discretion; (3) bad faith; (4) dishonesty; (5) an arbitrary action. Regarding the issue of “arbitrary action,” *Bogert* provides, “[i]f the trustee has gone through the formality of using his discretion, but has not deliberately considered the arguments pro and con, and thus has made a decision for no reason at all, his conduct may be characterized as arbitrary and capricious, as amounting to a failure to use his discretion. In this respect, *Bogert* suggests that the “arbitrary” action is a subset of a trustee failing to act.

The Restatement (Second) of Trusts three tier classification that was followed by *Scott* of (1) dishonesty; (2) improper motive; and (3) failure to act is also supported by many cases.\(^i\)

\(^i\) *In Re Jones*, 812 P.2d 1152 (Colo. 1991); *Ridgell v. Ridgell*, 960 S. W. 2d 144 (Tex. App. 1997); *Kansas Dept. of Social and Rehabilitation Services*, 866 P.2d 1052 (KS 1994); *Simpson v. State, Dept. of Social and Rehabilitation Services*, 906 P.2d 174 (Kan.App.,1995); *Wright v. Wright*, 2002 WL 1071934 (Iowa App. 2002) – not cited for publication. (However this is an excellent case of a psychotic child attempting to sue the parent trustees on a discretionary trust. Had the psychotic child had an enforceable right, the result would be more than problematic); *First Nat. Bank of Maryland v. Department of Health and Mental Hygiene*, 399 A.2d 891 (Md. 1979); *In re Tone's Estates*, , 39 N.W.2d 401, (Iowa 1949); *Town of Randolph v. Roberts*, 195 N.E.2d 72 (Mass. 1964).
Elements of a Common Law Discretionary Trust

- Uncontrolled Discretion – “in Trustees’ sole and absolute discretion”
- Permissive Language – “May”
- Ability to exclude other beneficiaries
- No Ascertainable Standard

E. Elements of a Common Law Discretionary Trust

Courts have emphasized four factors when classifying a trust as a “discretionary trust” under common law.

1. **Uncontrolled Discretion**

   The Restatement (Second) and most court holdings agree that the most important of these factors is granting the trustee uncontrolled discretion. *Restatement (Second) Sec. 187 comment j.*

2. **Permissive Language**

3. No Requirement of Equality

Other courts have noted that when the uncontrolled discretion is combined with the ability to discriminate among beneficiaries, there is little if any question that the settlor intended to create a discretionary trust. *Dryfoos v. Dryfoos*, 2000 WL 1196339 (Conn. Super. 2000) unreported case; *McNiff v. Olhstead County Welfare Dept.*, 176 N.W.2d 888 (Minn. 1970); *First NorthWestern Trust Company of South Dakota v. IRS*, 622 F.2d 387 (8th Cir. 1980); *Matter of Brooks’ Estate*, 596 P.2d 1220 (Colo. App. 1979); *Hamilton v. Drogo*, 150 N.E. 496 (Ct. App. NY 1926).

4. Standard is Not Ascertainable

Some courts have noted that words such as “comfort and general welfare” may not be capable of judicial determination, and that this language may remove a trust from being classified as a support trust. *Bohac v. Graham*, 424 NW 2d. 144 (ND 1988). New York requires that no ascertainable distribution standard be used. *Estate of Escher*, 420 N.E. 91 (Ct. App. NY 1981).
d. Second Restatement of Trusts

The Second Restatement of Trusts focuses on the grant of extended discretion to determine whether a beneficiary has an enforceable right. Absent clear settlor intent to the contrary, the use of the words “sole,” “absolute,” or “unfettered” discretion will almost always result in the classification of the trust as a discretionary trust. In this respect, regardless of whether a trust contained a standard capable of judicial interpretation or incapable of judicial interpretation, the trust would be classified as a discretionary trust, and a beneficiary would not have an enforceable right.
### Third Restatement Abolishes Discretionary/Support Distinction

<table>
<thead>
<tr>
<th>Discretionary Trust</th>
<th>Support Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>May in Trustee’s sole and absolute discretion</td>
<td>Shall for = HEMS</td>
</tr>
<tr>
<td>No Enforceable Rt.</td>
<td>Enforceable Rt.</td>
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**Under 3rd Restmt. Discretionary Trust Must Now Rely Only on Spendthrift Protection**

**e. Restatement Third Position**

**i. Abolishes the Discretionary-Support Distinction**

The traditional trust analysis has explained in detail the difference in asset protection with a discretionary dynasty trust, where neither the current distribution interest is an enforceable right nor the interest after the event date is a property interest. The asset protection afforded by a discretionary dynasty trust is based on a property or enforceable right analysis. On the other hand, for support trusts the asset protection is based on spendthrift protection, subject to the four exception creditors.

**ii. Claims 125 Year Court Distinction is Arbitrary and Artificial**

“Not only is the supposed distinction between support and discretionary trusts arbitrary and artificial, but the lines are also difficult – and costly – to attempt to draw. Attempting to do so produces dubious categorizations and almost inevitably different results (based on fortuitous differences in wording or maybe a “fireside” sense of equity) from case to case for beneficiaries who appear, realistically, to be similarly situated as objects of similar settlor intentions.” § 60 Rept Note to cmt. a.

**iii. Continuum of Discretionary Trusts**

The Restatement Third specifically states that there should be no discretionary/support trust dichotomy. Rather, the Restatement Third creates new law when it defines a continuum of discretionary trusts, from the most discretionary to a support trust.

**iv. Only Spendthrift Protection Remains For a Discretionary Trust**

The result of equating a discretionary trust to a support trust for asset protection purpose is now both trusts only enjoy spendthrift protection.
v. Creation of an Enforceable Right in Almost All Trusts

As detailed in the following quotations it appears the Restatement Third takes almost the opposite position than the Second Restatement of Trusts:

- At first blush, it appears the Restatement Third follows the common law discretionary trust view when it states, “A transferee or creditor of a trust beneficiary cannot compel the trustee to make discretionary distributions if the beneficiary personally could not do so.” However, the sentence immediately following the above sentence, for almost all purposes negates the above sentence. It state, “It is rare, however, that the beneficiary’s circumstances, the terms of the discretionary power, and the purposes of the trust leave the beneficiary so powerless.”

- “Reasonably definite or objective standards serve to assure a beneficiary some minimum level of benefits, even when other standards are included to grant broad latitude with respect to additional benefits.” In other words, similar to the aberrational line of discretionary-support trust cases in Ohio, Connecticut and to a lesser extent Pennsylvania, the Restatement Third adopts this distinct minority position.

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1. Restatement (Third) of Trusts, Section 60, comment e.

2. Id.

3. Restatement (Third) of Trusts, Section 50, comment on Subsection (2): d. first paragraph.
• Even if a trust does not include a standard, under the Restatement Third the beneficiary is not safe. ""It is not necessary, however, that the terms of the trust provide specific standards in order for the trustee’s good-faith decision to be found unreasonable and thus constitute an abuse of discretion."" The Restatement Third goes further to the most likely imputation of a distribution standard if there is no standard or guideline when it states, ""Sometimes trust terms express no standards or other clear guidance concerning the purpose of a discretionary power, or about the relative priority intended among the various beneficiaries. Even then a general standard of reasonableness or at least good-faith judgment will apply to the trustee (Comment b), based on the extent of the trustee’s discretion, the various beneficial interests created, the beneficiaries’ circumstances and relationships to the settlor, and the general purposes of the trust.""ii

• Reporter Comment under Section 60(a) that states, ""The fact of the matter is that there is a continuum of discretionary trusts, with the terms of the distributive powers ranging from the most objective (or “ascertainable,” IRC 2041 of standards (pure “support”) to the most open ended (e.g. “happiness”) or vague (“benefit”) of standards, or even with no standards manifested (for which a court will probably apply “a general standard of reasonableness.”){Emphasis added}. In other words, it is the Third Restatement view that a “reasonableness standard” of review should be applied to most discretionary trusts, regardless of whether or not the trustee is granted “sole,” “absolute,” or “unfettered” discretion.

• Regarding rights between remainder beneficiaries, the Restatement Third takes issue with common law that all (or none) of the trust could be distributed to a discretionary beneficiary. Referring to common law, ""This “one-sided” liberalization of the discretionary authority, where a court finds the settlor’s language was intended to assure generosity in favor of a life beneficiary, would thus tend to encumber the efforts of remainder beneficiaries who see to challenge what might otherwise be excessively generous decisions by a trustee.""iii

After reviewing the above quotations as well as reading Sections 50 and 60 (including comments and reporter comments), it becomes quite apparent that ""It is rare, however, that the beneficiary’s circumstances, the terms of the discretionary power, and the purposes of the trust leave the beneficiary so powerless” that such beneficiary cannot force a minimal distribution. Remember, as demonstrated by the minority line of discretionary-support cases, such minimal distribution disqualified the beneficiary from governmental assistance.

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i Restatement (Third) of Trusts, Section 50, comment on Subsection (1): b., third paragraph last line.
Third Restatement Reverses Nebulous Standard

**Common Law**

– Health, education, maintenance, support, *comfort, general welfare, joy and happiness*

– A factor indicating an intent to create a discretionary trust

**Restatement Third** Sec 50, comment sec (2)d.

– Each ascertainable factor creates a support standard

– Other standards may add or subtract to a support standard – comment Sec. (2)&(3).

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vi. Reverses Common Law Element of a Discretionary Trust

• “Reasonably definite or objective standards serve to assure a beneficiary some minimum level of benefits, even when other standards are included to grant broad latitude with respect to additional benefits.”

• “Other standards and supplementary language. . . . These provisions may permit or even entitle beneficiaries to receive greater or lesser, or different, benefits than would have been authorized under a support provision standing alone.”

• The terms of a discretionary standard occasionally include stronger language, such as the word “happiness.” Such language suggests an intention that trustee’s judgment be exercised generously and without relatively objective limitation. Although “happiness” alone expresses no objective minimum of entitlements (which to some extent may nevertheless be readily implied), the primary effect of such a term is to immunize from challenge by remainder beneficiaries almost any reasonable affordable distribution.

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i Restatement (Third) of Trusts, Section 50, comment on Subsection (2): d. first paragraph.

ii Restatement (Third) of Trusts, Section 50, comment on Subsection (2): d(3). first paragraph.

iii Restatement (Third) of Trusts, Section 50, comment on Subsection (2): d(3). Page 268 second paragraph.
e. Sample Trust Language

The language on the following page gives examples under the Restatement (Second) and Restatement (Third).
Support Trust

My Trustee shall make distributions to the beneficiaries listed in Section 1.07 for health, education, maintenance, and support.

Discretionary Distribution Standard – Restatement (Second) of Trusts

My Trustee may pay to or apply for the benefit of any one or more of the beneficiaries listed in Section 1.07 as much of the net income and principal as the trustee determines in his sole and absolute discretion for his or her health, education, maintenance, support, comfort, general welfare, an emergency, or happiness.

Discretionary Distribution Standard – Common Law

My Trustee may pay to or apply for the benefit of any one or more of the beneficiaries listed in Section 1.07 as much of the net income and principal as the trustee determines in his sole and absolute discretion for his or her health, education, maintenance, support, comfort, general welfare, an emergency, or happiness. The Trustees, in their sole and absolute discretion, at any time or times, may exclude any of the beneficiaries or may make unequal distributions among them.
Discretionary Distribution Language After the Restatement (Third) of Trusts

My Trustee may distribute as much of the net income and principal as my Trustee, in its sole, absolute, and unfettered discretion, determine to any beneficiary listed in Section 1.07. My Trustee, in its sole, absolute, and unfettered discretion, at any time or times, may exclude any of the beneficiaries or may make unequal distributions among them. Also, my Trustee, in its sole discretion may distribute all of the income and principal of this Trust to one of the beneficiaries and exclude all other beneficiaries from any of the Trust Property. When making distributions, my Trustee may, in its sole, absolute, and unfettered discretion may, but need not, consider a beneficiary’s income or other resources that are available to the beneficiary outside of the trust and are known to the Trustee. The power to make a distribution in my Trustee’s sole, absolute, and unfettered discretion includes the power to withhold making a distribution to any beneficiary in my Trustee’s sole, absolute, and unfettered discretion.

In keeping with the wholly discretionary nature of this trust and all separate trusts created hereunder, no beneficiary, except as regards to any irrevocable vesting in the beneficiary’s favor, shall have any ascertainable, proportionate, actuarial or otherwise fixed or definable right to or interest in all or any portion of any trust or its property. It is my intent that the trustee have all of the discretion of a natural person, and that a distribution beneficiary holds nothing more than a mere expectancy. It is also my intention that the above language be interpreted as to provide my Trustee with the greatest discretion allowed under law.

Distributions made to a beneficiary under this Article shall not be considered advances and shall not be charged against the share of such beneficiary that may be distributable under other provisions of this agreement. Any undistributed net income shall be accumulated and added to the principal of the trust.”

Note: Many trust companies will have problems accepting the above language
Illinois Case Law

- **Peck v. Froehlich, 853 N.E.2d 927 (Ill App. 2006)**
  - Arizona self-settled trust
  - "necessary to provide for [the settlor's] health, support[,] and maintenance."
  - "[W]hat may constitute an abuse of discretion by the trustee[ ] depend[s] on the terms of the discretion, including the proper construction of any accompanying standards, and on the settlor's purposes in granting the discretionary power and in creating the trust. “ Restatement Third Sec. 50(2)

- **First of America Trust Company v. U.S., 1993 WL 327684 (C.D.Ill.) – Not reported**
  - Income - "shall pay or apply the net income - sole & absolute"
  - Principal – “so much of principal – sole and absolute"

10. **Summary of the Nine Keys**
   
   **a. Nice Options, But Not Necessary**
   
   The following two of the nine keys are nice options that turbo charge the discretionary dynasty trust; however, they are not essential:
   
   (1) Spouse as a beneficiary serves as a safety valve;
   (2) Tiered FLP and LLC structure.

   **b. Helps Keep Children From Fighting**
   
   Most children would prefer not participating in a beneficiary controlled trust if such child might possibly end up sharing part of his or her inheritance with another child. Therefore, the following elements are regarded as essential, but not absolutely essential:
   
   (1) Trust splits on the death of the settlor into a separate trust for each child;
   (2) Upon the death of the child (i.e., primary beneficiary) of the separate child trust, the trust splits again – one separate trust for each grandchild;
   (3) The settlor holds a removal/replacement power over the trust until death;
   (4) After the settlor’s death, each child holds a removal/replacement power over each separate trust.

   **c. Absolutely Essential For a Beneficiary Controlled Trust**
   
   Each of the following three keys are absolutely essential for a discretionary dynasty trust:
   
   (1) Discretionary distribution standard;
   (2) Trustee may distribute all of the assets to the primary beneficiary; and
   (3) Trusts are dynasty trusts.
Illinois Case Law


- "the trustee shall use...."
- "I declare that my primary intent is to provide adequate care, support, maintenance needed for him during his lifetime and I desire that the use of income and principal be dependent on his needs."

10. Summary of the Nine Keys

a. Nice Options, But Not Necessary

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c. Absolutely Essential For a Beneficiary Controlled Trust

Each of the following three keys are absolutely essential for a discretionary dynasty trust:

(1) Discretionary distribution standard;
(2) Trustee may distribute all of the assets to the primary beneficiary; and
(3) Trusts are dynasty trusts.
f. Hybrid Trust or “Discretionary Support Trust”

It should be noted that three states and possibly four (Iowa, Nebraska, North Dakota, and possibly Pennsylvania) have taken the position that there is a third type of trust – a discretionary support trust. As discussed below, the language of a trust may include elements of both a support trust and a discretionary trust. A discretionary support trust is created when the settlor combines the explicit discretionary language “with language that, in itself, would be deemed to create a pure support trust.” Under the case law of these three or four states case law, the hybrid trust covers the middle ground between classic support trusts and classic discretionary trusts. If a trust is neither a classical support trust nor a classical discretionary trust, these courts have followed one of the following two approaches:

a. Allowing extrinsic evidence to determine the classification as either a discretionary or a support trust;

b. Requiring the trustee to carry out the purposes of the trust based on a “good faith” standard; and

c. Requiring the trustee to make minimal distributions.

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i Eckes v. Richland County Social Services, 621 N.W.2d 851 (ND 2001).


iii Bohac v. Graham, 424 N.W.2d at 144 (ND 1988).
i. Allowing Extrinsic Evidence to Determine Classification

- In *Bohaci*¹, the provisions of the trust allowed the Trustee to distribute principal as the “Trustee may deem necessary” for the beneficiary’s “support, maintenance, medical expenses, care, comfort, and general welfare.” {Emphasis added}. The court noted that the trust provisions created a hybrid trust, but decided that extrinsic evidence must be admitted to determine the settlor’s intent of whether the trust was a (1) support trust or (2) a discretionary trust. Even though the court noted that the words “comfort and general welfare” may result in the classification of the trust as a discretionary trust, the court held the trust was a support trust.

- In *Kryzsko v. Ramsey County Soc. Services.*², the trustee was given sole discretion to invade trust principal for the “proper care, maintenance, support, and education” of the beneficiary. The court held that the trustee did not have unfettered discretion and must follow a standard of providing proper support. The court noted that unlike a discretionary trust, which fixes no standard on the trustee’s absolute discretion whether to pay income or principal to a beneficiary, a support trust gives the trustee discretion only on the time, manner, and size of the payments needed to achieve a certain purpose such as support of a beneficiary.

- In *Lang v. Com., Dept. of Public Welfare*³, the terms of the trust stated “the trustee shall pay the income periodically to or for the support, maintenance, welfare, and benefit of my son or may, in the trustee’s discretion, add part or all of the income or principal to be invested as such.” “The trustee may distribute such part of the income not necessary for the support of my son, in equal shares to my children.” After looking at extrinsic evidence, suggesting it was the settlor’s intent to preserve trust assets particularly where public benefits were available to the beneficiary, the court held that the trust was discretionary.

ii. Requiring the Trustee to Carry Out the Purposes of the Trust in Good Faith

- In *Smith v. Smith*⁴, the Nebraska Supreme Court held that the trustee of a discretionary support trust can be compelled to carry out the purpose of the trust in good faith. The language of the trust stated, “The trustee shall pay over to, or for the benefit of one or more of the living members of a class composed of my son Richard and his issue, so much of the net income and principal of the trust as the Trustee shall deem to be in the best interests of each such person, from time to time. Such distributions need not be made equally unto all members of the class. In determining the amount and frequency of such distributions, the Trustee shall consider that the primary purpose of the trust is to provide for the health, support, care, and maintenance of my son Richard during his life.” {Emphasis added}.

¹ 424 N.W. 2d at 146.
² 607 N.W.2d 237 (ND 2000).
³ 528 A.2d 1335 (PA 1987).
⁴ 517 N.W.2d 394 (Neb 1994).
The court determined that the above language constituted a “hybrid trust,” where the trusts were not only created to support the primary beneficiary, but also to grant the trustee greater liberty in decision making that the trustee of an ordinary support trust. Factors a trustee should consider in determining distributions should be the degree of need experienced by the beneficiaries, the standard of living experienced by the beneficiaries at the time the trust was created, the financial relations between the settlor and the beneficiaries prior to the formation of the trust, and of course, the intent of the settlor.

iii. Creates a Minimal Distribution

A couple of courts have held that the effect of a discretionary support trust is to establish the minimal distributions a trustee must make in order to comport with the settlor’s intent of providing basic support, while retaining broad discretionary powers in the trustee. In this case, the court even held that the minimum distribution may be reached by a creditor. As previously noted, the drafting issues created by conflicting support language with discretionary language are addressed in detail in Section IV. H.

iv. What Did Ohio Do?

It should also be noted that the Ohio Supreme Court, without using the word hybrid trust, found the trust language to be neither purely discretionary or purely support. Therefore, the trust should be governed by a “reasonableness” standard which would not permit the beneficiary to become destitute. The result was the governmental agency could recover against the trust assets under the necessary expenses of a beneficiary exception. Further, the Ohio Supreme Court seemed to lean further toward becoming a “hybrid trust state,” when it stated in a subsequent case, “A trust conferring upon the trustees power to distribute income and principal in their absolute discretion, but which provides standards by which that discretion is to be exercised with reference to the needs of the trust beneficiary for education, care, comfort, or support is neither a purely discretionary trust nor a strict support trust.”

What is particularly troubling regarding the Ohio Supreme Court ruling is the standard of “reasonableness.” For over 100 years, the strong majority view has been that the standard is bad faith or abuse. Further, the purpose of a discretionary trust was to prevent the courts from reviewing the “sole and absolute” discretion of the trustee. With a discretionary trust, the settlor has chosen to put his faith in the trustee, not the courts. The support trust was the opposite. With the support trust, the settlor wanted the beneficiary to have a right to enforce the ascertainable trust terms, if the trustee did not follow the standard.

By creating a resonableness standard, the Ohio Supreme Court has now given the beneficiary of this hybrid type of trust the right to sue the trustee for unreasonably not making a distribution or not distributing enough. Further, such legal right will most likely be property right (i.e., an enforceable right) under state law, with the following question – does the creditor stand in the shoes of the beneficiary?

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iii  Bureau of Support in Dep’t of Mental Hygiene & Correction v. Kreitzer, 243 N.E. 2d 83 (Ohio 1968).

g. Minimum Distribution States

Four states have concluded that anytime a standard is coupled with uncontrolled discretion, the standard takes precedence over the uncontrolled discretion, and in three of these states a reasonableness standard of review was used.

i. Ohio

Metz v. Ohio Dept. of Human Services, 762 N.E. 2d 1032 (OH App. 2001); Bureau of Support in the Department of Mental Hygiene and Correction v. Kreitzer, 243 N.E.2d 83 (Ohio 1968); Matter of Gantz, 1986 WL 12960; Samson v. Bertok, 1986 WL 14819 (the creditor did not recover because it was not a governmental claim); Matter of Trust of Stum, 1987 WL 26246; Schierer v. Ostafin, 1999 WL 493940 (the creditor did not recover because it was not a governmental claim). In the above SNT cases, the government was able to attach the beneficiary’s interest and force a distribution pursuant to the standard.
ii. Pennsylvania

Using a slightly different analysis, Pennsylvania courts have generally held that if a discretionary support trust was for one beneficiary and such sole beneficiary was not receiving governmental benefits at the time of creating the trust, then the settlor intended that the principal of the trust as an available resource to the beneficiary. *Estate of Taylor v. Department of Public Welfare*, 825 A.2d 763 (Penn. 2003); *Shaak v. Pennsylvania Department of Public Welfare*, 747 A.2d 883 (Penn. 2000); *Estate of Rosenberg v. Department of Public Welfare*, 679 A.2d 767 (Penn. 1996); *Commonwealth Bank and Trust Co.*, 598 A.2d 1279 (Penn. 1991).

iii. Connecticut

Recently, the Supreme Court concluded that when a discretionary trust was coupled with any standard, the trust was classified as a support trust.

iv. Iowa

*Strojek v. Hardin County Board of Supervisors*, 602 N.W. 2d 566 (Iowa App. 1999) also see the follow up unpublished opinion where the Iowa Appellate Court expanded the definition of the distribution language as much broader than “basic needs.” *Strojek v Hardin County Board of Supervisors*, 2002 WL 180377 (Iowa App. 2002); *Also see McCabe v. McKinnon*, 2002 WL 31757533 (Iowa App. 2002) an unpublished decision.
Creditor’s Rights Against Either Interest

F. Creditor’s Rights Against a Current Distribution Interest

A creditor may seek to attach the current distribution interest, the interest after the event date or both. In simple terms, whether a creditor will be able to attach either interest (or both) first depends on whether the interest in trust is classified as a property interest under state law.

As previously noted most courts determine whether a beneficiary has a property interest or enforceable right under state law. Rather than using a property analysis, some courts will find that the beneficiary’s interest has no ascertainable value. In essence, the analysis is the same - there is no interest or enforceable right that a creditor may attach, because under this analysis there is no value to the beneficial interest. For purposes of this outline, the property analysis shall be used. Therefore, the beginning step in determining whether a creditor may recover against a beneficial interest in trust is to determine whether the current beneficial interest or the beneficial interest after the event date (e.g., the remainder interest) is a property interest or an enforceable right under state law.

i Carlisle v. Carlisle, 194 WL 592243 (Superior Ct. Connecticut 1994); Lauricella v. Lauricella, 565 N.E. 2d 436 (Mass. 1991);

ii Miller v. Department of Mental Health, 442 N.W.2d 617 (Mich. 1989); Henderson v. Collins, 267 S.E.2d 202 (Ga. 1980); In re Dias, 37 BR 584 (D. Idaho 1984).
1. Road Map

The above roadmap depicts all of the issues that need to be addressed to determine whether a creditor may recover against a beneficial interest. This outline will first discuss the property interest issue and then follow with the spendthrift provision and exception creditor analysis. Even if a trust is designed to avoid the exception creditors to a spendthrift trust, if a beneficiary retains too much control, a creditor may reach the beneficial interest. Finally, in some states, an estranged spouse actually may receive more rights than a normal creditor.

2. Creditor’s Rights Against A Current Distribution Interest

As previously noted most courts determine whether a beneficiary has a property interest or enforceable right under state law. Rather than using a property analysis, some courts will find that the beneficiary’s interest has no ascertainable value. In essence, the analysis is the same - there is no interest or enforceable right that a creditor may attach, because under this analysis there is no value to the beneficial interest. For purposes of this article, the property/enforceable right analysis shall be used. Therefore, the beginning step in determining whether a creditor may recover against a beneficial interest in trust is to determine whether the current beneficial interest or the beneficial interest after the event date (e.g., the remainder interest) is an enforceable right under state law.
3. What Constitutes a Property Right

What constitutes a property interest in many cases depends on state law. While state law may vary the following definition a bit, generally property is defined as "everything that has an exchangeable value or which goes to make up wealth or estate." An equitable interest in trust property is regarded as a property interest of the same kind as a trust res and is more than a mere chose in action. At first, this definition of a property interest seems too complex to understand. However, the analysis may be simplified. Generally, there are two methods for determining whether something constitutes property: (1) something that may be sold or exchanged, or (2) an enforceable right.

With regard to the first type of property, such property is freely alienable, and as such has a fair market value that may be determined by a market price. However, beneficial interests in trusts are generally restricted by spendthrift provisions (discussed in Section E. below), which prevent the transfer of any beneficiary’s interest. In this respect, there is no fair market value, because the property cannot be sold. On the other hand, under the second test, in many situations, a beneficiary has an enforceable right (i.e., a property interest). For example, with certain trusts a current beneficiary has a right to sue the trustee to force a distribution pursuant to a standard in the trust. Also, if a beneficiary has a vested remainder interest, a beneficiary will most likely receive property at some time in the future.
i. As previously noted in this outline, some courts will hold that the beneficiary interest of a discretionary trust has no ascertainable value. Hence, the analysis is the same.


4. Rights Against A Current Beneficial Interest
   
   a. Mandatory Distribution

   When the terms of a trust require a mandatory distribution to be made, there is no question that the beneficiary has an enforceable right to a distribution. The beneficiary may unquestionably sue the trustee to force a distribution. Therefore, a fixed interest, which is an interest that creates an enforceable right in the beneficiary, is a property interest. For example, *In re Question Submitted by the United States Court of Appeals for the Tenth Circuit*, the Tenth Circuit held that the future right to receive $1,000 a month by a beneficiary was a property interest. i  In this respect, the mandatory distribution right may be analogized to an annuity for a period of time.

   With a mandatory distribution, the creditor is not attaching the trust’s assets. Rather, the creditor is attempting to attach to the mandatory distribution stream. ii Since such interest is a property right, the only question is whether spendthrift provisions provide some type of protection for a mandatory distribution received by a trust. This is analyzed in Section VII of this outline.

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ii Restatement (Third) of Trusts, Section 56, comment a; Uniform Trust Code, Section 501.
b. A Support Distribution or Ascertainable Standards

The common law purpose of a support trust is to provide support for a beneficiary based on a “standard.” The most common standard used is to provide support for a beneficiary’s health, education, maintenance, and support. Such a support standard must be definite enough for a court to be able to determine whether a trustee is following the support standard. In this respect, magical words such as health, education, maintenance, and support have been determined to be definite. Words such as comfort and welfare may or may not be definite enough depending on state law. On the other hand, words such as joy and happiness are not capable of interpretation on a reasonable basis, and these words may easily result in a trust not being classified as a support trust.

As previously noted, if a trust is classified as a support trust, a beneficiary of a support trust can compel the trustee to make a distribution of trust income or principal merely by demonstrating that the money is necessary for his or her support, maintenance, education, or welfare.\(^1\) In other words, a beneficiary has a right to sue the trustee from failing to make a distribution from a support trust. If a beneficiary has the right to sue the trustee, the beneficiary most likely has a property interest under state law.\(^2\) If this is the case, does the creditor stand in the beneficiary’s shoes and may also sue the trustee to force the payment of the beneficiary’s debt? Absent spendthrift provisions, this would definitely be the case. Therefore, whether a creditor (including an estranged spouse) may recover must be discussed in the spendthrift portion of this article.

c. Discretionary Interest

Under the Restatement of Trusts (Second) and almost all of the case law to date, a discretionary beneficiary has no contractual or enforceable right to any income or principal from the trust, and the beneficiary cannot force any action by the trustee.\(^3\) This is because a court may only review a discretionary trust for abuse and bad faith. There is no reasonableness standard of review by a court for a discretionary trust. Further, the discretionary interest is not assignable.\(^4\) In this respect, a discretionary beneficiary’s interest is generally not classified as a property interest; rather, it is nothing more than a mere expectancy.\(^5\) If a beneficiary has no right to force a distribution from a trust, then the same rule applies to the beneficiary’s creditor – he or she may not force a distribution.

In this respect, the protection of the trust assets of a discretionary trust does not depend on spendthrift provisions with respect to the current beneficial interest. As will be seen in the discussion of the spendthrift provisions, the asset protection features of a discretionary trust is much stronger than that of a support trust or a mandatory distribution trust that must rely on spendthrift protection.

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\(^2\) Each state law must be analyzed in this respect. However, the author is unaware of a case where state law held that a beneficiary of a support trust did not have a property right (i.e., an enforceable right) to force the trust to make a distribution pursuant to the support standard.

\(^3\) *In re Marriage of Jones*, 812 P.2d 1152 (Colo. 1991); G. Bogert, *Trusts and Trustees*, Section 228 (2nd Ed. 1979).

\(^4\) *Id.*

\(^5\) *U.S. v. O'Shaughnessy*, 517 N.W. 2d 574 (Minn. 1994); *In re Marriage of Jones*, 812 P.2d 1152 (Colo 1991).
Support Trust Relies On Spendthrift Provision

- Provision creditor’s cannot attach a beneficiary’s interest
- Developed in common law
- Included in almost all trusts

What if such a provision was put in a partnership agreement – could not attach a member’s interest???

5. Spendthrift Provisions

A spendthrift provision is a provision in a trust that states that the beneficiary cannot sell, pledge or encumber his or her beneficial interest. Further, the provision states that a creditor cannot attach a beneficiary’s interest. At common law, the purpose of a “spendthrift trust” was to protect a beneficiary (other than the settlor of the trust) from his or her own spending habits. The idea was to provide for someone who could not provide for himself or herself, and to keep such beneficiary from becoming dependent on public assistance. Therefore, if a “spendthrift clause or provision” was added to a trust, the common law developed a legal principle that a creditor could not recover from the beneficiary’s interest. If the mere insertion of such a clause could protect a beneficiary’s interest, why not include such a provision in almost all trusts? Today, this is in fact the case, and almost all trusts include a spendthrift clause.

i  The U.S. Supreme Court followed the common law view of spendthrift protection in *Nichols v. Eaton*, 91 U.S. 716 (1875).

ii  Even though almost all drafters include a spendthrift provision in a trust, the trust instrument must still be examined to make sure that this is indeed the case. If a spendthrift clause is not included, a creditor stands in the shoes of the beneficiary and may enforce any right that he or she has: mandatory distribution; ascertainable standard distribution; or a remainder interest. *In re Katz*, 203 B.R. 227 (E.D. Pa. 1996); *Chandler v. Hale*, 377 A.2d 318 (Conn. 1977).

iii  As noted above, a creditor generally has no right of recovery against a discretionary interest, because the beneficiary does not have a property interest. Therefore, the analysis of spendthrift provisions is unnecessary for a discretionary trust. However, with a support trust, the beneficiary has an enforceable right and may force the trustee to make a distribution.
6. Exceptions Under the Restatement (Second) of Trusts

However, the same analysis is not true for a trust that is classified as a support trust. In this case, beneficiary may force a distribution from the trust pursuant to the standard provided in the trust instrument. So the question becomes, can a creditor stand in the shoes of the beneficiary and force such a distribution? By the language of the spendthrift provisions it prohibits a creditor from doing so. However, under which circumstances will courts make exceptions to spendthrift protection?

Except for certain types of creditors, a spendthrift provision protects the trust’s assets from attachment. The Restatement (Second) of Trusts, Section 157, (1959) carves out the following four key exceptions to spendthrift protection, where a creditor may attach the assets of a support trust:

1. alimony or child support;
2. necessary services or supplies rendered to the beneficiary;
3. services rendered and materials furnished that preserve or benefit the beneficial interest in the trust; and
4. a claim by the U.S. or a State to satisfy a claim against a beneficiary.

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ii Restatement (Second) of Trusts, Section 157 (1959).
a. Alimony or Child Support

Almost all, if not all, recent cases hold that a spouse may reach a beneficiary’s interest for alimony or child support.\(^i\) Therefore, if a trust is classified as a support trust, almost always an estranged spouse may reach the assets of the trust to satisfy a maintenance or child support claim. However, this exception does not apply to a division of marital property pursuant to a divorce.

b. Necessary Services or Supplies Rendered to the Beneficiary

Most cases in this area arise when a federal or state institution is attempting to attach a beneficiary’s interest for medical services rendered on behalf of the beneficiary.\(^{ii}\) Further, in almost all of these cases the drafting attorney conflicted the magical words of a discretionary trust with those of a support trust. This problem of conflicting the drafting language is discussed in C. below.

c. Services Rendered and Materials Furnished That Preserve or Benefit the Beneficial Interest in the Trust

These are generally claims by attorneys for fees incurred to either sue the trust or protect a beneficial interest. Unfortunately, while the other three exceptions of the Second Restatement are almost universally applied by the states, this one is not. In other words, frequently attorneys are not allowed to recover their fees from the trust.

d. A Claim by the United States or State to Satisfy a Claim Against a Beneficiary

Generally, these are tax liens. The Internal Revenue Service may generally reach a beneficiary’s interest in a support trust for payment of a tax lien.\(^{iii}\) First Northern Trust Co. v. Internal Revenue Service, 622 F.2d 387 (8th Cir. 1980) noting that it is a well-established legal principle that the income from a spendthrift trust is not immune from federal tax liens, notwithstanding any state laws or recognized exemptions to the contrary.\(^{iv}\)

In summary, there are four exception creditors that can reach a support trust’s assets to satisfy their claim. These creditors are referred to as “exception creditors” for the purpose of this outline. It should be noted that in a non-UTC state, these exception creditors (including the federal government) would have no claim against the trust assets if it had been drafted as a discretionary dynasty trust.


\(^{iii}\) Bank One Ohio Trust & Co., 80 F.3d 173 (6th Cir. 1996).

What Happens When The Judicial Review Standard Changes?

– Hybrid Trust
  ▪ Good Faith Standard
– Reasonableness

7. What Happens When the Standard Changes?

If a judge did not classify a trust with conflicting language as either a discretionary trust or a support trust, four states have indicated that it is a hybrid trust. In general, a hybrid trust results in a minimal distribution that a beneficiary has the right to sue the trustee for.¹ This being the case, the hybrid trust does not provide the same degree of protection as a discretionary trust. Rather, it is more similar to a support trust, and whether spendthrift provisions provide protection must be analyzed.

8. Could Be A Drafting Error

As noted above, with regards to the current distribution interest, a discretionary trust generally provides the strongest asset protection features, because the discretionary interest is generally not a property interest under state law. If a beneficiary does not even hold a property interest, how can a creditor possibly attach it?

Unfortunately, there is a tension between the asset protection features of a discretionary trust and who can be a trustee without a possible estate tax inclusion issue. Generally, clients wish to have someone who is related to them to serve as the trustee – a spouse or a child beneficiary. So long as distributions are made pursuant to an ascertainable standard, there are times when a spouse or a child/beneficiary may serve as the sole trustee of a trust without an estate tax inclusion issue. If the spouse or a child is the sole trustee and a beneficiary of a discretionary trust, the spouse or child will be considered to hold a general power of appointment – resulting in an estate inclusion issue.

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For example, if the beneficiary children are adults (i.e., the spouse has no support obligation) and the distribution standard is pursuant to ascertainable standards, the spouse may be the sole trustee without an IRC 2041 estate inclusion issue. It should be noted that many planners require co-trustees when a spouse or child/beneficiary is serving as a trustee. Properly drafted the use of co-trustees avoids some of the possible IRC Section 2041 inclusion issues of a spouse or trustee/beneficiary serving as a sole trustee.

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As a trustee, the spouse or child would have unlimited power to distribute any amount of the trust assets to himself or herself as a beneficiary of the trust.
Many estate planners attempt to get the best of both worlds. These planners would like a trust that would be considered discretionary for state law purposes so that a creditor of a beneficiary could not attach the trust. They also would like the trust to be deemed to have ascertainable standards for estate and gift purposes, giving the client greater selection over who could be a trustee. In an attempt to accomplish both of these objectives, these estate planners draft distribution language that uses both magical words from a support trust and magical words from a discretionary trust. For example, what if the trust document reads:

“The Trustee may, in his sole and absolute discretion, make distributions of income or principal based on health, education, maintenance, and support to any beneficiary.”

The magical discretionary words of “may,” and “discretion,” have been conflicted with the trust support words of “health, education, maintenance, and support”. Further, the discretionary language allowing the trustee to make distributions to one beneficiary and not the others has been implied.

Naturally, the Service would like to argue the above language constitutes a discretionary trust, because if the decedent, a spouse/beneficiary or a child/beneficiary is the sole trustee he or she holds a general power of appointment at time of death (IRC 2041). On the other hand the taxpayer would like to argue that distributions are pursuant to an ascertainable standard, to avoid the estate inclusion issue.

“The Trustee shall make distributions of income or principal based on health, education, maintenance, and support.”

The above language was circulated on one of the nation’s top estate planning list serves with the question – Is this a discretionary trust or one based on ascertainable standards? Below, I have listed some of the replies from some highly recognized estate planners:

- “It is a discretionary trust subject to making distributions only for the ascertainable standard of health, education, maintenance, and support.”
- “I treat the language as being subject to an ascertainable standard.”
- “I don’t know what it means, its bad language that can not be understood in any number of ways.”
- “The language is very confusing. When I first read it, I thought it was a mistake. I would not want to be the drafter of that trust. In my humble opinion it has opened the door for substantial litigation.”

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On the other hand, if the court concludes the trust is a “discretionary trust,” the court will most likely interpret the language as follows:

“The Trustee may make a distribution, in the trustee’s sole and absolute discretion, of so much of the income or principal of the trust that the trustee wishes to make for the beneficiaries health, education, maintenance, and support.”

As noted, almost all non-UTC courts will decide one way or the other, but not both. So if the estate planner was attempting to draft distributions pursuant to ascertainable standards, but the court holds it is a discretionary trust, there may be an estate inclusion issue. On the other hand, if the estate planner was attempting to draft a discretionary trust, but the court holds it is a trust where distributions are based on ascertainable standards (i.e., a support trust), a governmental agency or spouse may recover its claim against the assets of the trust.

By attempting to accomplishing the best of both worlds, the estate planner typically may well have done more damage than good: a possible estate inclusion issue or allowing a creditor to recover from the assets of the trust. For this reason the author strongly recommends against conflicting the trust language and drafting either a purely discretionary trust or a support trust (i.e., distributions based on ascertainable standards).

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One would hope that various judges throughout the states would agree whether similar conflicting language constituted a discretionary trust or one based on ascertainable standards. Unfortunately, this generally is not the case. As noted from the following case synopsis, judges appear to be equally confused on the issue. Further, even if in one state the judges would be consistent on what similar conflicting language meant, what if the trust changes jurisdictions to another state or nation? Will the new jurisdiction agree with the old jurisdiction’s interpretation of the conflicting language? For these reasons, the author strongly recommends that an estate planner use the pure language of ascertainable standards or discretion.

Support Trust Conflicting Language

The following court decisions noted that the language of the trust used both discretionary and support language, but held that the trust was a discretionary trust:

- “. . . my trustee shall hold, manage, invest and reinvest, collect the income there from any pay over so much of all the net income and principal to my son as my trustee deems advisable for his care, support maintenance, emergencies and welfare.” {Emphasis added}. Myers v. Kansas Depts of SRS, 866 P.2d 1052 (Kan. 1994).
- “The trustee shall hold the trust property and shall pay over to the beneficiary the income and any part or all of the principal at such time or times as in the judgment of the trustee the payment of same will be to the best interests of the beneficiary.” {Emphasis added}. Roorda v. Roorda, 300 N.W. 294 (1941).
- “The net income and so much of the principal shall be necessary for the general welfare, support, maintenance, and benefit of my said daughter, in the absolute and uncontrollable discretion of my said trustee, shall be paid over to my said daughter, or applied to or for her benefit in such amounts and as such times as my trustee in her discretion shall
9. Government Could Argue Both Sides

   a. Service’s Argument

   Naturally, the Service would like to argue the above language constitutes a discretionary trust, because the decedent (i.e., trustee) held a general power of appointment at time of death (IRC 2041). On the other hand the taxpayer would like to argue that distributions are pursuant to an ascertainable standard. *Estate of Carpenter*, 45 AFTR 2d 80-1784, 80-1 USTC 13,339 (D. Wis 1980); *Independence Bk. Waukesha (N.A.) v. U.S.*, 761 F.2d 442 (7th Cir. 1985) – tangential reference to “without court approval”; analogy – PLR 9118017; *but see Best v. U.S.*, 902 F. Supp. 1023 (D. Neb. 1995) – where “sole and absolute” language was not argued by the Service.

   b. Governmental Agency Argument

   On the other hand, if it is a governmental agency, who is a creditor of a beneficiary, and is seeking to recover payment from the trust, the governmental agency will argue that distributions are pursuant to an ascertainable standard. The client will argue that the distributions are discretionary.
G. Creditor’s Rights Against an Interest After the Event Date

(1) Not an Inseparable Interest

A remainder interest is definitely a property interest. However, as noted before, the Restatement (Second) of Trusts, Section 160 addresses this issue as an “inseparable interest.” A remainder by definition is separable. At some time, someone will receive the remainder interest based on the terms of the trust. Therefore, the analysis moves to the next step, the “indefinite” or “contingent” rule.

(2) Indefinite or Contingent

The Restatement (Second) of Trusts further provides, if a beneficial trust interest is “so indefinite or contingent that it cannot be sold with fairness to both the creditors and the beneficiary, it cannot be reached by creditors.”

There are two parts to this rule, (i) is the remainder interests “indefinite?;” and (ii) can it be sold with fairness to both the creditors and the beneficiary?

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Restatement (Second) of Trusts, Section 161 (1959).
Indefinite or Contingent Interest?

– Two Tests:
  ■ Indefinite or Contingent
    – Little case authority
  ■ Sold with Fairness
    – Highly discounted
    – Special power of appointment?

1. Two Tests
   
a. Indefinite and Contingent Interests

   A vested interest is not a contingent interest. A vested interest is one where the debtor/beneficiary or the debtor beneficiary’s estate will take at some point of time in the future. The clear majority rule appears to be that a vested remainder interest may be sold at a judicial foreclosure sale, unless part ii. applies discussed below or the trust contains spendthrift provisions (which is analyzed separately in Section B. below).i These cases follow the general property rule, that a remainder interest in property, even though it is a future interest may be sold.ii

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i Henderson v. Collins, 267 S.E.2d 202 (Ga. 1980) [vested remainder interest in a discretionary trust may be sold at judicial foreclosure sale.] Also See, Burrell v. Burrell, 537 P.2d 1 (Alaska 1975); Moyars v. Moyars, 717 N.E. 2d 976 (Ct. App. Ind. 1999); Benston v. Benston, 565 P.2d 395 (Or. App. 1983); Lauricella v. Lauricella, 565 N.E. 2d 436 (Mass. 1991) [under all of these cases, a vested remainder interest was considered marital property for division purposes.]

ii Mid American Corp. v. Geisman, 380 P.2d 85 (Okla. 1963) [where a debtor received a remainder interest under a will. Once the death of the willmaker had occurred, the remainder interest was vested. It was not in trust, and a simple future property analysis provided for the property to be received under the will to be sold at a judicial foreclosure sale.]
Regarding most estate planning trusts, some estate planners might consider a remainder interest as a contingent interest an (1) either one party must outlive the other party in order to take; (2) or the trust property is subject to complete divestment due to a special power of appointment usually held by the surviving spouse. However, Restatement (Second) of Trusts, Section 162, Illustration 1 as well as the cases cited in the footnote indicate that the fact that a child must survive a parent in order to take the trust property, this fact is not contingent; and therefore, unless part 2. below applies, absent spendthrift protection, a creditor would be able to judicially foreclose on the remainder interest.\footnote{In Re Neuton, 922 F.2d 1379 (9th Cir. 1990) [Where the fact that the debtor would need to outlive his mother in order to take the trust property was not so contingent as to prevent the judicial foreclosure sale of a 25% of the debtor’s interest by a bankruptcy trustee. See further discussion of this case under spendthrift provisions.] Also See, Balanson v. Balanson 25 P.3d 28 (Colo. 2001); Davidson v. Davidson, 474 N.E. 2d 1137 (Mass. 1985); Benston v. Benston, 656 P.2d 359 (Or. App. 1983); Trowbridge v. Trowbridge, 114 N.W. 2d 129 (Wis. 1962) [under all of these cases, vested remainder interests were not too indefinite to be classified as marital property for purposes of division]. But See, Loeb v. Loeb, 301 N.E. 2d 349 (Ind. 1973), where the contingency of outliving the debtor’s mother was considered too indefinite for purposes of equitable division in a divorce.}

Further, in the bankruptcy context, when the bankrupt was to receive her interest in trust when she attained the age of 25 one year later, the Bankruptcy Court held that the debtor/beneficiary’s interest was not too remote (i.e., contingent) to be included in the Bankruptcy estate.\footnote{In re Dias, 37 B.R. 584 (D. Idaho 1984).}

b. Sold With Fairness

Would a willing buyer or willing seller pay much for an interest in trust that was contingent on a child outliving his parent? Most likely, it would be highly discounted. However, what if the interest was subject to a special power of appointment in the surviving spouse what could divest the entire remainder interest? In this case, a purchaser at a judicial foreclosure sale most likely would pay little for the interest when compared to the amount that would ultimately be received by the remainder beneficiary.

First, the author would like to note that there are very few reported cases where anyone other than a former spouse attaches the remainder interest.\footnote{Mid America Corp. v. Geisman, 380 P.2d 85 (Okla. 1963) [In a one paragraph holding, the Supreme Court of Oklahoma reverses the appellate court decision to sell the remainder interest – noting the proper remedy was a lien. The Supreme Court thought the remedy was too drastic a measure as related to the beneficiary.]}

It is the author’s opinion that most creditors do not attempt to judicially foreclose on a remainder interest, because in almost all cases the “sold with fairness rule” would apply. Even if the “sold with fairness rule” did not apply, several states have passed state statutes preventing the forced sale of remainder interests.\footnote{Restatement (Third) of Trusts, Section 56, Reporter comment e.}
2. Spendthrift Protection & Remainder Interests

Absent spendthrift provisions, a beneficiary may transfer the remainder interest, and a creditor may attach such interest. This would include an estranged spouse as well as any other creditor could attach a remainder interest that was not protected by spendthrift provisions.

On the other hand, if spendthrift provisions are present, ordinary creditors may not attach a remainder interest. This is true even in Bankruptcy Court. The Federal Bankruptcy Court is required to look to state law to apply property rules. For example, In Re Neuton, a California state statute provided that spendthrift provisions protected 75% of the remainder interest. The debtor’s ordinary creditor could not recover against the amount protected by state law. However, if the creditor is one of the four exception creditors, the creditor may attach and/or judicially foreclose and sell the remainder interest.

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i Restatement (Second) of Trusts, Section 161 (1959); Henderson v. Collins, 267 S.E.2d 202 (Ga. 1980) [noting that in this case a remainder interest was a future property interest].

ii Martin v. Martin, 374 N.E.2d 1384 (Ohio 1978); Miller v. Department of Mental Health, 442 N.W. 2d 617 (Mich. 1989).

iii However, in the highly controversial case of U.S. v. Craft, 122 S. Ct. 1414 (2002), the Supreme Court overturned 50 years of well established property law when it stated that federal common law determined property rights.

iv In Re Neuton, 922 F.2d 1379 (9th Cir. 1990).

v Miller v. Department of Mental Health, 442 N.W. 2d 617 (Mich. 1989).
Conflicting Goals

–Asset Protection
–vs.
–Who Can Be a Trustee

H. Conflicting Goals

1. Asset Protection

As discussed in the following pages, a discretionary trust provides the strongest asset protection features, because the beneficiary does not hold a property interest under state law. If a beneficiary does not even hold a property interest, how could a creditor possibly attach it?

Unfortunately, as discussed in the Who Can Be Trustee Outline, a discretionary trust where a member of the family serves as the trustee (or co-trustee) many times will create an estate inclusion issue should such family member pass away.

2. Who Can Be a Trustee

Many times a client will want a spouse or a child to serve as a sole or co-trustee. If the trust is drafted where distributions are made pursuant to an ascertainable standard, in many cases this may be possible. Since the trustees power is limited by this objective standard, as previously noted, the power is disregarded for estate and gift tax purposes.

3. Conflicting Goals

Unfortunately, the goal of possibly allowing a close relative to serve as a trustee (or co-trustee) conflicts with the greater asset protection of a discretionary trust. With a discretionary trust, the trustee should not be a person who is related or subordinate within the meaning of IRC §672(c); Rev. Rul. 95-58.
I. Distributions Received From a Trust

1. Earlier Cases

Early common law held that a spendthrift provision generally protects a distribution received by a beneficiary from attachment. Bucknam v. Bucknam, 200 N.E. 918 (Mass. 1936); Jackson Square Loan & Sav'l Ass'n v. Bartlett, 53 A. 426 (Md. 1902); Boston Safe Deposit & Trust Co. v. Collier, 111 N.E. 163 (Mass. 1916). The distribution would be protected regardless of whether the trust had a mandatory distribution standard, a discretionary distribution standard or one based on ascertainable standards.

The purpose of a spendthrift trust was to protect a person who could not either adequately care for him or herself or could not control his or her spending habits. The public policy reason behind a spendthrift clause was to allow a trust to provide for the needs of a spendthrift so that such person did not become part of the welfare roles. If a creditor could attach a trust distribution once received by a beneficiary, the objective of spendthrift protection would be defeated.
2. State Statutes

Some state legislatures did not think that a spendthrift should be able to lead a life of luxury while they had outstanding obligations. Therefore, they limited the amount of protection to some formula of the reasonable needs of the beneficiary. For example, New York State Statute allowed a creditor to reach ten percent of the amount distributed to a beneficiary as well as the amount of principal held by the trust that was “unnecessary for the reasonable requirements of the judgment debtor.” California (Section 15307 of the California Probate Code) as well as Pennsylvania also appear to have this type of a state statute.

3. Restatement (Second) of Trusts

The Restatement (Second) of Trusts took the exact opposite position. Under Section 152 comment j, it held that a distribution was not protected once it was received by the beneficiary. The Restatement (Second) of Trusts omitted the earlier case law above and cited three cases to support its position. When the author reviewed these cases, he was unable to see how the facts of these cases strongly supported the position taken in the Restatement (Second) of Trusts. Further, if the position in the Restatement (Second) of Trusts is correct, as noted above, the original purpose behind creating the judicial exception allowing spendthrift protection would be defeated.

Further, since the three mid 1940 cases, the author is aware of two appellate cases on point. Without any supporting authority from any court or even citing the Restatement (Second) of Trusts and without any analysis in the opinion, the Montana Supreme court held that a creditor could execute on trust income once it was paid to the beneficiary. In a different case, the Tenth Circuit Court also reached the same conclusion. Unfortunately, the Tenth Circuit also did not cite any supporting authority for its holding or provide any analysis.

4. Uniform Trust Code and Restatement (Third) of Trusts

As noted above, earlier cases held that distributions from trust were protected when received by a beneficiary. Some states by statute limited this to the reasonable needs of a beneficiary. The Restatement (Second) of Trusts, Section 152 comment j took the position that a distribution may be attached after it was received by a beneficiary. After promulgation of the Restatement (Second) of Trusts, a couple of court cases appear to follow the Restatement, but make no mention of the Restatement in their findings. The Restatement (Third) of Trusts, Section 58 comment d. also takes the position that spendthrift protection does not extend beyond the point of distribution. However, both the Uniform Trust Code and the Restatement (Third) of Trusts make allowance for the reasonable needs of a beneficiary, by giving the court discretion to determine the reasonable needs of the beneficiary. In this respect, although it is not mandatory for a court to provide for the reasonable needs of a beneficiary, it is permitted under both the Uniform Trust Code and the Restatement (Third) of Trusts.

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i In re Vogel, 16 B.R. 670 (Bkrtcy S.D. Fla. 1981).


iv Guidry v. Sheet Metal Workers, Int’l Ass’n, 10 F.3d 700 (10th Cir. 1993), might be cited as one of those “bad facts make bad law” cases. Guidry misappropriated funds from his employer. The U.S. Supreme Court reversed and remanded the case back to the 10th Circuit and held the creditor could not reach the assets in Guidry’s pension plan. A pension plan is a spendthrift trust protected from attachment under ERISA. Upon being reversed, the 10th Circuit held once a distribution was made to a beneficiary (even if held in a segregated account), it was subject to attachment.

v Uniform Trust Code, Section 501 comment; Restatement (Third) of Trusts, Section 56, comment e.
J. Dominion and Control

1. Road Map

As previously noted, if a beneficial interest is not considered a property interest, under common law, the asset protection does not depend on spendthrift protection. In this case, unless a dominion or control issue or a divorce nuance is present, then no creditor may attach the beneficial interest in a discretionary/dynasty trust.

In the case of a support trust, an exception creditor may attach a current beneficial interest. However, unless a dominion or control issue or a divorce nuance is present, no other creditor may attach the current beneficial interest.

Generally, not even an exception creditor, may recover against a remainder interest. However, as noted in the following pages, a divorce nuance may well be an exception to this general rule.
Dominion & Control Issues

Attribution of Trustee Powers

- Sole Beneficiary Was the Sole Trustee
  - \textit{In re Bottom}, 176 B.R. 950 (Bkrtcy N.D. Fla. 1994)
  - Cannot protect against own improvidence
  - Does not discuss doctrine of merger

- Alter Ego Controlled by Settlor
  - No more than follows Settlor's instruction

2. Attribution of Trustee’s Powers

Several states require that in order for spendthrift provisions to be enforceable, not only must the settlor \textit{not} be a beneficiary, but the beneficiary must not have control or dominion over the assets of the trust. The concept of dominion and control is an attribution concept where most of the powers of the trustee are attributed to the beneficiary.

\textit{a. The Sole Beneficiary Was the Sole Trustee}

The purpose of spendthrift provisions is to protect the beneficiary from his own improvidence or incapacity for self-protection. If the sole beneficiary is the only trustee, he cannot protect himself from his own improvidence. Using a control and dominion argument, the court \textit{In re Bottom}, the spendthrift provision protection was not upheld,\textsuperscript{i} and the creditor was able to reach the assets of the trust. The doctrine of merger should also apply in a \textit{Bottom} fact pattern.

\textit{b. Alter Ego Trustee}

If the trustee does nothing more than follow the settlor’s instructions regarding investments and signing checks for distributions, the settlor controls the activities of the trust.\textsuperscript{ii} The trustee is nothing more than an instrument of the settlor. The same principal should also apply if a beneficiary is dictating all of the trustee’s actions.

\textsuperscript{i} \textit{In re Bottom}, 176 B.R. 950 (N.D. Fla. 1994).
\textsuperscript{ii} \textit{In re McCullough}, 259 B.R. 509, (D. Rhode Isl 2001).
Dominion & Control Issues

Trustee/Beneficiary Issues

– Co-Trustee/Beneficiary Without Absolute Control Over Distributions, Multiple Beneficiaries

“Another court may come to a different conclusion.” In re Hersloff – Bkrtcy Florida

In re Schwen – Bkrtcy Minn.

3 Beneficiary Serving as a Trustee

a. Beneficiary Serving as a Co-Trustee; Multiple Beneficiaries

On the other hand, two courts have held that the beneficiary/trustee did not control the trust when the beneficiary was a co-trustee and there were multiple beneficiaries.\(^1\) While these two courts indicated that the consent of at least one other person was sufficient to negate a dominion and control issue, another court may come to a different conclusion. In this respect, two cases may not be a representative sample on which to base one’s planning. Therefore, the author prefers not to use co-trustees where a beneficiary is also one of the trustees for asset protection planning purposes.

b. Beneficiary Serving as Sole Trustee; Multiple Beneficiaries

Some attorneys draft so that trusts (with an ascertainable standard distribution standard) and then have the primary beneficiary (i.e., the child) as the sole trustee of the trust. The trust has both the primary beneficiary and the primary beneficiary’s children as beneficiaries. To date, the author is aware of only one case which addressed the issue directly and another case that mentions the issue as dicta.

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\(^1\) In re Hersloff, 147 B.R. 262 (M.D. Fla. 1992); In re Schwen, 43 Collier Bankr. Cas. 2d 255 (D. Minn. 1999).
b. **Beneficiary Serving as Sole Trustee; Multiple Beneficiaries**

A recently published article in Trusts and Estates Dec. 2006 titled, *Beneficiary-Controlled Trusts Can Lose Asset Protection*, by Charles Harris and Tye J. Klooster warns of the problems of giving a beneficiary too much control – in particular where a beneficiary serves as the sole trustee. As primary authority for its conclusions, the article cites, *In re McCoy*, 2002 WL 161588 (ND. Ill. 2002) unreported case and the Restatement Third of Trusts, Section 60 comment g.

Some planners will disagree with the limited authority from which the authors base their conclusions. However, while the cases in this area are sparse, I do think that the article serves as a warning of that which may well become future planning issues. Particularly, in view of the unsupported position of law taken by *Restatement (Third) of Trusts*, Section 60 comment g.

i. **In re McCoy**

The primary issue discussed in *McCoy* was the dual discretionary distribution standards between the spouse/trustee and the children.

1. Regarding the children, the Trustee/Spouse could make distributions to them in his discretion for their health, education, maintenance, and support. He could also make unequal distributions between them.

2. However, in making distributions to himself as a trustee, he could distribute whatever was “required” or “desirable” for his own health, maintenance, and support. The trustee/spouse also “need not consider the interests of any other beneficiary in making distributions to my spouse or for his benefit.

The court concluded that the word “desirable” placed no ceiling on distributions, and that since he did not need to consider the interests of other beneficiaries he could distribute everything to himself. Therefore, he had control and dominion over the trust and the spendthrift provision was invalid.
Dominion & Control Issues

Sole Trustee is One of the Beneficiaries

- In re McCoy – probably bad fact case
- In re Coumbe, 304 B.R. 378 (9th Cir. 2003)
  - Different remainder beneficiaries
- Restmt. Third, Section 60, comment g.
  - No support under common law
  - However, how many judges know that in the area of creditor issues, the Restatement Third fails the definition of a Restatement?

ii. In Re Schwen - Dicta

In re Schwen, the court mentioned that if one of the beneficiaries was the sole trustee, the trustee/beneficiary’s control regarding making distributions was still limited by a fiduciary duty to other beneficiaries. Therefore, the trustee/beneficiary would not have control.\(^i\) It should be noted that in Schwen, there were actually two trustees and the court mentioned the sole trustee situation purely as dicta.

iii. In Re Coumbe

The 9\(^\text{th}\) Circuit in a review of a bankruptcy case has provided further guidance in this area when it held that a sole beneficiary could serve as the sole trustee for so long as there were different remainder beneficiaries.\(^ii\)

iv. Section 60 comment g.

Also, without any reported case law supporting its position, the Restatement (Third) of Trusts takes the position that the trustee/beneficiary interest may be reached as if the trustee/beneficiary were the settlor of a self-settled trust. Restatement (Third) of Trusts, Section 60, comment g. It is true that many states are passing laws, and even the UTC, reversed this unsupported position of law. However, in states that do not affirmatively fix this issue by statute, many judges will simply error by following the Restatement position that they would assume was based on common law.

\(^i\) David B. Young, The Pro Tanto Invalidity of Protective Trusts: Partial Self-Settlement and Beneficiary Control, 78 MARG.L.REV, 807, 855 (1955).

\(^ii\) In re Coumbe, 304 B.R. 378 (9\(^\text{th}\) Cir. 2003).
d. Co-Trustee Design Options

i. Independent Distribution Trustee

With a co-trustee option, the distribution should be independent within the meaning of IRC §672(c). This structure is theoretically sound from an estate planning perspective. Even when the beneficiary managing trustee holds a removal/replacement power over the distribution trustee, this structure is theoretically sound from an estate planning perspective.

ii. Grey Area

Unfortunately, it is uncertain whether this structure is theoretically sound from an asset protection planning perspective. When a single trustee may serve as trustee for multiple beneficiaries, we have already discussed the possible problems with such a planning structure. The above structure, is one more step removed from those issues.

Some planners will consider this structure, even though one step removed, is also a little too much in the grey area. Particularly if the fact pattern is that the managing trustee has a removal power over the distribution trustee and the distribution trustee is the managing trustee’s best friend.
K. Nuances Under Domestic Relations Law

1. Current Distribution Interest

The first nuance, was already discussed in detail under Spendthrift Provisions – Support Trust. In this section, the exception creditor status of an estranged spouse for child support or alimony was discussed. However, if the trust was drafted as a discretionary trust, the beneficiary did not hold a property interest or an enforceable right, and the spouse could not proceed against the assets of the trust.

Please note, while the exception creditor status allowed a spouse to proceed against the assets of a support trust for child support or maintenance, it does not allow an ex-spouse force a distribution of trust assets as a property settlement in the dissolution of the marriage.
2. Remainder Interest

Until recently, in the event of divorce, almost all asset protection planners thought that a remainder interest was free from division of marital property. First, most states provide that a gift (including the gift of a beneficial interest in trust) is separate property. Second, many courts in the domestic relations context have found that a remainder interest in trust is indivisible.\(^i\) Third, some courts have characterized a remainder interest in trust as to remote to be classified as marital property.\(^ii\) Finally, at least one court found that that a remainder interest in trust is an inchoate right and is nothing more than a mere expectancy.\(^iii\)

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\(^ii\) Loeb v. Loeb, 301 N.E. 2d 349 (Ind. 1973).

\(^iii\) Storm v. Storm, 470 P.2d 367 (Wyo 1970) [Note that since Wyoming has adopted the Uniform Trust Code, it is most likely that Storm v. Storm has been over turned by statute, under Section 501 of the Uniform Trust Code.]
a. The Shock Wave in Colorado

Most Colorado estate planners went into shock when the Colorado Supreme Court handed down the *Balanson v. Balanson* decision.\(^1\) The Colorado Supreme Court had held that the appreciation on a vested remainder interest subject to complete divestment was marital property eligible for equitable division. Please note, while Colorado law holds that inheritance is exempt from the definition of marital property, any appreciation on inherited property is considered marital property. Prior to this, Colorado had held that remainder trust interests were indivisible.\(^2\)

\(^{1}\) *In re Balanson*, 25 P.3d 28 (Colo. 2001).


\(^{3}\) Supra, Fn. 96.

i. Facts

The disturbing facts of *Balanson* begin when the daughter marries. A few years later, Mom and Dad create the standard estate plan in their wills or revocable trusts that creates the marital trust and the credit shelter trust (i.e., family, bypass, or exemption trust) upon the death of the first spouse. Several years later, mom dies and the first $1 million of her assets fund the credit shelter trust, the remainder fund the marital trust. Dad is the sole trustee of both trusts. All income of the marital trust is required to be distributed to Dad. However, distributions of income of the credit shelter trust and any corpus of either trust is based on ascertainable standards. Dad is in good health and may easily live another 15 years. Further, Dad has a testamentary general power of appointment over the marital share that allows him to completely extinguish the daughter’s interest should he desire by appointing all of the trust property to his son. Several years after Mom dies, Daughter files for divorce. Son-in-law claims that the daughter’s contingent remainder interest is marital property eligible for division in the divorce.

\(^{3}\) Supra, Fn. 96.

ii. Holding

The daughter’s remainder interest is contingent since she must outlive her father. Also, the daughter’s interest is subject to complete divestment, because her dad may exercise his special power of appointment solely in favor of his son. However, the Colorado Supreme Court ruled that even if a contingent remainder interest is subject to complete divestment, such an interest is still a property interest that can be valued for the purpose of division in a divorce.\(^{3}\) The logic behind the decision is that the Court values interests that are hard to value all the time, such as retirement plans or business valuations. Therefore, each side needs to merely bring in his or her experts – it’s only a valuation issue?!!?
b. A National Trend?

In *Balanson*, the Colorado case cited two other cases – *Davidson v. Davidson* (a Massachusetts case) and *Trowbridge v. Trowbridge* (a Wisconsin case) when it held that a contingent remainder interest subject to complete divestment was eligible for marital property division. So at first blush, following in Massachusetts footsteps, the Colorado Supreme Court appears to be crossing new legal ground. However, this does not quite appear to be the case. Rather, it appears that this is a national trend, rather than a few states with isolated occurrences. In fact, the author thinks that this issue will be similar to retirement plans. Approximately forty years ago, most courts held that retirement plans were not divisible and therefore not subject to division in the domestic relations context. However, now all states value retirement plan interests, and readily divide them in divorce settlements.

The following courts listed alphabetically by state detail where courts have found a remainder interest to be a marital asset eligible for division in a divorce:

(1) Alaska - *Burrell v. Burrell* - In 1975, the Alaska Supreme Court found a vested remainder interest is subject to division.

(2) Colorado - *Balanson v. Balanson* - In 2001, the Colorado Supreme Court held that any appreciation on a vested remainder interest subject to complete divestment was eligible for division as a marital asset.

(3) Connecticut - *Carlisle v. Carlisle* - In 1994, the Superior Court of Connecticut found remainder interests in a credit shelter trust, marital trust, and an irrevocable trust that were found to be marital property.

(4) Indiana – *Moyars v. Moyars* - In 1999, the Court of Appeals of Indiana distinguished the *Loeb v. Loeb*, 301 N.E. 2d 349 (Ind. 1973). *Loeb* had held that a contingent remainder interest was too remote to be considered marital property, because if the husband predeceased his mother, the entire trust property would pass to the husband’s siblings. In *Moyar*, the husband owned a vested one-third remainder interest in real estate. The remainder interest was not contingent on outliving his mother’s life estate. Rather, the remainder interest would pass to his estate if he predeceased his mother. Therefore, the Court of Appeals held that a vested remainder interest was marital property.

(5) Massachusetts - *Davidson v. Davidson* - In 1985, the Massachusetts Supreme Court held that neither uncertainty of value nor inalienability of husband’s vested remainder interest in a discretionary trust found sufficient to preclude division.

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ii  537 P.2d 1, (Alaska 1975).

iii  25 P.3d 28 (Colo. 2001)

iv  1994 WL 592243 (Superior Ct. of Conn. 1994).


vi  474 N.E. 2d 1137 (Mass. 1985). *Also see Lauricella v. Lauricella*, 565 N.E. 2d 436 (Mass. 1991) where a vested remainder interest in an irrevocable trust subject to a term of years subject to division of marital property.
In 1984, the Montana Supreme Court held that a husband who had benefited from his future interests (vested remainder interests) by using them as collateral, could not construe them as a mere expectancy and preclude them from property division as dissolution.

In 1994, the New Hampshire Supreme Court held that anti-alienation clause and circumstance that the defendant’s contingent remainder interest will not have value until his last parent dies does not preclude the treatment of the interest as marital property.

In 1994, the North Dakota Superior Court held that when where the present value of the husband’s vested credit trust was subject to contingencies and was too speculative to calculate, the court found the proper method of distribution was awarding the wife a percentage of future payments.

In 1978, the Ohio Supreme Court found a future interest whether contingent or executory is alienable.

In 1983, the Oregon Appeal court found vested as well as a contingent remainder interest is subject to division.

In 1992, the Vermont Supreme Court held techniques of actuarial valuation of pension interests held applicable to determining present value of husband’s vested, defeasible trust interest for the purposes of property division at dissolution.

In 1962, as dictum the Wisconsin Supreme Court held remainder interests in trust subject to conditions of survivorship, depletion of corpus, and spendthrift clause, are part of marital estate subject to division at divorce.

To date, twelve states have held that a vested remainder interest is property that is eligible for division in a divorce. Some states require the property to be vested, but most states hold that a vested remainder interest, even if subject to complete divestment is a marital asset. In this respect, the Balanson case is not the shock that many people first suspected. Rather, it appears to be a common finding in many courts when all or part of a remainder interest is considered marital property.

c. When is Division of a Remainder Interest An Issue For Marital Purposes?

One might ask why more states have not found a contingent remainder interest as property eligible for division. First as noted above, a hand full of states still follow the theories that a contingent remainder interest is not divisible, it is a mere expectancy, or it is to remote to be classified as marital property. However, the primary reason why more states have not found that a remainder interest is marital property is because in most states inheritance, including any appreciation on inheritance, is separate property. On the other hand, many of the aforementioned states which have concluded that a remainder interest is marital property have state statutes that in general are based on one of the following types:

ii 638 A.2d 1254 (N.H. 1994).
iii ND Sup Ct., No 940003 (1994).
iv 374 N.E. 2d 1384 (Ohio 1978).
v 656 P.2d 395 (Or. App. 1983).
vi 114 N.W. 2d 129 (Wis. 1962).
1. Inheritance is classified as a marital asset.

2. Inheritance is classified as separate property. However, the appreciation on inheritance is considered a marital asset.

3. The statute provides a factor test for dividing all property owned by either spouse at the time of dissolution. In other words, based on the state statute, the judge has complete authority to give the separate property of one spouse to the other spouse for reasons such as the length of the marriage, the contributions to the marriage of the receiving spouse, the needs of the spouse who has custody of the children, the lower income level of the receiving spouse, etc.

d. What About Spendthrift Provisions?

In the states that hold that a remainder interest is property eligible for division on the dissolution of a marriage, does an estranged spouse have greater rights than an ordinary creditor? Under the Restatement Second, an ordinary creditor cannot generally attach the remainder interest (until it is distributed), because the interest is either contingent or subject to spendthrift provision. However, as noted above, a spouse is an exception creditor for purposes of child support and alimony— but in most states this only applies in the situation of child support or alimony, not the division of marital property.

Further, from the older cases, it appears that the general rule was a spouse attempting to receive a property settlement stands no better than any other creditor. Unfortunately, the court cases cited in the twelve states above did not discuss the spendthrift issue. In one case, the Supreme Court of Massachusetts mentioned the spendthrift provisions in the facts of the case. Later in the opinion, without discussing the spendthrift provisions, the Court stated that it rejected the contention that “the content of estates of divorcing parties ought to be determined by the wooded application of the technical rules of the law of property. We [the Supreme Court of Massachusetts] think an expansive approach, within the marital partnership concept, is appropriate.” Therefore, as applied to remainder interests, a former spouse in many states has greater rights to a remainder interest than an ordinary creditor.

e. What is the Solution to the Remainder Interest Problem?

Once one of the aforementioned courts decided that a remainder interest was property, the only issue left was valuation. Therefore, the solution to the Balanson, Davidson, and other remainder interest problems is relatively straightforward—create an interest after the event date that is not a property interest for state law. In other words, create a dynasty trust for each child and his or her descendants.

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i Restatement (Second of Trusts), Section 162 (1959); Henderson v. Collins, 267 S.E. 2d 202 (Ga. 1980) [noting that a remainder interest was future property].

ii The author is aware that in some states statutes on domestic relations issues do not separate alimony and property settlements. Rather, these states view the two as
L. Discretionary Dynasty Trust

1. Definition of a Dynasty Trust

A dynasty trust is a trust where a remainder interest never vests in any beneficiary. Rather, the trust property continues to be held in one or more trusts until it is consumed, or a rule against perpetuities savings clause forces the trust to vest. A dynasty trust may be a multiple beneficiary trust, or the dynasty trust may split into separate dynasty trusts at each generation level. In a multiple generation beneficiary (sometimes referred to as “pot trust”), when the children, grandchildren, and great grandchildren are born, they all become beneficiaries of the same dynasty trust.

Unfortunately, the multiple generation beneficiary type of dynasty trust frequently results in fighting between siblings of all generations. Therefore, many planners prefer a dynasty trust which splits into multiple dynasty trusts when the parent passes away. For example, assume that Ted has two children, Doris and John. Ted settles a dynasty trust for his two children and their descendants. Upon Ted’s death (i.e., the event date), the trust splits into two separate dynasty trusts: one dynasty trust for Doris and her descendants and the second dynasty trust for John and his descendants. Also assume Doris has two children, Rebecca and Anne. At Doris’s death, Doris’s dynasty trust splits again into two separate dynasty trusts: one dynasty trust for Rebecca and her descendants and a second dynasty trust for Anne and her descendants. This division of the dynasty trusts into multiple dynasty trusts at each generation continues until the trust property of each dynasty trust is consumed or the rule against perpetuities savings clause forces it to vest.
3. **Who Uses a Discretionary Trust**

Discretionary trusts are primarily used for the following three purposes:

- **a. Problem Child or Child With a Problematic Spouse**

  Unfortunately, many families (maybe every other family) has a child where the parent does not trust the child’s decisions. This is true even though the child in many cases has grown to be an adult. In these cases, the parent typically will transfer this child’s inheritance in trust. The trustee will be a close friend or relative that the settlor (i.e., parent) has the utmost confidence to make the “hard” decisions. The client’s trusted friend, financial advisor, or relative is willing to accept the “thankless” trustee position and make the hard decisions, because the beneficiary has few rights to sue the trustee in court. (If the client [i.e., trust maker] had wanted the trust maker to have greater rights to sue the trustee, the client would have created a support trust.) Sometimes, it is not the child with the problem, rather the child’s spouse is considered an “outlaw” instead of an “in law” by the family. In this case, a discretionary trust may again be used as part of the planning process.

- **b. Special Needs Trust**

  A special needs trust is generally created by a parent for a person who is incapacitated: either physically or mentally. The parent wishes to restrict the gift to provide for benefits that are not covered by a governmental agency. Since a discretionary trust is not a “property interest,” a governmental agency cannot reach the assets in the trust. These trusts are generally not large trusts.

- **c. Wealth Preservation**

  These trusts tend to be the larger dollar trusts (usually greater than $1 million in assets). For families of wealth, these trusts are the preferred option of choice. Frequently, national speakers discuss these trusts under the names of the “mega trust,” “the beneficiary controlled trust,” the “intentionally defective beneficiary controlled trust,” “the dynasty trust,” the “beneficiary controlled trust,” and the “discretionary dynasty trust.”
Combining Asset Protection Features

- Current Distribution Interest
  - Support Trust – Attach the Interest
    - Exception Creditor - possibly force a distribution pursuant to the standard
  - Discretionary Trust = “nothing”

- Interest After the Event Date
  - Remainder Interest
    - Generally, could not attach
  - Dynasty Interest = “nothing”

2. Combining Asset Protection Features

The strength behind the discretionary dynasty trust lies with the combination of a current beneficial interest that has no value with an interest after the event date that also has no value. The result is that no interest in the trust is attachable by any creditor.
Why Not Generally Use a Discretionary/ Dynasty Trust

High Net Worth Client
- Mega trust or beneficiary controlled trust

Business Opportunities go to Trust

Marital Trust (A Trust) and Family Trust (B Trust) Planning
- What if the surviving spouse becomes dependent on governmental care

Special Needs Trust

Grandma Nancy

4. Discretionary/Dynasty Trust For Most Clients

Some estate planners are now advocating that almost all clients that do any planning should use discretionary/dynasty trusts. In other words, these estate planners are suggesting the opposite of what most estate planning practitioners currently do. Most practitioners tend to use ascertainable standards as the distribution standard and an age vesting as the remainder interest. Why do these planners think that the discretionary/dynasty trust should be the rule, rather than the exception?

As previously noted, the discretionary/dynasty trust is the vehicle of choice for high net worth individuals. So this concept is not new for these clients. How about a discretionary/dynasty trust when the client is an astute business client? If his or her parents could create a trust for the astute business client, the trustee could close future business opportunities of the clients. All of these future business opportunities would now be asset protected without going offshore or to a domestic asset protection trust state.

What about the standard marital and family trust client? If the husband passed away first, his assets are held in trust for the surviving spouse. What if the surviving spouse becomes eligible for governmental care? If the standard support trust had been drafted, the result is that governmental agency may reach the beneficial interest. On the other hand, if a discretionary/dynasty trust been used, the trust would function as a third party special needs trust. The result is that the government would not be able to attach the wife’s beneficial interest in trust.
Essential Keys

- **Asset Protection** – current or remainder interest
  - Beneficiary has no enforceable right
  - Beneficiary does not have a property interest

- All of the trust assets may be distributed directly to the beneficiary

- Control is not attributed by serving as a management trustee or holding a removal power
Problems in Uniform Trust Code States

A Beneficiary Code vs A Settlor Code

Conclusions From Roy Adams & Charles A Redd’s
July 18, 2006 Teleconference

Vermont Caller:
As practitioner’s, do you welcome the UTC in its present form and fill comfortable practicing under it?

Roy Adams:
I could live with it if it is the state’s law as long as I was certain that my change of situs clause would let me get out of it – in certain circumstances. Sir, overall and this is going to be a dangerous comment, perhaps [referring to the UTC] one step forward and two steps backward would be my concern.

Charles Redd:
If I have to answer the question do I welcome it [the UTC] meaning do I have to take it all or leave it all, I would say I do not welcome it.
NOTICE

If you are wearing a wireless Lavalier microphone, please be sure it is turned off. ALL conversations and other ambient noises can be transmitted to your conference room.
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Uniform Trust Code States

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Charles Redd:
If I have to answer the question do I welcome it [the UTC] meaning do I have to take it all or leave it all, I would say I do not welcome it.
Backbone of the UTC

➢ “There appears to be no foreseeable likelihood that the basic policy of tolerating spendthrift restraints will change in this country.” Ed Halbach, Reporter Restatement Third – Calif. Law Review, Dec. 2000

➢ “Dean Grizwald” – Who hated spendthrift provision

➢ Citing Dean Grizwald as a proponent of asset protection is like . . .

C. Interpretation Problems

A fundamental flaw in the hull of the UTC ship is the design of the code as interrelated to its comments and the Restatement Third. A statute should be able to stand by itself, because it is the code, not the comments that legislatures pass as law. Further, comments should not contain substantive law or reference to 900 page treatises for substantive law. Unfortunately, the UTC is built on a small code, comments that are three and one-half to times greater than the statutory text. Further, the UTC references over 100 times into the Restatement Third, many times importing substantive law.

The UTC’s importation of law from sources outside the statutory code is not analogous to a construction statute referencing a building code. A building code has engineering specifications for density, strength, height, length, width, and weight. These are certain measurements that professionals do not disagree regarding the composition. On the other hand, in the area of creditor’s rights, the Restatement Third is simply not a restatement. In some areas it is a creation, and in many others it is an aggregation of distinct minority opinions. Sadly, the Restatement Third in the area of creditors rightst appears to be nothing more than what as select few would wish the law to become. Unfortunately, to the detriment of all estate and SNT planners that relied on hundreds of years of common law to protect beneficial interest, this wish of a select few may well become a reality over time by the UTC’s adoption of the “continuum of discretionary trusts” and multiple references into the Restatement Third for substantive law.
A Few Amendments

- After originally denying any problems with the UTC, a few issues were addressed

- NCCUSL 2004 and 2005 Amendments
  - Comment under § 106 was amended from giving Restatements a slight preference under common law to look to state law first
  - UTC § 504(e) was added so that any creditor could not attach a sole trustee’s interest.
  - UTC § 501 was modified and comment added in the hope a judge would not allow all creditors to attach at the trust level.
  - Comment under UTC § 501 modified so that creditors could not force the judicial foreclosure sale of all beneficial interests in trust (i.e., both current and remainder) – Now up to Restatement Interpretation
  - UTC § 503(c) – hopefully an exception creditor can only attach present and future distributions
  - UTC § 506 was modified so that an “undefined mandatory distribution” would not be interpreted as a right to demand a distribution.
  - UTC § 504 comment modified so that abolishment of the discretionary-support distinction would only apply to creditors.

A. A Few UTC Amendments Based on the Concerns Expressed

The authors have received an incredible number of positive comments regarding the articles listed on the previous page. As expected, there are differences of opinion voiced by some members of UTC committees. Several Uniform Trust Code (“UTC”) committees have made modifications to the UTC in an attempt to resolve some of the issues addressed in these articles. In fact, the National Conference of Commissioners on Uniform State Laws (“NCCUSL”) recently proposed changes that were finalized on February 18, 2005. We are honored that many of changes made by NCCUSL’s and state UTC commissions attempt to resolve some of the issues that we raised. While these changes appear to be a step in the right direction, these modifications are simply insufficient to resolve the major problems created by the undefined “continuum of discretionary trusts.”

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The proposed North Carolina, and South Carolina Uniform Trust Codes have made modifications to Article 5. Ohio has made a weak effort with its wholly discretionary trust. While Virginia has not made significant modifications to Article 5, it has attempted to address some third party SNT issues by adding special needs protective provisions. Similar to the Ohio model, the Virginia model falls drastically short regarding the available resource issues discussed in this article. The Missouri UTC has also met with the Missouri Elder Law Section to also attempt to deal with the many threats to SNTs created by the UTC.
Based on the issues voiced by those of us expressing of the UTC, the following amendments have been made by NCCUSL:

- The original comment under UTC Section 106 implied that Restatements had priority in interpretation over common law. This was modified to state:
  
  “The Code is supplemented by the common law of trusts, including principles of equity. To determine the common law and principles of equity in a particular state, a court should look first to prior case law in the state and then to more general sources [Emphasis added], such as the Restatement of Trusts, Restatement (Third) of Property: Wills and Other Donative Transfers, and the Restatement of Restitution.”

Unfortunately, this comment now appears to conflict with the goal of uniformity and UTC § 1101. Further, legislators do not pass comments as substantive law, and allowing substantive law to be changed by a national committee rewriting a comment is simply very poor drafting.

- UTC § 504(e) was added so that any creditor could not attach a sole trustee’s interest. The ability for a creditor to attach a sole trustee’s interest in a trust had no basis in common law.

- UTC § 501 was modified and a comment added so that it was hopeful that a judge would not interpret UTC § 501 to mean that all creditors could attach at the trust level.

- The comment under UTC § 501 appeared to allow for the judicial foreclosure sale of current beneficial interests as well as remainder interests. Allowing the judicial foreclosure sale of current beneficial interests is a position that had virtually no legal support in common law. This comment has now been deleted. The UTC committee has added language referring to both the Third Restatement and Second Restatement regarding the judicial foreclosure sale of remainder interests. Regrettably, the UTC comment does not disclose that the Restatement Third has changed the strong presumption against the judicial foreclosure sale of a remainder interest to a presumption of a judicial foreclosure sale in favor of the creditor.

- UTC § 503(c) was added and the comment modified with the hope that the only remedy granted to an exception creditor was the ability to attach present and future distributions. After this amendment, hopefully an exception creditor, such as an estranged spouse, may no longer force the judicial foreclosure sale of a beneficiary’s interest. Unfortunately the specific language of the amended UTC does not reflect the intent of the amended comment. The specific language of UTC § 503(c) does not provide that attachment of present and future distributions is the sole remedy.
Even After Amendment
Substantial Asset Protection Concerns Remain

Roy Adams
– Would you agree Clary that in many respects, the UTC broadens creditor rights?

Charles Redd
– Yes, I do agree that the UTC substantially broadens creditor rights.

B. Substantial Asset Protection Issues Remain

While some changes were made to address some of the many asset protection concerns expressed by the UTC, many substantial asset protection concerns remain. At their July 18, 2006 Estate Planning teleconference, Roy Adams and Charles Redd both agreed that the UTC substantially broadened the rights of creditors. In addition to the above statements, the following concerns were also expressed:

Roy Adams:

“Trusts are used so often on a spendthrift reason alone Clarry, at least I see in my practice the children receive certain property outright at a certain point in time, but something is held back that others can’t reach – third parties, and those rules have been substantially weakened.”

“A discretionary trust is not treated like under common law where discretion does not give them any property right, but under statutory law of the UTC where it is a property right.”

Charles Redd:

“Everyone in our state [Missouri] believed that before we enacted the UTC in our estate, which became effective January 1, 2005, that there was a huge distinction with regard to creditor’s rights between discretionary and support trusts. [The UTC eliminates the advantage of discretionary trusts.]”
C. Interpretation Problems

A fundamental flaw in the hull of the UTC ship is the design of the code as interrelated to its comments and the Restatement Third. A statute should be able to stand by itself, because it is the code, not the comments that legislatures pass as law. Further, comments should not contain substantive law or reference to 900 page treatises for substantive law. Unfortunately, the UTC is built on a small code, comments that are three and one-half to times greater than the statutory text. Further, the UTC references over 100 times into the Restatement Third, many times importing substantive law.

The UTC’s importation of law from sources outside the statutory code is not analogous to a construction statute referencing a building code. A building code has engineering specifications for density, strength, height, length, width, and weight. These are certain measurements that professionals do not disagree regarding the composition. On the other hand, in the area of creditor’s rights, the Restatement Third is simply not a restatement. In some areas it is a creation, and in many others it is an aggregation of distinct minority opinions. Sadly, the Restatement Third in the area of creditors rightst appears to be nothing more than what as select few would wish the law to become. Unfortunately, to the detriment of all estate and SNT planners that relied on hundreds of years of common law to protect beneficial interest, this wish of a select few may well become a reality over time by the UTC’s adoption of the “continuum of discretionary trusts” and multiple references into the Restatement Third for substantive law.
Interpretation Problems

- “A judge considering a trust law question covered in the Trust Code, therefore, will have a wonderful tool to use for research and will have the solace of knowing that the Uniform Trust Code is positive law and therefore the judge can ignore any argument of counsel that the Restatement is not binding because it has not been enacted by a legislature.”

  Maurice A. Hartnett III, Drafter of the UTC

- Hard to determine what is adopted by reference and what is not;
- May always argue both sides of the coin.

Full quote:

“A major help for those who will use the Uniform Trust Code is the relationship between the Trust Code and the Restatement of Trusts 3rd (now partially completed). The Trust Code was drafted at the same time that Edward C. Halbach Jr. was preparing the Restatement of Trusts 3rd for the American Law Institute. Although the Restatement and the Uniform Trust Code were separate projects, Reporter Halbach attended and vigorously participated in each drafting session for the Trust Code and representatives of the Trust Code attended the sessions of the Advisors to the Restatement of Trust Project. The Reporter for the Trust Code, David English, and Reporter Halbach also shared their drafts. This informal cooperation between the Trust Code Drafting Committee and the Reporter for the Restatement is perhaps unique. It resulted in cross-references from the Restatement of Trusts 3rd to the Uniform Trust Code and from the Code to the Restatement. This combination, coupled with the Comments and Reporter’s Notes contained in the Restatement and the official Comments to the Trust Code, has resulted in a concise and accurate statement of the law of trusts.

A judge considering a trust law question covered in the Trust Code, therefore, will have a wonderful tool to use for research and will have the solace of knowing that a particular provision in the Uniform Trust Code is positive law and therefore a judge can ignore any argument of counsel that the Restatement is not binding because it has not been enacted by a legislature.”

A Judge’s View of the Uniform Trust Code, Maurice A. Harnett III, UTC Notes 3rd Qtr. Fall of 2003.

The authors agree that both committees worked on both projects together. The authors disagree that in the area of creditors rights and reformations that either the Uniform Trust Code or the Restatement Third is even close to an accurate representation of common law.
D. Abolishes the Discretionary – Support Distinction

1. Abolishes the Discretionary-Support Distinction

The traditional trust analysis has explained in detail the difference in asset protection with a discretionary dynasty trust, where neither the current distribution interest is an enforceable right nor the interest after the event date is a property interest. The asset protection afforded by a discretionary dynasty trust is based on a property or enforceable right analysis. On the other hand, for support trusts the asset protection is based on spendthrift protection, subject to the four exception creditors.

2. Claims 125 Year Court Distinction is Arbitrary and Artificial

“Not only is the supposed distinction between support and discretionary trusts arbitrary and artificial, but the lines are also difficult – and costly – to attempt to draw. Attempting to do so produces dubious categorizations and almost inevitably different results (based on fortuitous differences in wording or maybe a “fireside” sense of equity) from case to case for beneficiaries who appear, realistically, to be similarly situated as objects of similar settlor intentions.” § 60 Rept Note to cmt. a.

3. Continuum of Discretionary Trusts

The Restatement Third specifically states that there should be no discretionary/support trust dichotomy. Rather, the Restatement Third creates new law when it defines a continuum of discretionary trusts, from the most discretionary to a support trust.

4. Only Spendthrift Protection Remains For a Discretionary Trust

The result of equating a discretionary trust to a support trust for asset protection purpose is now both trusts only enjoy spendthrift protection.
Discretionary Trusts
Nothing More Than Support Trusts??

■ Common Law Definition of a Discretionary Trust
   – Not a property interest;
   – A beneficiary does not have an enforceable right to a
distribution; and
   – It is nothing more than a mere expectancy.

■ Third Restatement
   – Almost every beneficiary has an enforceable right to a
distribution
   – On an undefined continuum of discretionary trusts

E. Discretionary Trusts Nothing More Than Support Trusts
   1. Common Law
      Prior to the Third Restatement and the UTC, the definition of a
discretionary trust was that a beneficiary did not have an enforceable right to a
distribution. Therefore, a beneficiary did not have a property interest and held
nothing more than a mere expectancy of a distribution. As discussed in detail,
the reason a beneficiary did not have an enforceable right to a distribution was
the high threshold that a beneficiary must meet before a court would even
review the trustee’s discretion.

      2. Third Restatement
      With apparently no common law to support its position, the Third
Restatement abolishes the discretionary–support distinction under common
law. Replacing hundreds of years of discretionary common law, the
Restatement Third adopts a new undefined continuum of discretionary trusts.
Under the Restatement Third, almost all beneficiaries have an enforceable
right to a distribution. The only question is how much on an undefined
continuum. In essence, the term discretionary trust has been completely
redefined by the Restatement Third. As explained in detail in this outline, in
essence the term “discretionary” is a misnomer. A more appropriate definition
is that the UTC has created an undefined “continuum of support trusts.”

      3. Roy Adam’s and UTC
      “A discretionary trust is not treated like under common law where discretion
does not give them any property right, but under statutory law of the UTC
where it is a property right.” Roy Adams, 2006 Estate Planning
Teleconference, July 18, 2006.
3. Second Restatement of Trusts

The Second Restatement of Trusts focuses on the grant of extended discretion to determine whether a beneficiary has an enforceable right. Absent clear settlor intent to the contrary, the use of the words “sole,” “absolute,” or “unfettered” discretion will almost always result in the classification of the trust as a discretionary trust. In this respect, regardless of whether a trust contained a standard capable of judicial interpretation or incapable of judicial interpretation, the trust would be classified as a discretionary trust, and a beneficiary would not have an enforceable right.
### Third Restatement

#### Enforceable Right

<table>
<thead>
<tr>
<th>Discretionary Language</th>
<th>Pure Support Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>-words of “may,” and/or “unfettered discretion”</td>
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</table>

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4. **Restatement Third Position**

As detailed in the following quotations it appears the Restatement Third takes almost the opposite position than the Second Restatement of Trusts:

- At first blush, it appears the Restatement Third follows the common law discretionary trust view when it states, “A transferee or creditor of a trust beneficiary cannot compel the trustee to make discretionary distributions if the beneficiary personally could not do so.” However, the sentence immediately following the above sentence, for almost all purposes negates the above sentence. It state, “It is rare, however, that the beneficiary’s circumstances, the terms of the discretionary power, and the purposes of the trust leave the beneficiary so powerless.”

- “Reasonably definite or objective standards serve to assure a beneficiary some minimum level of benefits, even when other standards are included to grant broad latitude with respect to additional benefits.” In other words, similar to the aberrational line of discretionary-support trust cases in Ohio, Connecticut and to a lesser extent Pennsylvania, the Restatement Third adopts this distinct minority position.

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i  *Restatement (Third) of Trusts*, Section 60, comment e.

ii  Id.

iii  *Restatement (Third) of Trusts*, Section 50, comment on Subsection (2): d. first paragraph.
Even if a trust does not include a standard, under the Restatement Third the beneficiary is not safe. “It is not necessary, however, that the terms of the trust provide specific standards in order for the trustee’s good-faith decision to be found unreasonable and thus constitute an abuse of discretion.” The Restatement Third goes further to the most likely imputation of a distribution standard if there is no standard or guideline when it states, “Sometimes trust terms express no standards or other clear guidance concerning the purpose of a discretionary power, or about the relative priority intended among the various beneficiaries. Even then a general standard of reasonableness or at least good-faith judgment will apply to the trustee (Comment b), based on the extent of the trustee’s discretion, the various beneficial interests created, the beneficiaries’ circumstances and relationships to the settlor, and the general purposes of the trust.”

Reporter Comment under Section 60(a) that states, “The fact of the matter is that there is a continuum of discretionary trusts, with the terms of the distributive powers ranging from the most objective (or “ascertainable,” IRC 2041 of standards (pure “support”) to the most open ended (e.g. “happiness”) or vague (“benefit”) of standards, or even with no standards manifested (for which a court will probably apply “a general standard of reasonableness.”) In other words, it is the Third Restatement view that a “reasonableness standard” of review should be applied to most discretionary trusts, regardless of whether or not the trustee is granted “sole,” “absolute,” or “unfettered” discretion.

Regarding rights between remainder beneficiaries, the Restatement Third takes issue with common law that all (or none) of the trust could be distributed to a discretionary beneficiary. Referring to common law, “This “one-sided” liberalization of the discretionary authority, where a court finds the settlor’s language was intended to assure generosity in favor of a life beneficiary, would thus tend to encumber the efforts of remainder beneficiaries who see to challenge what might otherwise be excessively generous decisions by a trustee.”

After reviewing the above quotations as well as reading Sections 50 and 60 (including comments and reporter comments), it becomes quite apparent that “It is rare, however, that the beneficiary’s circumstances, the terms of the discretionary power, and the purposes of the trust leave the beneficiary so powerless” that such beneficiary cannot force a minimal distribution. Remember, as demonstrated by the minority line of discretionary-support cases, such minimal distribution disqualified the beneficiary from governmental assistance.

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i Restatement (Third) of Trusts, Section 50, comment on Subsection (1): b., third paragraph last line.
F. What’s At Stake

Discretionary trusts are primarily used for the following three purposes:

1. Problem Child or Child With a Problematic Spouse

Unfortunately, many families (maybe every other family) has a child where the parent does not trust the child’s decisions. This is true even though the child in many cases has grown to be an adult. In these cases, the parent typically will transfer this child’s inheritance in trust. The trustee will be a close friend or relative that the settlor (i.e., parent) has the utmost confidence to make the “hard” decisions. The client’s trusted friend, financial advisor, or relative is willing to accept the “thankless” trustee position and make the hard decisions, because the beneficiary has few rights to sue the trustee in court. (If the client [i.e., trust maker] had wanted the trust maker to have greater rights to sue the trustee, the client would have created a support trust.) Sometimes, it is not the child with the problem, rather the child’s spouse is considered an “outlaw” instead of an “in law” by the family. In this case, a discretionary trust may again be used as part of the planning process.

2. Special Needs Trust

A special needs trust is generally created by a parent for a person who is incapacitated: either physically or mentally. The parent wishes to restrict the gift to provide for benefits that are not covered by a governmental agency. Since a discretionary trust is not a “property interest,” a governmental agency cannot reach the assets in the trust. These trusts are generally not large trusts.

3. Wealth Preservation

These trusts tend to be the larger dollar trusts (usually greater than $1 million in assets). For families of wealth, these trusts are the preferred option of choice. Frequently national speakers discuss these trusts under the names of the “mega trust,” “the beneficiary controlled trust,” “the intentionally defective beneficiary controlled trust,” “the dynasty trust,” “the beneficiary controlled trust,” and the “discretionary dynasty trust.”
G. Discretionary Dynasty Trusts

1. Beneficiary Now Has An Enforceable Right in Almost All Discretionary Trusts

As discussed later in this outline, a beneficiary now has an enforceable right in most, if not all trusts, and therefore, must rely on spendthrift protection. This is particularly problematic in the divorce area as well as a discretionary dynasty trust functioning as an SNT – should the need arise.

2. Ability to Distribute the Entire Trust To One Beneficiary

In 1989 in the reported case of *In re Estate of Winograd*, 582 N.E.2d 1047 (Ohio 1989), the Ohio Appellate court applied a “reasonableness” standard as applied to a discretionary trust. Unlike the *Kreitzer* line of cases where the Ohio definition of “abuse” or the “good faith” standard allowed the governmental Medicaid and special needs creditors to either recover from the trust or deny benefits, *Winograd* attacks the basis of a beneficiary controlled trust. One of the key concepts behind a beneficiary controlled trust is that a beneficiary is happy to receive his or her share of inheritance in trust because should the beneficiary need the funds, the trustee may distribute all of the trust fund to the primary beneficiary. In other words, the trustee may completely exclude any other beneficiaries from any distributions and all amounts may be paid to the primary beneficiary if needed. In applying a reasonableness standard, the Ohio Appellate Court held that the trustee abused his discretion by distributing all of the income to the primary beneficiary. The Court came to this conclusion even though the trust had the specific language that the trustee could make distributions of income “to or for the benefit of any one or more to the exclusion of any one or more” of the beneficiaries, and the trustee should consider the primary beneficiary first and only second the primary beneficiary’s descendants in making distributions. Unfortunately, Ohio is not alone in destroying one of the fundamental aspects of a beneficiary controlled trust. The Restatement Third also takes the same position as the appellate court in *Winograd*. *Restatement of Trusts (Third)*, Section 50, comment c., last paragraph.
H. Divorce Issues Created By The UTC

A discretionary dynasty trust is frequently used by estate planners when an estranged spouse lurks in the background constantly thinking of another way to attempt to “extract something for nothing” from a former spouse. For a detailed discussion of these issues please see The UTC – A Divorce Attorney’s Dream, Merric, Stevens, and Freeman, Journal of Estate Planning, Oct.-Nov. 2005. This article may be downloaded at www.InternationalCounselor.com.

1. Spouse Suing By Sole Custody

Under common law, a discretionary beneficiary does not have a right to force a distribution. However, under the UTC, most, if not all, discretionary beneficiaries have a right to force a distribution pursuant to the undefined continuum of discretionary trusts. Since now each beneficiary has a right to force a distribution from a discretionary trust, may an estranged spouse stand in the shoes of a minor beneficiary and demand a distribution from the trust? The answer will most likely depend on the rights granted to the spouse under state law. If a spouse has sole custody, it seems that such estranged spouse may represent a child in an action against the trust. Further, could the estranged spouse ask for attorney fees under UTC Section 503(b)(2)? Unfortunately, this again appears to be the correct result.

Imagine the predicament the estate planner is now in. Prior to the UTC, the child had no right to force a distribution, and the estate planner had told the parents this. Now, even though the estranged spouse is not an exception creditor, he or she now has a right to stand in the shoes of the child, demand a distribution on behalf of the child. Further, the estranged spouse has a good chance of receiving legal fees for bringing such an action.
Divorce Issues

Settlor

Settlor’s Spouse

Brutus

Cleopatra

GC1

GC2

Spouse Has Sole Custody

Anytime “descendants” are listed as beneficiaries

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Divorce Issues

Marital Property Issue
- Where no enforceable right to distribution – not a property interest – *Balanson, Jones, McGuiness*
- UTC Beneficiary now has enforceable right to force distribution pursuant to standard under §504(d).
- Enforceable right = it becomes a property interest.
- Only issue is valuation of the “appreciation”

Factor For Equitable Division in Divorce

Imputed Income for Alimony or Divorce

2. Marital Property Issue

Under the majority rule, if a beneficiary did not have an enforceable right, a property interest, the beneficiary’s interest in the trust property was not marital property. However, under the UTC § 504(d), the beneficiary now has an enforceable right to sue the trustee pursuant to a good faith standard under § 814(a). Once a beneficiary has an enforceable right, the beneficiary holds a property interest, and the only remaining issue is that of valuation. *Balanson v. Balanson*, 25 P.3d 28 (Colo. 2001).

3. Equitable Factor For Division of Marital Property

Regardless of whether a judge holds that a trust beneficiary’s interest is marital property under the UTC and domestic relations law, the judge may consider the enforceable right as a factor in determining the equitable division of marital property. Remember, regardless of whether the trust was previously classified as a discretionary or support trust under common law, the beneficiary now has an enforceable right to a distribution.

4. Imputed Income To Determine Alimony or Child Support

Under UTC § 504(d), the beneficiary has an enforceable right to sue for a distribution pursuant to whatever standard is in the trust. If a standard is not present, the court will create one. Therefore, why wouldn’t the beneficiary’s enforceable right to income be considered in the computation of child support and alimony? Similar to the SNT “available resource” issue, does a beneficiary have an “available resource” from which a judge should may impute distributions to calculate income for child support? *Dwight v. Dwight* discusses this issue.
5. *Dwight v. Dwight*
   
a. *A Fairy Tale?*

Whether concerns over unbridled expansion of power are overblown may be illustrated by the case of *Dwight v. Dwight.* At first, the author was unable to reconcile this case with existing law based any analysis of the case law of discretionary trusts. Further, the author had read a brilliant commentary by one of the lead asset protection and estate planning attorneys who also had reached the same conclusion. However, if one refers to the UTC or the Third Restatement of Trusts, the court’s decision becomes clear. However, first we need to discuss the facts of the case.

b. *Facts*

Upon dad’s death, sixty percent of the estate went to his two daughters outright, and the other forty percent of the estate went to the son in a discretionary trust. The trust was discretionary, providing that the trustee make distributions of income and principal as the trustee deemed necessary or desirable for the support, comfort, maintenance or education of the beneficiaries. It appears the court interpreted this to be a discretionary standard. The beneficiaries were the husband and the husband’s issue. During the nine years prior to the Massachusetts Appellate Court decision, the trust made one discretionary distribution in the amount of $7,000 to the husband. During this period of time, the trust corpus grew from $435,000 to $984,000.

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The trial judge stated that it was highly likely that the principal reason the husband received his inheritance in trust, rather than outright like his two other sibling, was to defeat a claim for alimony. The trial court further found the husband had access to additional funds at anytime he desired based on two facts:

1. the broad purposes for which the trustee may make payments to the husband; and
2. a statement the husband made to the trustee that he did not need any additional money.

The trial court found that the husband’s earnings from the discretionary trust should be imputed for the purpose of alimony. The Massachusetts Court of Appeals agreed with the trial court.

c. Analysis Under the Third Restatement

Without any discussion, the Appellate Court decision dismisses the husband’s contentions that the trust is a discretionary trust. Rather, the opinion cites the Restatement of Trusts (Third) Section 59 (Ten. Draft No. 2, 1999) as authority for dismissing the husbands claim. As noted, under the Restatement Third and the UTC¹, a spouse can reach the assets of a discretionary trust for alimony and child support.

Further, a judge may determine what the trustee should be “reasonably” distributed or distributed in “good faith.”² In acting reasonably, the broad standards for the purpose of distributions must be analyzed to determine whether distributions should have been made and therefore become part of the alimony computation. Here, the court opined that the purpose of the trust was a bad purpose - to defeat an alimony claim. Therefore, under both the UTC and the Restatement Third, the court was within its authority to completely disregard the discretionary trust and impute income to the husband for the computation of alimony, even though he only receive a token of what was imputed to him.

¹ Uniform Trust Code, Section 504, National Conference of Commissioners on Uniform State Laws 2001.
² Restatement (Third) of Trusts, Section 50 comment b.; Uniform Trust Code, Section 814(a).
d. Control Analysis

The Appellate Court also appeared to be making a control type argument that the mere statement to the trustee that the beneficiary did not need funds combined with the broad standards of distribution meant the settlor could get funds whenever he needed them. In essence the trial court and the appellate court claimed the settlor controlled the trust and could receive a distribution at anytime. The argument is similar to that of a dummy trustee. Yet, the author remains perplexed. The author is unaware of any holding in any state on these small facts that would even remotely come to the conclusion that the beneficiary controlled the trust. In this respect, the author would disagree with the Appellate Court.

e. Should the Trust Pay Attorney Fees?

It should be noted that while Dwight v. Dwight relied on the Restatement Third, it was decided before the Restatement Third was even finalized. Further, Massachusetts has not adopted the UTC. However, if Massachusetts had adopted the UTC, to add insult to injury, the former spouse would have been able to recover legal fees from the trust.

f. Expands the Ohio Kreitzer logic of cases

Remember the judicial standard of review discussion and “Ohio – A Tale of What Not to Do.” In these cases, income was imputed from a discretionary trust for the purpose of determining whether the beneficiary would qualify for Medicaid. After the imputation, the beneficiary no longer qualified. The decision in Dwight expands the logic of the Ohio Kreitzer case where the court imputed income and disqualified a beneficiary from Medicaid to imputing income in a domestic relations situation. The question then becomes where else can this concept be extended? One only need remember UTC § 506 where all creditors may attach a deemed overdue distribution.
I. Beginning of the End of SNTs?

1. Where Did Third Party SNTs Originally Come From?

   With the earlier cases and currently in many states, a discretionary trust serves as a SNT. The analysis is simple, since the beneficiary has no right to reach the assets of the trust, then neither does a creditor – including the government. In other words a discretionary interest in a trust was neither a property interest or an enforceable right.

2. Beginning of the End of Third Party SNTs?

   For states that pass the UTC, the author suggests that it is only a short period of time before third party Medicaid or special needs type planning will be eliminated in these states. A third party Medicaid or special needs trust is a trust where the parents or grandparents have created the trust for the benefit of a child. In order to gradually reduce or eliminate third party Medicaid or special needs trusts two steps must be accomplished:

   (1) the discretionary/support distinction must be eliminated so that all trusts rely on spendthrift protection; and

   (2) after that, all the federal government or state legislature needs to do to pierce any trust (discretionary or support trust) is to provide in a statute that the government may attach the beneficiary’s interest and most likely reach some or all of the trust assets.

   With the rising costs to care for the elderly, it is only a matter of time before most, if not all, states will do this, as well as the federal government. Remember, prior to the UTC or Third Restatement, states determined property law rights, and a discretionary trust was not a property interest. As previously noted, both third party Medicaid trust planning and special needs trust planning depend on the dichotomy analysis between discretionary and support trusts related to this property issue.
Is the UTC the Beginning of the End for Third Party SNTs?

- Proponents argue that the Federal Government could always do this, and federal law preempts state law
  - Property interest defined under state law
  - But see, *Craft*
  - Highly unlikely a federal trust act defining state property rights would occur.

- Two Part Analysis:
  - Is the SNT considered an available resource?
  - May the governmental agency attach the trust?

3. **Proponent’s Preemption Argument**

Proponents of the UTC dismiss the two step approach argument as irrelevant, because the federal government can pass a comprehensive amendment accomplishing both steps in one act. They contend that federal law automatically preempts state law. With this argument, the proponents of the UTC have accepted a broadening of the authority of the federal government, which is not justified as a matter of policy and may well involve constitutional issues regarding due process, state’s rights, and impairment of contract, particularly since these provisions are made retroactive.\(^i\)

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\(^i\) As noted in In Re Wilson, 140 B. R. 400 (N. D. Texas 1992). “Spendthrift and similar protective trusts are not sustained out of consideration for the beneficiary; their justification is found in the right of the settlor to control his or her bounty and secure its application according to his or her pleasure.” and “To allow the IRS to reach any part of the trust in question would frustrate Mrs. Huval's intentions and deprive the residual beneficiaries of what is rightfully theirs.” But see, *U.S. v. Craft*, 122 S.Ct. 1414 (2002). In *Craft* the federal government was allowed to attach tenancy-by-entirety property contrary to Michigan state law. However, *Craft* may be distinguished from a discretionary trust interest under state law. In *Craft*, there is no question that the debtor held an interest in property. With a discretionary trust under common law the beneficiary holds no property interest under state law – until the UTC created one.
The UTC concedes this undue expansion of power of the federal government in the official comments to UTC Code § 503(c) that states that “federal preemption guarantees that certain federal claims, such as claims by the Internal Revenue Service, may bypass a spendthrift provision no matter what this code might say.” Under common law, a discretionary interest in trust is not a property interest under state law. Therefore federal preemption has not been applicable with respect to discretionary trusts.\(^i\) Absent the UTC creating a property interest in almost all, if not all, discretionary trust interests, not even the Internal Revenue Service with its expansive powers has been able to force a distribution from any common law discretionary trust.\(^ii\) After the UTC concedes the Constitutional issues to the federal government, all that the federal government need do is make reference in any statute that it is an exception creditor under the UTC.

Even if the federal government could overcome the Constitutional and property interest issues under state law with one act, there are non-legal practical issues involved. It is believed that a one-step approach where the federal government redefines a discretionary trust to be a property interest and then allows attachment and possibly judicial foreclosure of beneficial interests is highly unlikely to occur. Such a sweeping change in common law protection of the poor would not go unnoticed. Lobby groups, bar associations, and handicapped persons would strongly oppose such legislation. In addition, an overhaul of established trust law is unprecedented. In sum this third point appears to be an area where opinion, not legal analysis, is the source of disagreement with some proponents of the UTC.

\(^i\) U.S. v. Taylor, 254 F.Supp. 752 (D.Cal. 1966) stating “On the other hand, the Supreme Court has only recently reemphasized the importance of the role played by the states in creating and defining property interests; a federal tax lien cannot attach to property in which, under state law, the taxpayer has no property interest at all. Citing Aquilino v. United States, supra, 363 U.S. at p. 513, n. 3, 80 S.Ct. 1277.

\(^ii\) U.S. v. O'Shaughnessy, 517 N.W. 2d 574 (Minn. 1994); First Northwestern Trust Co. of South Dakota v. Internal Revenue Service, 622 F.2d 387 (D. Ct. 1980); First of America Trust Co. v. U.S., 72 A.F.T.R.2d 93-5296, 93-2 USTC P 50,507 (C.D.Ill.,1993) (where the income interest was a support trust, but the principal was a discretionary trust). At first blush, it looks like the Restatement (Third) of Trusts, § 60, Reporter comment e and e(1) made an incredible blunder when it states the Internal Revenue Service could recover from a discretionary trust in Magavern v. U.S., 550 F.2d 797 (2d Cir. 1977). The first thing to note is that Magavern is a support case under common law, and the federal government was an exception creditor. The second point to note is that the Third Restatement has redefined the term discretionary trust to mean all trusts including support trusts. Only when read in light of the new definition of a discretionary trust does this citation in the Third Restatement make any sense.
Is the UTC the Beginning of the End for Third Party SNTs?

- Discretionary Trust without guidelines may no longer function as a SNT
  - These trusts now subject to court implying a support standard
- Public Policy Exception
  - Little step – Governmental Agency becomes an exception creditor
  - Broad authority granted by the UTC and Third Restatement to rewrite all or part of any trust

4. Discretionary Trusts With Standards

Almost all estate planners of discretionary trusts would generally include a standard that was incapable of judicial interpretation. Such as “the trustee may, in the trustee’s sole and absolute discretion, make distributions to the beneficiaries for health, education, maintenance, support, comfort, general welfare, well being, happiness, and joy.” The Third party SNT planners who also recommended this approach many times argued that there was no need for special needs language in and one did not unduly need to limit the trustee’s authority. Prior to the Restatement Third and most likely the UTC rewriting trust law, these planners were correct and had little to fear. Unfortunately, now they do have something to fear.

5. Discretionary Trust Without Standards

Since the tale from the three hybrid-trust states, many attorneys have suggested that a discretionary trust should not even include a standard of distribution. By eliminating a distribution standard, it would be difficult for a judge to conclude that the trust was anything other than a discretionary trust (i.e., a judge would not mistake the trust as a support trust). Unfortunately, Section 50, comment (b) of the Restatement Third provides “It is not necessary, however, that the terms of the trust provide specific standards in order for a trustee’s good-faith decision to be found unreasonable and thus constitute an abuse of discretion.” If a standard is omitted, the court will still apply a reasonableness or good-faith judgment, “based on the extent of the trustee’s discretion, the various beneficial interests created, the beneficiaries’ circumstances and the relationships to the settlor, and the general purposes of the trust.”

i Restatement of Trusts (Third), Section 50, comment d., adopted on May 16, 2001 by the American Law Institute, published 2003.
Mid-Stream UTC
2005 Change

■ Originally
  – UTC Adopted the Restatement Third Position
  – After the many flaws in the Restatement Third and UTC position were published, the UTC did a mid-stream change

■ The Comment to 504 was modified to state
  – It only abolished the distinction for creditor purposes
  – Allowing a “comment” to change substantive law???
  – Section 814(a) – Regarding rights of a beneficiary

J. UTC’s Mid-Stream Change
UTC Comment Section 504

“This section addresses the ability of a beneficiary’s creditor to reach the beneficiary’s discretionary trust interest, whether or not the exercise of the trustee’s discretion is subject to a standard. This section, similar to the Restatement, eliminates the distinction between discretionary and support trusts, unifying the rules for all trusts fitting within either of the former categories. See Restatement (Third) of Trusts Section 60 Reporter’s Notes to cmt. a (Tentative Draft No. 2, approved 1999).

Amended 2005 Comment

“This section addresses the ability of a beneficiary’s creditor to reach the beneficiary’s discretionary trust interest, whether or not the exercise of the trustee’s discretion is subject to a standard. This section, similar to the Restatement, eliminates the distinction between discretionary and support trusts, unifying the rules for all trusts fitting within either of the former categories. See Restatement (Third) of Trusts Section 60 Reporter’s Notes to cmt. a (Tentative Draft No. 2, approved 1999).

By eliminating this distinction, the rights of a creditor are the same whether the distribution standard is discretionary, subject to a standard, or both. Other than for a claim by a child, spouse or former spouse, a beneficiary’s creditor may not reach the beneficiary’s interest. Eliminating this distinction affects only the rights of creditors. The affect of this change is limited to the rights of creditors. It does not affect the rights of a beneficiary to compel a distribution. Whether the trustee has a duty in a given situation to make a distribution depends on factors such as the breadth of the discretion granted and whether the terms of the trust include a support or other standard. See Section 814 comment. [2005 amended language in italics.]
### New Two Tier Analysis

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<th>Beneficiary Tier: When does a beneficiary have an Enforceable right?</th>
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| Creditor Tier: | Discretionary trust protection has been eliminated, Only spendthrift provision remains |

Will a judge even realize there is now a two tier process?

#### 1. Two Tier Analysis

The UTC creates a two tier analysis for creditor rights. The first tier is does the beneficiary have an enforceable right, and one should look to Section 814(a) to determine whether this is the case. The second tier is that any exception creditor may now attach present and future distributions. UTC § 503.

#### 2. Will a Judge Realize There is a Two Tier Analysis?

Legislators pass statutes, not comments. Most trial court judges have little, if any knowledge, regarding trust law. Will a judge even read a comment and realize that for the first time in history there is now a two tier system: one that delineates creditor rights, and another that delineates beneficiary’s rights to a distribution.
Will a Judge Apply the Restatement Third View?

Nowhere in Sec 814(a) does it state that the discretionary/support distinction is being maintained.

Rather, the comment under Section 504 solely references to the Restatement Third Section 60, which abolishes the discretionary/support distinction for all purposes.

The comment under 814(a) also references Section 50 of the Restatement Third, and Section 187 of the Restatement Second, and Ed Halbach’s 1961 Article.

3. Will A Judge Apply the Restatement Third View?

As previously noted, if a judge applies the Restatement Third view of trusts almost all discretionary trusts will be deemed to create an enforceable right. Unfortunately, Some proponents of the UTC attempt to argue that the UTC is not taking a position on this issue. However, the cross references to the Restatement Third, the citing to the article that originated this new view of trust law combined with the comments under 814(a) not even mentioning that the discretionary/support distinction had been retained may easily lead a judge to adopt the Restatement Third position.
4. **Elements of a Common Law Discretionary Trust**

Courts have emphasized four factors when classifying a trust as a “discretionary trust” under common law.

   a. **Uncontrolled Discretion**

   The Restatement (Second) and most court holdings agree that the most important of these factors is granting the trustee uncontrolled discretion. *Restatement (Second) Sec. 187 comment j.*

   b. **Permissive Language**

   Generally, a discretionary trust uses permissive language: the word “may” instead of the word “shall.” *State ex. rel. Secretary of SRS v. Jackson, 822 P2d 1033 (KS 1991).* Some courts have placed greater emphasis on the discretionary nature of the trust with words such as “may” v. “shall.” *Tidrow v. Director, Division of Family Services, 668 S.W. 2d 912 (Mo. Ct. App. 1985); Matter of Henry’s Estate, 565 P.2d 1166 (Wash 1977).*

   c. **No Requirement of Equality**

   Other courts have noted that when the uncontrolled discretion is combined with the ability to discriminate among beneficiaries, there is little if any question that the settlor intended to create a discretionary trust. *Dryfoos v. Dryfoos, 2000 WL 1196339 (Conn. Super. 2000) unreported case. McNiff v. Olhstead County Welfare Dept., 176 N.W.2d 888 (Minn. 1970).*

   d. **Nebulous Distribution Standard**

   Some courts have noted that words such as “comfort and general welfare” may not be capable of judicial determination, and that this language may remove a trust from being classified as a support trust. *Bohac v. Graham, 424 NW 2d. 144 (ND 1988).*
The Amended Language of the Comment Suggests an Enforceable Right

“A grant of discretion establishes a range within which the trustee may act. The greater the discretion, the broader the range.” - implies the UTC is adopting the continuum of discretionary trusts.

Whether a trustee has a duty to make a distribution depends on
- “Whether a standard grants discretion and its breath;
- Whether this discretion is coupled with a standard;
- Whether a beneficiary has other available resources.”

The is the Restatement Third’s opinion, not common law

5. UTC Comments Suggest an Enforceable Right

The comment to UTC Section 814(a) does not even mention the common law factors that would result in classification of a trust as a discretionary trust. Rather, the UTC discusses the newly espoused theories of discretionary trusts created by the Restatement Third.

“The comment states, “Despite the breadth of discretion purportedly granted by the wording of a trust, no grant of discretion to a trustee, whether with respect to management or distribution, is ever absolute. A grant of discretion establishes a range within which the trustee may act. The greater the grant of discretion, the broader the range. Pursuant to subsection (a), a trustee’s exercise of discretion must be in good faith Consistent with the trustee’s duty to administer the trust (see Section 801), the trustee’s exercise must also be in accordance with the terms and purposes of the trust and the interests of the beneficiaries. “Interests of the beneficiaries” means the beneficial interests provided in the terms of the trust. See Section 103(8).

The above italicized language implies an adoption of the Restatement Third’s newly espoused and undefined “continuum of discretionary trusts” theory, not a discretionary/support dichotomy. The next sentence in the comment states:

“Subsection (a) does not otherwise address the obligations of a trustee to make distributions, leaving that issue to the case law.”

Some proponents of the UTC, ignoring the first part of the paragraph above, have stated that this means the UTC does not take a position on a beneficiary’s rights to a distribution. Even if the first part of the paragraph could be ignored, the UTC comment immediately contradicts that it not taking a position. The factors to determine how discretionary a trust in are not common law, rather they are the factors espoused by the Restatement (Third) of Trusts.
6. Problems With the Good Faith Standard of Review

Some proponents of the UTC misstate those expressing concerns' position when they claim the argument is that “good faith” and “bad faith” are synonymous. Under the UTC, the issue is where does the bright line rest so planners may safely navigate the waters and draft trusts to achieve their client’s goals. What is the magical language that a planner should use to avoid the creation of an enforceable right? The proponents of the UTC consistently fail to address this question.

a. Loose definition – Good faith – Bad faith

In contrast, under the discretionary-support dichotomy, when the judicial standard of review is the trustee (1) acting dishonestly; (2) with an improper motive; or (3) failing to act the courts have held that the beneficiary does not have an enforceable right thus, no available resource. So no one would misinterpret our article and then proceed to misstate our position like the proponents of the UTC did, in the two articles the proponents were criticizing, we specifically stated and continue to maintain that “courts define the term “bad faith” slightly differently and we used the above standard as our definition.” The reason we need to define “bad faith” is because courts use the term “good faith” and “bad faith” loosely. For example, Black’s law dictionary 6th edition defines “good faith” as:

“an intangible and abstract quality with no technical meaning or statutory definition and it encompasses, among other things, an honest belief, the absence of malice and the absence of design to defraud or seek an unconscionable advantage, an individual’s personal good faith is concept of his own mind and inner spirit and, therefore, may not conclusively be determined by his prostrations alone.”

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Naturally, the above definition stressing no “technical meaning or statutory definition” leaves wide latitude for reasonable persons to disagree. In the SNT context, this becomes a major concern, because drafter’s must be certain not to create an enforceable right in a beneficiary that will be deemed an available resource. Further, when drafting a discretionary dynasty trust to protect wealth or to protect an inheritance from an estranged spouse certainty is vital. The issue is not whether “good faith” is synonymous with “bad faith” but rather whether courts use the nebulous definition of “good faith” to create an available resource in the SNT context or allow recovery by an exception creditor. Rather than deal with the somewhat elusive or arbitrary definitions of “good faith” or “bad faith,” both the first and second Restatement of Trusts defined the judicial review standard for a discretionary trust with reference to specific actions or inactions of a trustee – the trustee (1) acts dishonestly; (2) acts with an improper motive; or (3) fails to act.

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i The Uniform Trust Code: A Divorce Attorney’s Dream, supra note 1.

ii For an analysis of terms used to prevent a creditor from recovering against a discretionary trust see In re Tone’s Estates, 39 N.W.2d 401 (Iowa 1949) This case cites the three leading secondary source materials (Restatement of Trusts; American Jurisprudence; and Corpus Juris Secundum). Two of these sources used improper motive, dishonesty, and failure to act. One of them used bad faith. None of them used the term “good faith.”:

iii Restatement of Trusts, § 187 comment j., 1935; Restatement (Second) of Trusts, § 187 comment j., 1959.
Review Standards That Create Enforceable Rights

- What language does the courts use that prevent the creation of an enforceable right in a discretionary trust
  - Improper motive, dishonesty, and failure to act
  - Bad faith, no mention of good faith

- Split results when courts combine “good faith” with “bad faith”

- Many more problems when “good faith” used alone

- Many problems when reasonableness used

b. Court Decisions That Find an Enforceable Right

i. Restatement 1st and 2nd Position – No Problem

When courts use the standard judicial review standard of only (1) improper motive; (2) dishonesty; or (3) failure to act as defined in Scotts or Boggerts, the authors are not aware of any case where the trust assets are available to the beneficiary’s creditors. There is a “bright line” where the courts hold that a beneficiary does not have either an (1) enforceable right or (2) a property interest.

ii. Bad Faith Standard – No Problem

The authors were also unable to find any discretionary trust case where “bad faith” was used alone in the opinion, without any reference to good faith where the court found a beneficiary that held an enforceable right.¹

¹ Possibly without exception, when courts have used the term “bad faith” with no reference to “good faith” the courts have found that neither the beneficiary nor the creditor had an enforceable right. SunTrust v. Children’s Hospital, 2003 WL 21085046 (Va. Cir. Ct. 2003); In re Estate of McInery, 289 Ill. App. 3d 589 (Ill. App. 1997); Simpson v. State, Dept. of Social and Rehabilitation Services, 906 P.2d 174 (Kan.App.,1995); First Nat. Bank of Maryland v. Department of Health and Mental Hygiene, 399 A.2d 891 (Md. 1979); Town of Randolph v. Roberts, 195 N.E. 2d 72 (Mass. 1964); In re Maeder’s Estate, 329 N.Y.S.2d 663 (N.Y.Sup. 1972); Greenwich Trust Co. v. Tyson, 10 Conn. Supp. 147 (Conn. Super. 1941). According to Andy Strauss of the North Carolina UTC committee, this was the primary reason why North Carolina chose the term “bad faith” over “good faith” as the judicial review standard under UTC § 814(a). Also, Scott on Trusts appendix cites the term “bad faith” and gives several references, but no mention is made of the term “good faith.”
iii. Good Faith and Bad Faith in the same opinion

However, if the court used the term “good faith” and “bad faith” synonymously, the result is often uncertain.1

iv. Good Faith and No Mention of Bad Faith

When courts used the term “good faith” as the standard of judicial review, the nebulous standard resulted in some discretionary trusts becoming available resources thereby allowing a governmental creditor to force a distribution.ii

1 Unfortunately, the distinction between “good faith” and “bad faith” adopted by North Carolina and Ohio UTC committees may be short lived. As noted by the proponents of the UTC (Walsh, supra note 2), courts have combined the terms “good faith” and “bad faith,” and these terms have been used synonymously. In re Ferrels Estate, 258 P.2d 1009 (Cal. 1953). In re Ferrel, holds the beneficiary of a discretionary trust coupled with a standard does not have an enforceable right under a good faith or bad faith standard. Therefore, a governmental agency was not allowed to force distributions from a discretionary trust coupled with a standard. On the other hand, the Court In re Ventura County Dept. of Child Support Services v. Brown,1 authorized invasion of a discretionary trust coupled with a standard even though the court found that the debtor/beneficiary had no enforceable right. Again, holding that a creditor has greater rights than a trust beneficiary flies in the face of the common law definition of a common law discretionary trust but not the UTC definition.

ii Some UTC proponents complain about our reliance on a hand full of cases that that interpret the “good faith” standard with the standard of reasonableness. However, their struggle to find support of their position that the good faith standard does not change anything, they incorrectly cite In re Estate of McCart, 847 P.2d 184 (Colo. App. 1992). This case is a classic discretionary trust case where the trustee did not make distributions to current discretionary beneficiary because the trustee was the remainder beneficiary and wanted the trust assets for himself. The Appellate Court noted: “The trial court specifically found and concluded that Goss had abused his discretion and acted arbitrarily and capriciously. The improper motives with a clear conflict of interest as trustee seeking to conserve the trust funds for himself and his heirs as remainderman under the trust, and also in breach of his fiduciary responsibilities to act with the utmost good faith and fairness toward a beneficiary.”
These proponents quoted only the “in breach of his fiduciary responsibilities to act with the utmost good faith and fairness toward a beneficiary,” and then they concluded that, because these words were used in combination with a discretionary trust, the review standard of “good faith” was the same as the discretionary common law standard. Despite these proponents careful selection of phrases to support their position, a cursory review of the case yields the opposite of their conclusion. *In re Estate of McCart* is nothing more than a classic discretionary trust case with the judicial review standard only for (1) acting dishonestly; (2) acting with an improper motive; or (3) failing to act.
c. Inconsistent use of good faith and bad faith within the UTC

There is extreme uncertainty in codifying trust law. The rules of statutory construction require that each word has meaning. Even the drafters of the UTC are inconsistent in the use of the terms “good faith” and “bad faith.” If the drafters meant for the terms to be synonymous, why did they use “good faith” under §§ 105(b)(1); 801; 814(a); and 1012 and the term “bad faith” under §§ 1002(b) and 1008(a)(1). Further, in some parts of the UTC, the term “good faith” refers to specific actions. In other parts, the UTC references to other body’s of law for a definition of “good faith”. Unfortunately, the use of the terms “good faith” and “bad faith” within the UTC itself confirms Black’s Laws Dictionary’s nebulous definition and our concern that a judge may interpret this term in almost any way he or she chooses.

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i  UTC § 1013 official comment paragraph 4.

ii  UTC § 1012 official comment there under.
d. Other UTC Statutes and Proposed Statutes Express Concern

The authors are not alone in expressing concerns when using a “good faith” standard of review. North Carolina has substituted the word “bad faith” as the review standard for all trusts.\(^i\) Ohio in its definition of a wholly discretionary trust defines the review standard as the trustee acting (1) dishonestly; (2) with an improper purposes; (3) failing to act; (4) or acting in bad faith.\(^ii\) After over four years of study, the Colorado Uniform Trust Code committee concluded in its official comments to the UTC. Part of the comment under § 504 reads:

“Colorado courts have followed the Restatement (Second) position with respect to discretionary trusts. Our courts have held that neither the beneficiary nor a creditor of a beneficiary can compel exercise of discretion and that the interest of the beneficiary in a discretionary trust is not “property” but rather, a “mere expectancy. . . . This section [referring to UTC Section 504] may be seen as an overruling of the Colorado Supreme Court in Jones, supra. However, the Jones case left open the possibility of interference if the trustee acts dishonestly, from an improper motive, or fails to use his judgment.\(^iii\)

The Missouri UTC technical correction act also expresses concern where it rewrites Section 814(a) as follows:

“Notwithstanding the [breadth of discretion granted to a trustee in the terms of the trust, including the] use of such terms as “absolute,” “sole,” or “uncontrolled,” in the exercise of discretion under an ascertainable standard, the trustee shall exercise [a] such discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

\(^i\) N.C.S. § 36C-5-814(a).

\(^ii\) Ohio Statute § 5808.14(a).

\(^iii\) Colorado UTC official comments. At the November 19, 2004 Colorado UTC Committee, Stanton Kent, co-chair of the committee, stated that he had changed his position, and the UTC did not overrule In Re Jones.
Problems With The Good Faith Standard

- Delaware and South Dakota APT statutes exclusively use the word “bad faith”
  - The drafters of these statutes obviously saw a difference between the two terms

- Richard Covey and Dan Hastings question whether combining the words of “good faith” with the “purposes of the trusts and the interest of the beneficiaries” expands a judge’s ability to review the trustee’s discretion

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e. Delaware, & South Dakota APT statutes

The Delaware and South Dakota APT statutes uses the term “bad faith” instead of “good faith” throughout the statute.

f. Richard Covey and Dan Hastings.

Richard Covey and Dan Hastings in Practical Drafting discussed the problem of the UTC adopting this judicial standard of review, particularly as qualified by the words “in accordance with the terms and purposes of the trust and the interests of the beneficiaries.” Their analysis in the October 2003 issue of Practical Drafting is quoted below and their interpretive comments are italicized.

Section 814(a) provides:

Notwithstanding the breadth of discretion granted to a trustee in the terms of the trust, including the use of such terms as “absolute”, “sole”, or “uncontrolled”, the trustee shall exercise a discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

Traditionally, the words “absolute” and “uncontrolled,” absent an accompanying standard that would limit their effect, have been regarded as sufficient to dispense with a “reasonable man” test in evaluating a trustee’s conduct, while preserving the requirement of good faith:

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i Covey and Hastings, Practical Drafting, October 2003; Richard Covey is Senior Counsel at Carder, Ledyard & Milburn, LLP. Dan Hastings is counsel at Skadden, Arps, Meagher & Flom, LLP. Both are the primary drafters of Practical Drafting.
"Section 814(a) illustrates the uncertainty that codifying the trust law may create. What do the words “and in accordance with the terms and purposes of the trust and the interests of the beneficiaries” mean? Do they create a stricter limit on the discretion that may be conferred upon a trustee than the common law test set forth in the above quotation from Scott? It seems likely that courts will use them to do so in particular cases, yet their application to particular facts remains as hard to predict as that of the common law. Has anything been gained by codification?"

In the April 2004 issue of Practical Drafting, Richard Covey and Dan Hastings again explained their conclusion regarding UTC § 814(a).

. . . we discussed Section 814(a), which provides that “[n]otwithstanding the breadth of discretion granted to a trustee in the terms of the trust, including the use of such terms as ‘absolute’, ‘sole’, or ‘uncontrolled’, the trustee shall exercise a discretionary power in good faith and in accordance with the terms and purposes of the trusts and the interests of the beneficiaries.” We noted that the words following “good faith” arguably represent a tightening of the traditional formulation of the common law rule, and give the courts a new tool, of uncertain scope, with which to control trustee discretion.

We agree with Richard Covey and Dan Hastings that the words following “good faith” arguably give the court “a new tool, of uncertain scope, with which to control trustee discretion.” For example, the clause “in accordance with the terms and purposes of the trust and the interests of the beneficiaries” has little, if any, meaning. We also note that this problem is further magnified by the Iowa, Ohio, Connecticut, and Pennsylvania cases. A judge need not interpret the term “good faith” as reducing the discretionary trust threshold to that of “reasonableness” to create an available resource. Rather a judge need only find that the standard of review is something slightly less than the discretionary trust common law standard. This may result in the minority discretionary-support line of cases being a national problem instead of a localized one.

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i Covey and Hastings Recent Developments in Estate, Gift and Income taxation – 2004, 39th Annual Heckerling Institute on Estate Planning, University of Miami School of Law, page 193-194.

ii For a detailed analysis of how “uncertain the scope” might be see Merric, Stein, & Berger, The Uniform Trust Code: A Continuum of Discretionary Trusts or a Continuum of Continuing Litigation, supra note 1.

iii Covey and Hastings Practical Drafting, April 2004.

iv Id.

v Supra note 25.
Two Arguments Regarding Judicial Review Standard?

- Two standards of review under the discretionary/support trust
  - Reasonableness – support trust
  - Improper motive, dishonesty, failure to act – discretionary trust

- Minimum level of Trustee Conduct for all Trusts

7. Two Arguments Regarding a Judicial Review Standard
   a. Common Law

   Under common law, there were two different judicial review standards: reasonableness for a support trust, and improper motive, dishonesty, failure to act for a discretionary trust. The UTC makes no mention of the dual judicial review standards depending on the type of trust.

   b. Proponents Argument

   Proponents of the UTC argue that there is a minimum level of care for a trustee for all trusts, and this level is “good faith.” When making this point, Proponents omit any discussion of the dual standard of judicial review under common law.
Standard of Review

Creditor cannot force a distribution

Bad Faith*

Good Faith

Reasonableness

Exception

Creditor May Stand in the Shoes of the Beneficiary

* Improper motive, dishonesty, failure to act

\[153x397\] a. Common Law Review Standard For a Discretionary Trust

Under the common law a court would only interfere with a trustee’s “sole and absolute” discretion of a discretionary trust if the trustee (1) acts dishonestly, (2) acts with an improper motive, or (3) fails to use his or her judgment.\(^1\) (For purposes of this chapter the term “bad faith” is defined as the aforementioned three conditions as explained in footnote 7.) A beneficiary had little if any standing to sue for a distribution or question the amount of a distribution, unless the beneficiary could prove one of the above factors of why the trustee was failing to make a distribution. In almost all states, there was no reasonableness or good faith standard for a discretionary trust that used qualifying adjectives of the trustee’s “absolute,” “unlimited,” or “uncontrolled” discretion. Section 187 at page 408 of the Restatement (Second) of Trusts held that such qualifying adjectives dispensed with the standard of reasonableness.

### Proponent’s View

**Minimum level for all trusts**

<table>
<thead>
<tr>
<th>Sets a floor of acceptable behavior</th>
<th>Bad Faith = Good Faith</th>
</tr>
</thead>
</table>

When does a beneficiary not have an enforceable right?

Where is the dual review standard for a discretionary trust?

Has the review standard for a support trust been reduced to good faith, instead of reasonableness?

#### b. Proponent’s View – Minimum Level For All Trusts

Some proponents of the UTC argue that “good faith” and “bad faith” are the same, and that “good faith” sets a floor of acceptable trustee conduct. Therefore, the UTC is only setting a minimum floor for trustee discretion.

This view brings up several interesting questions.

First, when does a beneficiary not have an enforceable right under the UTC? This is a question that the proponents consistently fail to address.

Second, where is the dual standard of review for a discretionary trust? If one looks to common law, there are three hybrid states that are inconsistent. Can these state laws be used as authority in other states under the uniformity clause of UTC §1101?

Third, has the standard of a support trust been reduced from reasonableness to good faith? If so, has the UTC greatly diminished beneficiary’s rights in support trusts to demand a distribution?
UTC Sec 504(d)

Discretionary Trust
– (d) This section does not limit the right of a beneficiary to maintain a judicial proceeding against a trustee for an abuse of discretion or failure to comply with a standard for distribution.

A beneficiary does not have an enforceable right under a discretionary trust

8. UTC §504(d)

Under common law, a beneficiary of a discretionary trust did not have a right to enforce a distribution. All the beneficiary had was a mere expectancy. However, a beneficiary has always had a right to proceed against a trustee for abuse – (1) improper motive; (2) dishonesty; (3) failure to act. Therefore, the first part of the above sentence does not cause any concern.

On the other hand, “failure to comply with a standard for distribution” creates a great alarm. Currently, there are three hybrid states that under common law hold that any standard combined with a trustee’s discretion creates a beneficiary right to a minimal distribution. It is this extreme minority opinion that the Restatement Third of Trusts supports. The above UTC code section implies that this is the rule for all states, rather than a minority line.

It should be noted that Iowa was formerly a hybrid state, however, the estate and elder law attorneys realized the grave problems created by such a position and fixed the issue by statute. See Iowa Code 633.4702
i. Ohio

Metz v. Ohio Dept. of Human Services, 762 N.E. 2d 1032 (OH App. 2001); Bureau of Support in the Department of Mental Hygiene and Correction v. Kreitzer, 243 N.E.2d 83 (Ohio 1968); Matter of Gantz, 1986 WL 12960; Samson v. Bertok, 1986 WL 14819 (the creditor did not recover because it was not a governmental claim); Matter of Trust of Stum, 1987 WL 26246; Schierer v. Ostafin, 1999 WL 493940 (the creditor did not recover because it was not a governmental claim). In the above SNT cases, the government was able to attach the beneficiary’s interest and force a distribution pursuant to the standard.

ii. Pennsylvania

Using a slightly different analysis, Pennsylvania courts have generally held that if a discretionary support trust was for one beneficiary and such sole beneficiary was not receiving governmental benefits at the time of creating the trust, then the settlor intended that the principal of the trust as an available resource to the beneficiary. Estate of Taylor v. Department of Public Welfare 825 A.2d 763 (Penn. 2003); Shaak v. Pennsylvania Department of Public Welfare, 747 A.2d 883 (Penn. 2000); Estate of Rosenberg v. Department of Public Welfare, 679 A.2d 767 (Penn. 1996); Commonwealth Bank and Trust Co., 598 A.2d 1279 (Penn. 1991).

iii. Connecticut

Recently, the Supreme Court concluded that when a discretionary trust was coupled with any standard, the trust was classified as a support trust. Corcoran v. Department of Social Services 271 Conn. 679, 859 A.2d 533, (Conn. 2004).

Overruled by Statute - Iowa Code 633.4702

iv. Iowa

Strojek v. Hardin County Board of Supervisors, 602 N.W. 2d 566 (Iowa App. 1999) also see the follow up unpublished opinion where the Iowa Appellate Court expanded the definition of the distribution language as much broader than “basic needs.” Strojek v Hardin County Board of Supervisors, 2002 WL 180377 (Iowa App. 2002); Also see McCabe v. McKinnon, 2002 WL 3175733 (Iowa App. 2002) an unpublished decision.
Will A Judge?

- Recognize that there is a two tier system?
- Follow the Restatement Third, which is almost always equals an enforceable right?
- Follow the implied continuum of discretionary trusts under the UTC comment?
- Follow common law?
- South Dakota, Nevada, Alaska, Delaware??

9. Will A Judge Find an Enforceable Right in a Discretionary Trust?

A statute should be clear on its face. Unfortunately, in the area of creditor’s rights, the UTC requires reading the comments to divine several possible meanings. In this respect, there is considerable uncertainty whether a judge will recognize that there is a two tier system?

If so, how many trial judges are well versed in trust law? Unfortunately, the answer is very few. How many of these judges will pick up the Restatement Third and not realize that it is a great deviation from common law in the area of creditor rights.

A judge may not look to the Restatement Third, rather the judge may imply that an enforceable right to a distribution exists because of the UTC § 814 comment endorsing the Restatement view.

A judge could also follow common law.
K. Only Spendthrift Protection Remains

1. Reduction in Asset Protection For a Discretionary Trust

Under common law, the asset protection of a discretionary trust does not depend on spendthrift protection.

§ 155(1) states “[Except for a self-settled trust], if 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, a transferee or creditor of the beneficiary cannot compel the trustee to pay any part of the income or principal.”

Comment (1) b. “. . . a discretionary trust is to be distinguished from a spendthrift trust. In a discretionary trust, it is the nature of the beneficiary’s interest rather than a provision forbidding alienation which prevents the transfer of a beneficiary’s interest. The rule stated in this section is not dependent upon a prohibition of alienation which prevents the transfer of the beneficiary’s interest; but the transferee or creditor cannot compel the trustee to pay anything to him because the beneficiary could not compel payment to himself or application for his own benefit.”

Also see, Tyler v. Preston Ridge Financial Services Corp., 1999 WL 33744315 (Tex. App. 1999) unreported case where the trust did not include a spendthrift provision. Rather, it was the nature of the discretionary nature of the beneficiary’s interest that protected the beneficial interest from creditor attachment.
Uniform Trust Code Exception Creditors

- Alimony and child support
- Attorney fees
- Any federal or state governmental claim that specifically refers to attachment
  - Includes Medicaid and state governmental aid
  - How long before all governmental claims are exception creditors?

2. Uniform Trust Code Exception Creditors
   a. Short-Term

   From an asset protection perspective in the area spendthrift protection, at first blush, it appears that the UTC is an improvement over the Restatement (Second) of Trusts, since it reduces the number of exception creditors to three – instead of four exception creditors. The exception creditor of “necessary expenses of the beneficiary” at first glance appears to have been deleted.

   (a) “a beneficiary’s child, spouse, or former spouse who has a judgment or court order against the beneficiary for support or maintenance, or
   (b) a judgment creditor who has provided services for the protection of a beneficiary’s interest in the trust, may obtain from a court an order attaching present or future distributions to or for the benefit of the beneficiary.”
   (c) “A spendthrift provision is unenforceable against a claim of this State or the United States to the extent a statute of this State or federal law so provides.”

   b. Long Term

   However, how long before all governmental claims will become exception creditors? Also, will the statutes allow the government to force a distribution from a trust?

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Increased Remedies

Attaching the Beneficial Interest Until Claim is Satisfied- Trust Level

1. "Includes present and future distributions"
   ▪ Another Minority Position

2. "No Payments For the Benefit Of"
   ▪ Little case authority, but appears to be another change in the common law

L. Increased Remedies Under the UTC

   1. Present and Future Distributions

   In most states prior to the UTC, a creditor was not allowed to attach future distributions from a trust, rather, only present distributions. The UTC followed another minority position by allowing exception creditors (and possibly all creditors) to attach all future distributions until the claim is satisfied.

   2. Direct Payment of Debtor/Beneficiary Expenses By the Trustee

   Many estate planners have indicated that with a discretionary trust, all the trustee need do to avoid attachment and still support the beneficiary is to pay the debtor/beneficiary’s expenses directly, instead of making a distribution to the beneficiary.\(^i\) Both the UTC and Restatement Third of Trusts end this possibility. Section 503(c) of the Uniform Trust Code provides that a creditor may attach “present or future distributions to or for the benefit of the beneficiary.” Section 60 comment c. and Illustration 4. of the Restatement Third provides that, “If the trustee has been served with process . . ., the trustee is personally liable to the creditor for any amount paid to or applied for the benefit of the beneficiary in disregard of the rights of the creditor.

\(^i\) Duncan v. Elkins, 45 A.2d 297 (NH 1946).
Creditor Cannot Force A Distribution?

- UTC Sec. 504(b)
- In some states, this will increase asset protection for a support trust
  - Must be a support trust
  - State must have exception creditors
  - State law creditor must have been able to force a distribution under common law
- Does not apply to child support
- Probably not to future governmental creditors
- Sole Remedy?

M. Creditor Cannot Force A Distribution

1. UTC § 504(b)

   (b) Except as otherwise provided in subsection (c), whether or not a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution that is subject to the trustee’s discretion, even if:

   (1) the discretion is expressed in the form of a standard of distribution; or
   (2) the trustee has abused the discretion.

2. In Some States it Increases Asset Protection For A Support Trust

   a. Discretionary Trust

      Under common law, a discretionary trust is not an enforceable right or a property interest. Therefore, this provision adds no asset protection when compared to a common law discretionary trust.

   b. Exception Creditor

      At best, half of the states allow an exception creditor to a support trust for child support. Less than a handful allow an exception creditor for attorney fees. Finally, few allow an exception creditor for governmental claims. It is only in the states that allow for exception creditors that the UTC would increase the protection of a support trust.
c. Exception Creditor Remedy Would Depend on State Law

With a support trust, an exception creditor could attach the beneficiary’s interest. Therefore, the exception creditor would be entitled to receive any future distributions from the trust that would have been made to the debtor/beneficiary. From this point, the Restatement of Trusts (Second) is silent on creditor remedies under state law. Other than the above, the Restatement of Trusts (Second) states that, “The rules of procedure by which a creditor can subject the interest of the beneficiary to the satisfaction of his claim are not with the scope of the Restatement (Second) of this Subject.” In this respect, states had different methods of possible attachment of a beneficiary’s interest. For example some states have an equitable remedy known as a “creditor’s bill” or a “bill for equitable execution.”

Absent, the state remedy of a “creditor’s bill” or a “bill for equitable execution,” as noted above, an exception creditor could attach a current beneficiary’s interest through a receiver. Therefore, a beneficiary may not receive a distribution until the creditor was paid. In many cases, the exception creditor could in essence stood in the shoes of the beneficiary, and could many times reach the underlying property, by forcing a distribution pursuant to the distribution standard – health, education, maintenance, and support. For example, the exception creditor in *Sligh v. First National Bank of Holmes County*, the exception creditor was allowed to garnish the trust assets for the entire claim of $313,677.

d. Sole Remedy?

The comment to UTC § 504 states that attachment of present and future distributions is a creditor’s sole remedy. However, one must remember that legislatures pass statutes, not comments, and a judge is not required to follow the comment. Therefore, the judicial foreclosure sale of UTC § 501 beneficial interests becomes a possibility.

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i  *Restatement of Trusts (Second)*, Section 157.

ii  *Restatement of Trusts (Second)*, Section 157(h). Under this section, the court could appoint a receiver, and the trustee could be appointed to compel payment of the income to the receiver.

iii  *Restatement of Trusts (Second)*, Section 147, comment c.

iv  704 So. 2d 1020 (Miss. 1997).
3. **Charging Order Analogy**

An analogy of the new creditor rights under both the UTC and Third Restatement may be made to the creditor remedies against a partnership interest. For example, when a creditor attaches a partnership interest, the creditor receives a “charging order.” A charging order is in essence an assignment of income, and as soon as there is a distribution it becomes the creditors.¹

¹ Some have defined the term “charging order” in layman’s terms as a right to a distribution when and if ever made (by the general partner).
Judicial Foreclosure Sale

- No spendthrift clause
- Judge does not follow the comment in UTC Sec. 503

All Trust Interests

- Amended but now allows either
- Restatement Third position = possible sale
- Restatement Second position = most likely no sale

N. Judicial Foreclosure Sale

Prior to the 2005 amendment, the comment to UTC § 501, the UTC provides for the judicial foreclosure sale of all interests. The judicial sale of a discretionary or support current beneficial interest was virtually unheard of. In this respect, the UTC had adopted another extreme minority position. Fortunately this comment was deleted by a 2005 amendment.

However, in its place, the 2005 amendment, allows a court to follow either the Restatement Third or Restatement Second view. The Restatement Second view would almost always prevent the sale of the a beneficiary’s interest, because the sale proceeds must be fair to the value of the beneficial interest to the beneficiary. The Restatement Third view changes the Restatement Second view and allows a court much more discretion in selling the beneficiary’s remainder interest to satisfy a creditor’s claim, because the “fairness” test is now only a factor that a judge should consider.
O. Creditors Attaching a General Power of Appointment

In this area, again, both the UTC and the Third Restatement follow the minority opinion – allowing any creditor to attach a general power of appointment. Under the definitions of UTC § 103(10), an intervivos general power of appointment is classified as a “power of withdrawal.” Under UTC § 603(a), to the extent that a person holds a general power of appointment, he or she is classified as the settlor. A settlor has no spendthrift protection. Finally, under UTC § 505(b)(1), any creditor of the power holder may reach any property subject to an intervivos power of withdrawal – a general power of appointment. The Third Restatement §58 comment b(1) and Reporter comment b-b(3) refers to inter vivos GPAs as ownership equivalents for creditor purposes.

1. Crummey Powers

With regard to Crummey powers, the ability of any creditor to attach is limited to the amount of the currently outstanding GPA. In this respect, any creditor may attach the unexercised portion of any Crummey power. For a further discussion of this issue as applied to Irrevocable For a further discussion of this issue as applied to ILITs see Merric, Stein, and Gillen, The Effect of the UTC on ILITs, Steve Leimberg’s Estate Planning Newsletter #733. A copy of this article may be downloaded at www.InternationalCounselor.com.

Many of the larger ILITs utilize hanging crummey powers. Now trustees of ILITs will be forced to borrow against the policy to pay the claims of any creditors who attach a beneficial interest. This brings up the question, are planners now under an affirmative obligation to advise clients that they should form ILITs outside of the state. As noted in the flight of trusts part of this outline, does the client need to exchange the policy for a policy issued in a non-UTC state?
2. 5 x 5 Powers, GPA Marital Trusts, Non-exempt Dynasty Trusts

Typically, with trusts containing 5 x 5 powers, GPA Marital Trusts, and Non-exempt Dynasty Trusts, the GPAs do not lapse. Therefore, to the extent that a beneficiary holds one of these interests, any creditor may attach and exercise the power in favor of the creditor.

3. Another Distinct Minority Position

Currently, only two states, Illinois and California allow a creditor to exercise a GPA and follow the UTC. However, the time tested strong majority opinion holds a creditor cannot force the exercise of an inter-vivos GPA. To name a few of the courts that have ruled a GPA may not be exercised by a creditor - University Bank v. Rhoadarmer, 827 P.2d 561 (Colo. 1991); Irwin Union Bank and Trust Company v. Long, 312 N.E.2d 908 (Colo. App. 1974); In re Shurley, 115 F.3d 333 (Bankr. Ct. Tx. 1997); Krausse v. Barton, 430 S.W.2d 44 (Tex.Civ.App.1968); Hicks v. Hicks, 22 B.R. 243 (Bkr. GA. 1982).
P. Substantial Asset Protection Issues Remain

While some changes were made to address some of the many asset protection concerns expressed by the UTC, many substantial asset protection concerns remain. At their July 18, 2006 Estate Planning teleconference, Roy Adams and Charles Redd both agreed that the UTC substantially broadened the rights of creditors. In addition to the above statements, the following concerns were also expressed:

Roy Adams:

“Trusts are used so often on a spendthrift reason alone Clary, at least I see in my practice the children receive certain property outright at a certain point in time, but something is held back that others can’t reach – third parties, and those rules have been substantially weakened.”

“A discretionary trust is not treated like under common law where discretion does not give them any property right, but under statutory law of the UTC where it is a property right.”

Charles Redd:

“Everyone in our state [Missouri] believed that before we enacted the UTC in our estate, which became effective January 1, 2005, that there was a huge distinction with regard to creditor’s rights between discretionary and support trusts. [The UTC eliminates the advantage of discretionary trusts.]”