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HOW COURTS UNRAVEL ASSET PROTECTION TRUST STRATEGIES AND PROTECTING YOUR TRUST

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1. Categories of Asset Protection Trusts: Know Your Alpo

There are two categories of trusts that seek to achieve creditor protection: third-party created trusts (e.g., parent creates a trust for the benefit of their child); and self-settled asset protection trusts (e.g., individual creates a trust for the benefit of herself in a domestic asset protection trust jurisdiction with a third-party as trustee).

Within each variety, there are two subsets.

Of the third-party created trusts, 95% of those will be the garden variety; that is, to protect against a beneficiary's future creditors. "My children have no creditors currently, but gee, both are medical doctors and they could get sued." Or, "My son-in-law is a great guy. Today, however, if he gets divorced from my daughter, I will consider him the scum of the earth and I don't want him getting any of my property." The other 5% will be an iteration of a special needs trust: "The state is paying for my son's care, and I certainly do not want this trust to be used for reimbursement."

Today, the majority of self-settled trusts involve a grantor seeking to protect his or her assets from future creditors: "I am not so sure my LLC will protect my personal assets from attachment if third parties start suing my business."

The other common variety involves creditor situations already in existence, or likely to come into existence: "If only we hadn't defrauded our investors, we could have made a lot of money with our investment protocol. Hmmmm. Wonder if I can protect my personal assets when this Ponzi scheme falls apart?"

a. Understanding the Correct Mantra

Given the variety among these four types of potential asset protection trusts, we know that courts will view each strategy, and the protection it offers, quite differently. As practitioners, and notably since 2013, understanding the balancing between "intellectual stimulation" and "mercenary pragmatism" is critical to our practice.

b. Confusion

Be careful to understand the distinction between intellectual stimulation (ego?) and mercenary pragmatism (reward?), and to consider the influence of each on your financial wellbeing versus defendant status in a lawsuit.

When dealing with asset protection strategies, and the use of trusts to achieve insulation from creditors, a practitioner should understand that discrepancy. As a starting point, the practitioner needs to consider which variety of trust merit judicial deference. Referencing back to "mercenary pragmatism" versus "intellectual stimulation," the answer is straightforward. As a heuristic, nineteen out of twenty trusts created by a practitioner for creditor protection purposes will be third-party created trusts. Accordingly, understanding how courts view third-party created trusts, and how the law is evolving in this area, is critical to a practitioner's daily practice.

The majority of this outline is devoted to how courts can (and do) unravel these third-party trusts, and therefore how we, as practitioners, should both present these strategies to clients and add defensive features to these trusts. For example, certain trusts will not achieve creditor protection for public policy reasons, no matter how brilliantly crafted. That would be the case in certain jurisdictions if the creditor is seeking to enforce a child support order.

Others will be unwound because the beneficiary has a withdrawal right, conveying too much power. *See, e.g., Frisch v. Frisch* (U.S. Bankruptcy Court, D.C. Michigan, No 13-80072) (withdrawal right at age thirty allows creditors access to funds at that age despite spendthrift protection because beneficiary "has the equivalent of complete ownership"). *See also In re Rolfe*[1], 34 B.R. 159 (N.D. Ill 1983) (holding that beneficiary with absolute right to withdraw property cannot protect that property from her creditors).

Other trusts might be unwound because the standard of distribution is too broad, or the beneficiary is a trustee. We will explore these fact patterns and related court holdings, and note the evolution in this regard.

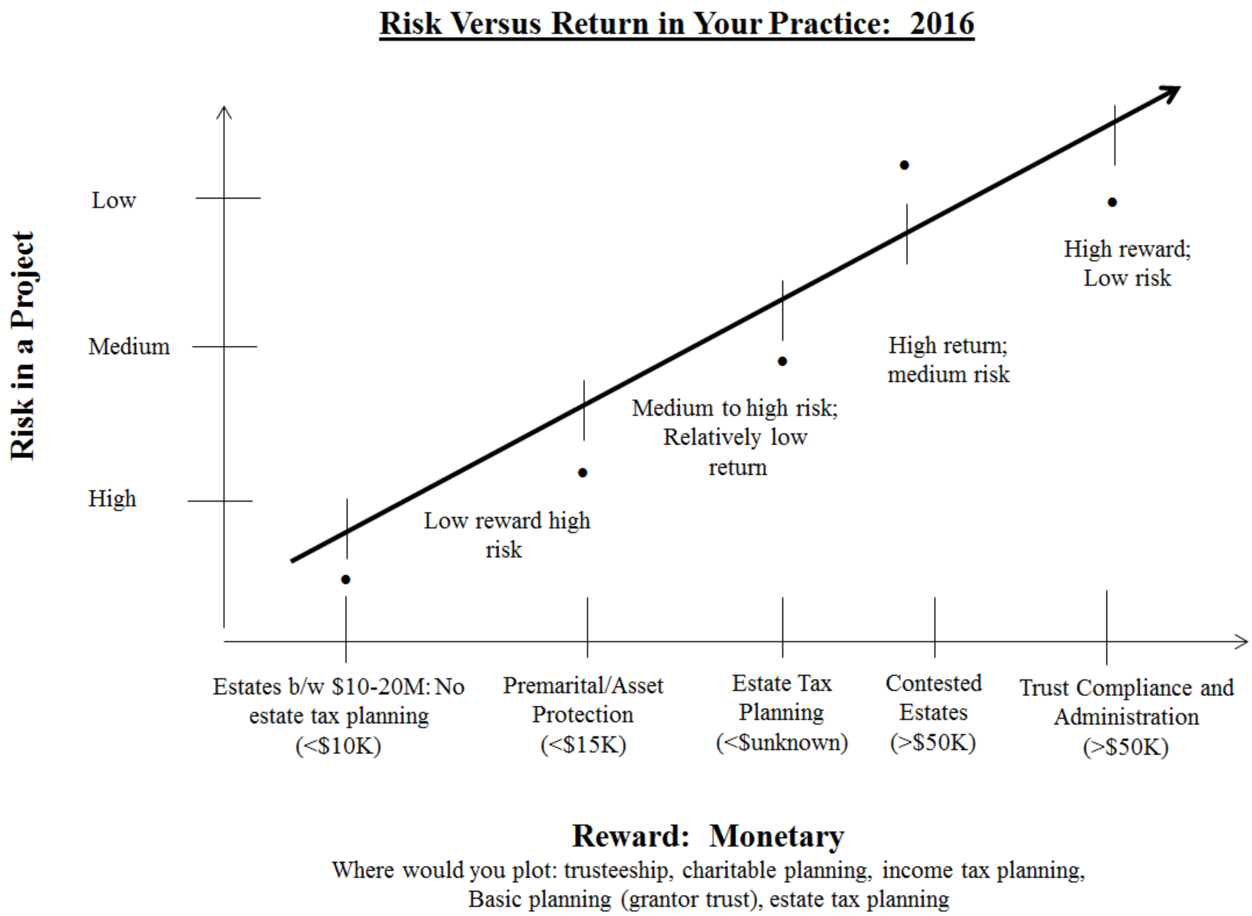
We will also explore the variety of third-party created trusts known as "special needs trusts."

We will then spend some time on an area which has developed into a niche practice: the self-created asset protection trust. This area of law is both newer and evolving faster than that of third-party created trusts, as courts will unwind these self-settled trusts using different standards.

In particular, self-settled asset protection trusts intended to protect against existing or likely creditors are often unwound via the equitable notion of fraudulent conveyance. This tiny subset of asset protection trusts implicates ethical considerations for the practitioner as drafter and adviser, and should be avoided.

[1] The holding in that case makes me want to throw up.

c. Imprint this on Your Mind



Practice Tip: *The most value in the estate planning practice today, in the eyes of clients, is in the creditor protection feature of third-party created trusts. We already know that irrevocable trusts (grantor trusts and GRATs, for example) provide tax protection from the most notorious creditor, the Department of the Treasury. In addition, clients will always focus on the creditor protection of trusts from in laws upon divorce, and even tort claims against their children. The protections afforded these trusts from these predators/creditors/exes is a critical part of any estate planning discussion, and would be plotted in the upper right-hand quadrant of the above chart. Understanding the law and the structuring, then, is our next discussion. Be mindful of "mercenary pragmatism" in this area.*

With the focus then being on mercenary pragmatism (third-party created trusts), the following summary on judicial review begins.

2. Spendthrift Trusts: Much Ado about (Almost) Nothing, or Is It?

In discussing the creditor protection of trusts, practitioners almost always focus on whether the trust has a spendthrift provision and the protections afforded by the spendthrift provision. This is much like focusing on whether your MLB team finishes in 3rd versus 4th place. Instead, the focus should be on what is necessary to get to 1st place, with emphasis (as discussed later) on the discretionary provisions, trustees, and the absence of certain powers of appointment and withdrawal rights.

The spendthrift provision is relevant, ironically, not for the protection provided, but for its implications when a court holds it to be inapplicable—in that instance, creditors can reach in and often obtain assets then available to a beneficiary. For example, a court might hold that a spendthrift provision is rendered ineffective by an unlimited right of withdrawal, *see, e.g., Frisch*, and then by implication allow a creditor access to the trust property by implying that the creditor can attach (in essence force) the beneficiary's exercise of that right of withdrawal in favor of the creditor (as discussed in section b below).

A spendthrift trust is typified by the following provision:

> "*Spendthrift. No interest under this instrument shall be assignable by any beneficiary, voluntarily or involuntarily, or be subject to the claims of his or her creditors, including claims for alimony or separate maintenance. The preceding sentence shall not be construed as restricting in any way the exercise of any right of withdrawal or power of appointment or the ability of any beneficiary to release his or her interest*."

But what does it mean, really? And how is it differentiated from the protection afforded by a discretionary trust?

a. The Genesis of the Spendthrift Trust

There was a time (during the Telephone Booth Dynasty) when mandatory income trusts, with no discretionary principal, were extremely popular. But now, other than functioning in the QTIP context, the mandatory income trust has fallen out of favor.

Instead, modern trusts are established with discretionary income and principal distributions pursuant to a standard, whether that standard is health, support and maintenance (for tax or non-tax purposes), or welfare or best interests, or in the total discretion of the trustee. The practitioner should be prepared to answer the question as to whether there is greater protection afforded a "spendthrift trust" versus a "purely discretionary trust." While the courts may view this differently, the difference from a protective perspective is marginal.

Here's why.

First, we cannot recall the last time we saw a trust drafted without a spendthrift provision. We would venture to say they are always in there, and they are an accompaniment to the protection offered by the discretionary feature.

Second, with a discretionary trust, the creditor protection is sound provided (1) the trustee does not make any distributions, (2) the jurisdiction does not have *Berlinger* – like rules, discussed, *infra*, and (3) the beneficiary (in the eyes of certain state courts) cannot force the trust to make a distribution (e.g., the beneficiary does not have a withdrawal right, or serve as trustee of a trust with an unascertainable distribution standard).

Third, the spendthrift provision merely prevents a third-party creditor from attaching the income or other interest by substituting him or herself for the beneficiary of that income interest. For example, assume the beneficiary of a $100 spendthrift trust is entitled to all the income on a mandatory basis. A third-party creditor of the beneficiary cannot substitute herself for the beneficiary to satisfy a debt or creditor interest. However, once the trustee makes a distribution to the beneficiary, the funds are in the beneficiary's hands and can then be reached by the creditor.

With a discretionary trust, created by a third party, the general rule is that a creditor cannot force the trustee to make a distribution. [2] Therefore, the creditor cannot effectively substitute in as the beneficiary. Because no mandatory distributions are required to be made, in a purely discretionary trust, a creditor would have no interest absent the trustee making, or being "required to make," a distribution to the beneficiary.

Practice Tip: *Focus on the discretionary provisions in a trust in determining creditor protection, rather than relying solely on the spendthrift provision for any great creditor protection. For example, as a rule of thumb, a purely discretionary trust, with no mandatory income interest, has in effect more relevant creditor protection than a mandatory income trust coupled with the typical spendthrift provision.*

b. But a Spendthrift Trust Does Allow the Trustee to Play a Game

It boils down then to the following. A spendthrift clause in a discretionary trust provides a practical layer of creditor protection in that creditors "may not reach the …distribution …before its receipt by the beneficiary." *See, e.g.,* section 502 (b) of the Uniform Trust Code. This has two practical results.

First, courts (see all case law discussed here) often allow third-party creditors access to trust funds, ignoring fiduciary constraints on discretionary distributions, whenever they find the spendthrift clause is rendered ineffective. Those same courts may ignore the discretion to the trustee and the trustee's fiduciary obligation in exercising that discretion. For example, where the beneficiary and trustee are the same person, subject to a discretionary standard for distribution, the court may conclude that that degree of control renders the spendthrift clause dysfunctional (ineffective is the actual word), and then imply that a third-party creditor can reach into the trust and obtain the trust property. This condenses what is truly a two-step process into one.

Step two should be: Has the trustee exercised, or must the trustee exercise, its discretionary authority? Focusing on the spendthrift clause often causes a court to conclude that it can override this second step. Therefore, right or wrong, practitioners should try to preserve and argue for the application of the spendthrift clause.

Second, if the spendthrift clause is valid, then trustees may then try to use funds for the beneficiary's benefit by making a distribution to a third party, or may make a distribution to a beneficiary that requires the creditor to go after the distribution after it is in the hands of the beneficiary.

If the trustee then makes distribution to a third party for the use of the beneficiary (e.g., to pay down the mortgage on the personal residence that perhaps has already qualified for the homestead exemption), in most jurisdictions the creditor will not be able to pull back that distribution for the

[2] *See*, *e.g.*, section 504 of the Uniform Trust Code (regardless of whether the trust has a spendthrift clause, a trust with a distribution standard prevents a creditor of the beneficiary from reaching the beneficiary's trust interest). *See also* section 60 of the Restatement of Trusts (Third) (A transferee or creditor of a trust beneficiary cannot compel the trustee to make discretionary distributions if the beneficiary personally could not do so.) While a creditor could argue "abuse of discretion," we would posit that a reasoned decision against making the distribution would not be an abuse of discretion if the standard is "may," not "shall." The Restatement goes so far as to suggest that the existence of a creditor should create a strong argument supporting fiduciary discretion against making distributions. Section 60, Restatement, *infra*, "a trustee's refusal to make distributions might not constitute an abuse as against an assignee or creditor" even when it would constitute an abuse if there had been no creditor.

creditor's use. However, evolving case law may give creditors greater rights even here, including obtaining a garnishment order under state law. *See, e.g.,* Florida section 736.0504 and *Berlinger, infra*.

Practice Tip: *Using the spendthrift provision, in the event that there are creditors, the trustee can undertake two approaches. First, discuss a compromise on the debt with the creditor since the creditor may be waiting a long time for a distribution to the beneficiary; that compromise could be twenty or thirty cents on the dollar. And second, without a compromise, to consider making all distributions "for the benefit of" (to third parties) of the beneficiary while, at the same time, allowing the beneficiary to enroll in the FBI witness protection program for relocation.*

3. The Long-Standing Law Tradition of Third-Party Created Trusts, and Creditor Protection to Beneficiaries, Deserves a Bit of Respect

Generally, English law has provided protection against beneficiaries' creditors in third-party created discretionary trusts.

A recent article by Professor Kent Schenkel, "Trust Law and the Title-Split: The Beneficial Perspective," provides a James Thurber-like stream of consciousness analysis as to why beneficial interests in trusts should not be entitled to the protections afforded under State law. Although his argument has not been accepted by courts, the evolving court attitudes certainly favor eroding the creditor protection afforded by third-party trusts.[3]

a. How Protective from Tort Creditors are these Trusts?

i. Common Law.

Common law dictates the following. A self-settled trust is entitled to no creditor protection.[4] That is, under common law, one cannot create an irrevocable trust, be the beneficiary, and then argue that the funds are free from that beneficiary's creditors because the trustee has "discretion" whether to make distributions. Evolving state statutes are, in contrast, providing protection to these self-settled trusts, and the level of that protection is discussed in section 6.

Alternatively, a discretionary trust created by a third party ("third-party settled trusts"), such as a parent for the child, is generally entitled to creditor protection as to that (child) beneficiary. Even when the beneficiary is also the trustee, but subject to limited standards as to distribution (such as health and education), that beneficiary's interest may also be protected from the beneficiary's creditors.

The uncertainties develop in that the laws and judicial results are constantly evolving in each of the 50 states, sometimes favoring protecting the beneficiary and sometimes against, as they apply to third-party settled trusts. For example, a jurisdiction may permit a third-party settled trust to have the

[3] In this snooze-fest piece, after dragging the reader through a rather dull history on trust law, the author reaches his main argument, that "trusts dodge the intent of the law by shirking legal responsibilities corollary to ownership of property, all to the advantage of the trust beneficiary." Since this argument is directly contrary to what is desired by practitioners and what is allowed and reflected by State law, by the trust restatements, and by judicial precedent, there should be caution by the practitioner in accepting an argument challenging that conclusion.

[4] In recent years, this common law rule has been eroded with the advent of state laws, such as those of Delaware and Alaska, allowing self-settled trusts to have a certain degree of creditor protection.

beneficiary as trustee, allow distribution discretion tied to a health, support, welfare or best interests standard, and still prevent that trust from being attachable by the beneficiaries' creditors.[5]

ii. The Answer Depends on State Law.

Consider Illinois law. Illinois law used to be clear that as to a third-party trust, the beneficiary could be trustee and have discretion to make distributions pursuant to an ascertainable standard,[6] while the trust remained free of creditor claims.[7] Illinois law was ambiguous with regard to whether a broad standard, "best interests," with the beneficiary as trustee, protected the beneficiary from creditors.

Demonstrating how state law in this area is rapidly evolving, recently even the limited standard was called into question. In the case of *McCoy v. McCoy* (274 B.R. 751) (2002), a surviving spouse was the beneficiary of a family trust created by the predeceased spouse. The family trust provided, in part:

> *The trustee may in its discretion pay to my spouse, or for his benefit, so much or all of the principal of the Family Trust as the trustee from time to time determines to be required or desirable for his health, maintenance and support. The Trustee need not consider the interests of any other beneficiary in making distributions to my spouse or for his benefit.*

Under Illinois law, the above standard is an ascertainable standard and would facially be considered sufficient to prevent creditor demands that the trustee make a distribution so that the creditor could satisfy its judgment. The court confused the concept of a discretionary trust with that of a spendthrift trust, albeit its error in nomenclature may not be relevant. That is, the court determined that the standard -- whether the discretionary right to principal meant just that -- was whether:

> *"[T]he beneficiary does not have unregulated dominion and control over or right to distribution from trust for the trust to qualify as a valid spendthrift trust."*

The court held that even with an ascertainable standard, the use of the word "desirable" indicated that "the settlor intended Debtor to have complete dominion and control over the corpus." Though the language would be interpreted by most planners as ascertainable, the court held that the standard was not ascertainable. Therefore, the court concluded that a creditor in bankruptcy could obtain the interest in the trust of the beneficiary, and that interest was the entire trust.[8]

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[5] By attachable, I mean that a creditor can force the trustee to exercise discretion to make a distribution. Once a distribution is made, a creditor can try to obtain the funds from that distribution.

[6] By analogy to Code section 2041, one related to "health, support, maintenance, and education."

[7] If the Trust had only used the terms "[as] required [for] health, maintenance and support", such a standard limiting discretion would likely be acceptable under Illinois law. *Rock Island Bank & Trust Co. v. Rhoads,* 353 Ill. 131 (1933) (intimating that a discretionary provision would have placed sufficient restriction on the beneficiary if it had used "comfort" alone to limit the beneficiary's access).

[8] Because the Debtor "in bankruptcy has the unfettered ability to possess and own [it]," the trust property is "therefore not protected by the exclusionary language of Section 541(c)(2). *In re Rolfe,* 34 B.R. at 161. Accordingly, the Trust property belongs to the bankruptcy estate and the Trustee will be granted Summary Judgment on Count IV of his Complaint on Count I of the Interveners' Cross Complaint, and on Debtor's Cross Motion for Summary Judgment on those Counts." *Cf.* section 60 of Restatements of Trusts (3rd).

The *McCoy* holding indicates that under Illinois law, even a standard relating to health, support or maintenance can subject a third-party settled trust to the creditors of the beneficiary. But in those Illinois cases, a key fact is that the beneficiary was also the trustee, a bad fact as discussed in more detail below. Though the court focused on the use of the word "desirable,' I do not think the result could have been eliminated by the use of the word, "necessary," rather than "desirable."

Instead, the focus seems to be on whether the beneficiary was also the trustee. For example, in *Hawley v. Simpson* (Bankruptcy Court, CD Illinois, No. 02-83674, 2004), the debtor's ability to access the trust funds, or to control the timing or manner of distribution, such as in the debtor's capacity as trustee, rendered the spendthrift provision ineffective and made the trust funds available/reachable by the creditor.

Other states' courts also reflect this view. In *Dollinger v. Bottom*, 176 B.R. 950 (N.D. FL 1994), the debtor's interest was in trust to be paid to the debtor as the trustee determined to be for the "support, care, comfort and maintenance" of the debtor. In other words, this trust should have been protected until the trustee exercised its discretion to distribute principal. The debtor was the sole trustee. As a result, the court reasoned, incorrectly (because it was ignoring Bottom's fiduciary duty to the remainder beneficiaries) that "the only one that can guard Bottom from his own improvidence is Bottom himself." This dual capacity, beneficiary and trustee, rendered the spendthrift provision obsolete and allowed creditor access to the trust.

As another example of the judicial confusion caused when a beneficiary serves as the trustee, see *Strong v. Page*, 239 B.R. 755 (W.D. Mich 1999), in which the court invalidated the spendthrift clause when the trustee and beneficiary were the same person, reasoning that there is a merger of legal title. In that case the trust by its terms had terminated, so the trustee was merely holding title pending termination. In that context, the court's holding was correct; but if the trustee were not entitled to distribute the principal except according to a standard (HEMS for example), the court's holding would have gone too far.

Even actions by a beneficiary in his capacity as beneficiary can be interpreted to allow a creditor access to the trust. For example, when a beneficiary dictates the figurehead-trustee's actions (even if the beneficiary has no right under state law to control the trust), that may render the spendthrift clause ineffective and the trust corpus susceptible to creditor attachment. For example, in *Richardson v. McCullough,* 259 B.R. 509 (Rhode Island, 2001), the debtor was not the trustee. In what I would regard as dicta (since the beneficiary had an outright interest in the trust, once the third-party trustee wrapped up administration), the court indicated that the trustee took all actions under the beneficiary's "direct, unsupervised control." "[I]t is clear that the Debtor exercised sufficient control and dominion over the Trust funds to invalidate the spendthrift trust provision," and to make the trust subject to his creditors. *Infra* at 25.

Practice Tip: *Determine how protective these trusts should be and draft conservatively without the beneficiary is trustee if needed (e.g., child is a medical doctor who already has two malpractice cases against him).*

b. Does it Matter that State Law is Shifting?

The ultimate judicial or statutory result does not matter too much for the planner. The planner cannot draft for evolving laws in this area. Rather, we have to understand the laws in place at this time, and create a situation for the strongest argument that the beneficiary's interest is free of creditors. Further, we should not hesitate to encourage a beneficiary from resigning as trustee, even after creditor issues arise.[9]

This is a win-tie strategy. If the trust is effective for tort purposes, the beneficiary benefits; if not, the beneficiary is in the same position as if no trust existed. The key here for the practitioner is avoiding over-representing what these trusts do and don't do.

Consistent with the argument made by author Schenkel, *infra,* courts have begun to erode the common law creditor protection of third-party created trusts. There have been specific trends where courts or specific state statutes will force the trustees to make (attachable) distributions to the beneficiaries, even in third-party created discretionary trusts.

These include distributions to satisfy support decrees, whether in the form of child or spousal (primarily ex-spouse) support. *See, e.g., Estate of Creamer*, 41 Pa. D. & C. 377 (2014) (support obligations to a beneficiary's child recognized as exception to spendthrift protection by case and statutory law, and in dicta, similar support obligations to a spouse recognized). *See also Ventura County Dept v. Brown*, 11 Cal. Rptr. 3d 489 (2004) (citing both California statutory and case law as allowing exception to spendthrift protection to provide for support Orders to spouse or child).

The UTC in essence voids the spendthrift protection and attaches the beneficiary's interest, but still requires the creditor to overcome a trustee discretionary distribution standard even if the creditor has a court-ordered spousal or child claim (e.g., the creditor must show that the trustee should exercise its discretion to make the distribution; a showing of an abuse of discretion can force the trustee to make that distribution to the creditor).

For an intelligent (in my view) discussion of what it means for spendthrift protection to be unavailable, see Florida Trust Code section 736.0503 and 736.0504, and *Berlinger v. Casselberry* 133 So. 3d 961 (2013). The Florida statute reflects the public policy of most states in indicating that spendthrift protection is not enforceable against a court-ordered child or spousal support determination. But, according to the court's interpretation of the same statute, the creditor (spouse or child) may not "compel a distribution that is subject to the trustee's discretion or attach or otherwise reach that interest." Instead, (somewhat bizarre) a spouse or child can obtain a writ of garnishment against disbursements made by a trustee.

A garnishment in law can mean two results. First, it can embellish the taste of any argument.[10]

Second, a "writ of garnishment" is an order requiring a third-party to withhold some type of property (usually money) of the defendant's (also called the "garnishee" or "judgment debtor") for delivery to a creditor to whom they owe an overdue debt. It means that the creditor can tell the trustee, in effect, "any time you want to make a distribution to or for the benefit of my deadbeat husband, your beneficiary, you have to give it to me first."

Practice Tip: *Third-party created trusts are intended to preserve separate property as separate property. Those trusts should be effective for those purposes, even under evolving (unfortunately and*

[9] A resignation does not mean there is a fraud on creditors. Given that the whole area on trustee/beneficiary/discretionary principal distributions is uncertain, taking an action that makes the result more certain is not a fraud on creditors. Resigning as trustee is in the whole a different genre than a troubled beneficiary transferring assets from the beneficiary to the beneficiary's spouse.

[10] Really bad pun there. Okay, that first meaning is nonsense, as you no doubt realize before you read this footnote.

incorrectly) statutes eroding a certain amount of protection. Judges may look at these trusts in providing equitable reasons for giving the non-moneyed spouse, the other spouse, a greater share of marital property, or increased maintenance amounts. And these trusts may be accessible to pay for unpaid maintenance obligations. To increase protection of these trusts, consider moving the situs and trusteeship of the trust to a jurisdiction that is more protective of these trusts, say Alaska, Delaware or Nevada; and avoid California or Minnesota, for example.

Not all jurisdictions will support this court involvement, but the trend is to provide those distributions.

Further, distributions for tax purposes, to satisfy federal tax liens and amounts due, have certainly been mandated by courts. [11]

Also, the Restatement of Trusts (Third) provides that third parties who provide necessities to or for the benefit of trust beneficiaries may reach the trust interests of the beneficiaries.[12]

In the continuing downward erosion of creditor protection, the Restatement of Trusts (Third) contemplates that the spendthrift and other protection of these trusts should be voided on certain public policy grounds. These would include consistent tortious conduct[13] and direct harm to the trust which is seeking to be protected.[14]

Nevertheless, when advising clients, these trusts are still effective shields, in the event of divorce or for typical third-party creditors bringing tort or contract cases against the beneficiary. The question is then one of structuring.

4. <u>Give me the Off the Shelf Product…or Maybe Not</u>

Typical trust structuring for adult children from the 1950s through the 1980s focused on spendthrift trusts, as needed, special needs trusts, as needed and staggered withdrawal rights for most adult children.[15]

The creative expansion of these boundaries in the last twenty years has been well received by clients, and operationally effective when administered.

This creative expansion focuses on the need for testamentary trusts for adult children to be protected from spousal claims, protected from other creditor claims, and not always accessible. In this

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[11] *See, e.g.,* Restatement (First, Second or Third) of Trusts, section 58. See also UTC, section 503.

[12] Restatement (Third) of Trusts, section 59(c).

[13] I would think one tort would be enough, versus "consistent" tortious behavior.

[14] Restatement (3rd) of Trusts, section 59 ("The nature or a pattern of tortious conduct by a beneficiary ... may on policy grounds justify a court's refusal to allow spendthrift immunity to protect the trust interest."). Under the UTC, *infra*, tortious conduct may not be sufficient to erode the protection. *Cf. United Mine Workers of America v. Boyle*, 567 F.2d 112 (1977) (intentional diversion of pension funds not an act sufficient to abrogate spendthrift provision). *But see Sligh v. First National Bank of Holmes County*, 704 So. 2s 1020 (1997) that reaches into a trust when the beneficiary was convicted of a drunk driving felony and a civil judgment thereafter obtained.

[15] For example, 1/3 at age 25, 1/3 at age 30, and 1/3 at age 35.

world today, clients understand the theme that "too much money can pollute," and are receptive to trusts that prevent that from happening.

a. Creditor Protection Trusts for Adult Children

An interesting development is the distribution of funds to adult, well-to-do children, or, to state it another way, the distribution to adult children who are not spendthrifts. In those instances, there may be no reason to hold funds in trust, at least not for the traditional reason of protecting children against their own self-indulgences. However, creditors, including a child's spouse, lurk in many dark and not so dark corners of the world.

Practice Tip: *In the world of estate planning in 2017, there should be no outright distributions to children. All children's distributions should be in trust, and then the client (and practitioner) needs to balance the level of beneficiary-control over that trust, with the certainty of creditor protection that the trust may provide.*

b. Drafting Creditor "Shield" Trusts

Consider discussing with the client the various trustee alternatives to provide a creditor protection shield for funds left in the trust not needed for the child's consumption, as the child determines from time to time. Note the use of the word "shield," versus "insulation." These trusts are intended to balance flexibility for the child in terms of access to the principal, with some protection against creditors, rather than completely insulating.

For planning purposes, assume the client and planner have determined that a flexible creditor protection trust for adult children is desired. Therefore, the question becomes how close to the edge can the trust be pushed. For example, can the child be trustee or a co-trustee? If so, must the standard be a narrow one related to health, support or maintenance? Or should the standard be expanded to "best interests?"[16]

Practice Tip: *Because powers of withdrawal or general powers of appointment (express) will under case law allow creditors to access that power, see, e.g., Frisch, infra, eliminate lifetime powers in these trusts for a beneficiary. Instead, make each trust a fully discretionary trust during the life of the beneficiary (child).*

The next question is the standard for distribution, as well as the selection of the trustee. The answer is a strange intersection of case law, practitioner bias, and client receptivity.

Case law: do not have the beneficiary as trustee; do not have enforceable beneficiary rights to principal (e.g., avoid the trustee "shall," and favor "may"). The recent Illinois case, *In re Lunkes*, No. 09 B 00583 (Bankruptcy, ND Ill, 2009), highlights this result by holding no spendthrift protection is afforded when the trust instrument has a "shall" direction to the trustee (the trustee "shall" distribute the following amounts to the beneficiary) versus "may."

Practitioner bias: Create absolute creditor protection, versus, the other end of the practitioner bias spectrum; allow the beneficiary essentially unfettered access.

[16] "Best interests" is a scary standard for trusts controlled by beneficiaries for tax purposes, but perhaps not for creditor protection purposes.

Client receptivity: "I want my children to have access to the funds."

Do you as the practitioner feel like King Solomon? Well, for those of us grey in the temple (hair), we know this is exactly what the clients want-provide them practical advice as to what they should be doing.

Practice Tip: *In drafting the discretionary standard for distribution, make sure to use the word "may" after trustee, versus "shall." Also, given the Illinois McCoy case, infra, I am not as focused on ascertainable standards as I am on who is the trustee. Therefore, revert to an unascertainable standard in most of these trusts.*

Practice Tip*: Consider an evolution to a completely discretionary trust. The world of thoughtful trust standards has paradoxically tipped in a toxic direction. In those cases in which the grantors wanted a HEMS standard, a rather limited one related to health, support and maintenance, somehow courts have focused on the "support" aspect of this to achieve rather unintended consequences from the grantor's perspective, especially in the creditor world. Accompany unlimited grantor discretion with careful trustee selection (committee of trustees) and precatory letters of intent.*

The question of trustee is then the remaining conundrum. Ideally, we would like it be someone other than the child, the Generation Two (G2 as has become popular estate planning lexicon. We are a funny group of practitioners).

Most clients want it to be the child.

We know from evolving case law that courts could force a trustee, who is also a beneficiary, to make a discretionary distribution to the beneficiary in order to satisfy a creditor. For example, under the Restatement of Trusts (Third), section 60, paragraph (g), the creditor can reach the "maximum amount the trustee-beneficiary can properly take." In the example under that paragraph, the creditors are able to reach out of the trust, when the beneficiary/debtor is the trustee, "the maximum amount of trust funds that [the debtor] may, without abuse of her discretion, distribute to herself for authorized purposes." The spendthrift provision would not offer a restraint, according to the comment in paragraph (g).

Hmmmm. Creates a bit of a conundrum, maze, inconsistency, and other words that mean the same thing. Discussing the options with clients will be much like discussing portability during the life of husband and wife. Client: "So, the question is whether I should try to get an increase in basis in my assets after I am dead, and before my wife dies, versus perhaps saving more estate taxes, but this depends on the law and changes in the law and investment returns and consumptions. You know Lou, it's Friday afternoon, and I am not that gleeful about discussing my mortality. So on the portability issue, I have an idea. You are fired."

Personally, I like the beneficiary as trustee, with the understanding that the beneficiary could resign as trustee prior to a creditor event occurring, or when the trust is created, the beneficiary (who then has creditor issues or who thinks he or she may) can just decline to act. For those clients with adult G2s, this gives the practitioner the opportunity, if the client consents, to discuss the future planning with those adult children.

But even in this case, a court may look askance at the declination or resignation to act and hold that once that power was available, any actions thereafter taken are ignored. *See, e.g., Bottom, infra* (implying that resigning as trustee would be ignored for purposes of determining the trust's creditor protection).

An alternative would be a co-trustee situation, with the beneficiary having participation rights only as to ascertainable distribution decisions, and the co-trustee having rights as to discretionary distributions for "welfare or best interests." *See, e.g., In re Schwan*, 240 B.R 754 (Minn 1999) (holding trust protected from creditors because of co-trustee and because of fiduciary duties to follow terms of trust and distribution standards). *See also McCauley v. Hersloff*, 147 B.R. 262 (M.D. Fla 1992) (Discretion to make a distribution rested in multiple trustees, of which the beneficiary was only one; therefore, spendthrift protection valid. "Moreover, in exercising that discretion each trustee has a fiduciary obligation to the remaining beneficiaries"); Restatement of Trusts (Third), section 60 (no forcing of distributions if the beneficiary is merely a co-trustee, and the other co-trustee has fiduciary obligations to other beneficiaries, which would almost always be the case).

And the most protective strategy? Not naming the beneficiary as trustee at all. Note that not acting as trustee is a good step, but not sufficient if the beneficiary can indirectly appoint himself as trustee. For example, in *In re Baldwin*, Bankruptcy Court, Ohio, No. 2-88-05792 (1992), the court first acknowledged Ohio law that there was no spendthrift protection (and the trust could be poached by creditors) if the beneficiary is the trustee, or if there are withdrawal/revocation rights (the court used "revocation" but clearly also meant withdrawal), or if "the beneficiary has [other] dominion and control over the trust." In that case, the trust limited the debtor to replacing the third-party trustee with a corporate trustee. But then the court hypothesized that the debtor could theoretically create a corporation that the debtor controlled, remove the trustee, and replace that trustee with the debtor-controlled corporation. And in that way the debtor had the ability "to exercise dominion and control over the trust," rendering the trust susceptible to creditors.

Practice Tip*: Recognize that the courts are generally offended by debtors, and therefore will do whatever necessary to mess with the computer program so that the spendthrift protection, and inability to access the trust, gets an error message; such that the trust becomes available to the creditor for reimbursement.*

I tend to think that co-trustee situations are the best today for most trusts, for a variety of reasons: assisting in the administration, allowing tax planning if the co-trustee is a knowledgeable tax practitioner, allowing accountability, providing a sounding board, creating plausible deniability when someone asks a beneficiary for money, avoiding mistakes, and for a few more (that I will not bore you with).

Practice Tip*: Going forward, try to have the creditor protection trust for a G2 have both the G2 plus another as co-trustees. If not achievable, live with the G2 as sole trustee and recognize that there may not always be complete creditor protection.*

c. <u>The Shelf Product</u>

The practitioner, based on state law and knowledge of the client's family, has to recommend the format that should be used.

Drafting Example: (The Adult Creditor Shield Trust)

Child's Separate Trust

> Any trust property allocated for a child of mine subject to the Child's Separate Trust withholding provisions shall be added to or used to fund the principal of a Child's Separate Trust for the child. The trustee shall administer each Child's Separate Trust as follows:

Section 1.01 Discretionary Payments of Income and Principal. During the child's lifetime, the trustee may pay to the child so much of the income and principal as the trustee from time to time considers necessary for the health, education, support, maintenance in reasonable comfort, welfare, or best interests of the child. Any income not so paid in each tax year shall be added to principal at the end of each tax year.

Section 1.02 Power of Appointment at Death. On the death of the child, the trustee shall distribute the principal to any one or more persons or organizations (including the child's estate) as the child appoints by Will, specifically referring to this power of appointment.

Section 1.03 Distribution on Termination. On the death of the child, the trustee shall distribute the Child's Separate Trust not otherwise effectively appointed as follows:

(a) Any Descendant Living. If the child has any descendant then living, to the child's then living descendants, per stirpes; or,

(b) No Descendant Living. If the child has no descendant then living but I have any descendant then living, to the trustee to allocate in shares of equal value for my then living children, subject to the Child's Separate Trust withholding provisions hereof; provided that if a child of mine is not then living but a descendant of the child is then living, the trustee shall distribute the share that would have been allocated for the child, if living, per stirpes to the child's then living descendants.

d. Cutting Back the Creditor Protection Trust to a Creditor "Annoyance" Trust

Further, coordinate the trustee provision so that a child at a certain age can get control over this creditor protection trust, in the child's capacity as a co-fiduciary, or even as sole fiduciary.

Drafting Example: Child as Trustee of Creditor Annoyance Trust

Section 1.04 Trustee of Child's Separate Trust. Notwithstanding any other provision, upon attaining age thirty (30), each child of mine shall have the following powers with respect to the Child's Separate Trust established for the child's benefit under this instrument:

(i) Co-Trustee. The child shall have the right to appoint himself or herself as co-trustee.

(ii) Remove and Appoint. The child may remove any trustee at any time by a signed instrument, but only if, on or before the effective date of removal, a successor trustee (other than the child) has been appointed by that child or at least one trustee will continue to act after the removal.

e. Manning Up—Consider Insurance.[17]

[17] This section has nothing to do with "manning up," but I do find humor in this trite phrase that has crept into the everyday lexicon, "you know," "like," "I mean." Technology is truly turning us into idiots.

For a child's separate trust created under estate planning documents, consider the purchase of special assets that themselves have a degree of creditor insulation. In this regard, the purchase of insurance, especially one designed and analyzed to create positive financial results, should be considered.

5. The Government Wants its Money Back

The question on the protections afforded trusts from state (and federal) reimbursement claims, for example, when the beneficiary qualifies for state support payments, is generally a question of state law. However, the following heuristic has developed.

If the trust is drafted as a supplemental needs trust, where distributions cannot be made to the beneficiary for direct support, these should be sufficient to withstand claims for government reimbursement.

Example:

ARTICLE 1

Administration During Beneficiary's Lifetime

During the Beneficiary's lifetime, the trustee shall administer the trust estate as the Lou Aiken Supplemental Needs Trust as follows:

1.1 Discretionary Payments. The trustee may pay as much of the income and principal of the Lou Aiken Supplemental Needs Trust for the benefit of the Beneficiary as the trustee from time to time considers desirable in the trustee's sole discretion for the Beneficiary's extra and supplemental care, extra and supplemental maintenance, and extra and supplemental education in addition to, and over and above, and not in lieu of, any benefits the Beneficiary otherwise receives as a result of a disability from any local, state, or federal government or from any private agency, any of which provides services or benefits to disabled persons. The trustee may also pay as much of the income and principal of the Lou Aiken Supplemental Needs Trust as the trustee from time to time considers necessary to provide for the Beneficiary's medical, dental, and other health care expenses which are not reimbursable by insurance coverage (including without limitation deductible amounts, co-pay amounts, and premium payments) due to policy limits or exclusions or due to the Beneficiary's complete absence of health insurance coverage. Any income not so paid in any tax year shall be accumulated and added to principal at the end of such tax year. I recommend that the trustee make no payments of income or principal hereunder for the benefit of the Beneficiary if other assets (including without limitation supplemental security income, social security disability income, and benefits under Medicaid or Medicare) known to the trustee are reasonably available for the Beneficiary for the same purposes.

1.2 *(Optional to allow shift from a special needs trust.)* Trust Protector's Power of Appointment. During the Beneficiary's lifetime, the Trust Protector may appoint any part or all of the Lou Aiken Supplemental Needs Trust to one or more other trusts (each a "Receiving Trust") for the benefit of the Beneficiary, by written instrument specifically referring to this power of appointment, subject to the following conditions:

(a) The Beneficiary must be the sole current beneficiary eligible for distributions of income or principal from a Receiving Trust during the Beneficiary's lifetime.

(b) A Receiving Trust may permit the trustee to make discretionary distributions to or for the Beneficiary which are for narrower or broader purposes than, or otherwise substantially different from, the discretionary distributions permitted by the Lou Aiken Supplemental Needs Trust.

(c) The successor, contingent, and remainder beneficiaries of a Receiving Trust shall be any one or more of the descendants of Bruce Aiken, any one or more of the successor, contingent, and remainder beneficiaries of the Lou Aiken Supplemental Needs Trust, or any one or more charitable organizations which shall then be in existence as entities described in Sections 170(c) and 2055(a) of the Code. In no event may a Receiving Trust grant any beneficial interest to the Trust Protector, the Trust Protector's creditors, the Trust Protector's estate, the creditors of the Trust Protector's estate, or any person whom the Trust Protector has a legal obligation to support.

(d) A Receiving Trust may grant general or limited powers of appointment to the Beneficiary, the permissible objects of which shall be any one or more of the descendants of Bruce Aiken, the creditors of the Beneficiary's estate, any one or more of the successor, contingent, and remainder beneficiaries of the Lou Aiken Supplemental Needs Trust, or any one or more charitable organizations which shall then be in existence as entities described in Sections 170(c) and 2055(a) of the Code. In no event shall the permissible objects of any such power of appointment include the Trust Protector, the Trust Protector's creditors, the Trust Protector's estate, the creditors of the Trust Protector's estate, or any person whom the Trust Protector has a legal obligation to support.

(e) The grantor of the Receiving Trust need not be the Grantor of the Lou Aiken Supplemental Needs Trust.

(f) The initial and successor trustees of the Receiving Trust need not be limited to the initial and successor trustees of the Lou Aiken Supplemental Needs Trust.

1.3 Allocation on Termination. On the death of the Beneficiary, the trustee shall distribute the Lou Aiken Supplemental Needs Trust not otherwise effectively appointed as follows:

(a) Any Descendant Living. If the Beneficiary has any descendant then living, to the Beneficiary's then living descendants, per stirpes; or,

(b) No Descendant Living. If the Beneficiary has no descendant then living, to my then living descendants, per stirpes; or,

(c) Ultimate Gift. If I shall have no descendant then living, to my spouse, Marcia B. Aiken, if she shall then be living, or if she shall not then be living, to the personal representative of the Beneficiary's probate estate.

If the trust allows the trustee discretion to distribute funds for a beneficiary's support, then state case and statutory law may allow reimbursement, or may not.[18]

An example of a state law that protects even these trusts is Illinois.

[18] Kruse, Third-Party and Self-Created Trusts: Planning for the Elderly and Disabled Client (3rd Ed. ABA, 2003, out of print).

(760 ILCS 5/15.1) (from Ch. 17, par. 1685.1) Sec. 15.1. Trust for a beneficiary with a disability. A discretionary trust for the benefit of an individual who has a disability that substantially impairs the individual's ability to provide for his or her own care or custody and constitutes a substantial disability shall not be liable to pay or reimburse the State or any public agency for financial aid or services to the individual except to the extent the trust was created by the individual or trust property has been distributed directly to or is otherwise under the control of the individual, provided that such exception shall not apply to a trust created with the property of the individual with a disability or property within his or her control if the trust complies with Medicaid reimbursement requirements of federal law. Notwithstanding any other provisions to the contrary, a trust created with the property of the individual with a disability or property within his or her control shall be liable, after reimbursement of Medicaid expenditures, to the State for reimbursement of any other service charges outstanding at the death of the individual with a disability. Property, goods and services purchased or owned by a trust for and used or consumed by a beneficiary with a disability shall not be considered trust property distributed to or under the control of the beneficiary. A discretionary trust is one in which the trustee has discretionary power to determine distributions to be made under the trust.
(Source: P.A. 99-143, eff. 7-27-15.)

Practice Tip*: Draft all special needs trusts as supplemental needs trust, to create the best argument for full protection from governmental reimbursement claims.*

6. Protect My Assets from My Future Creditors

Domestic asset protection trusts are a completely different breed of trust. The common law rule is that a self-settled trust is entitled to no spendthrift protection, and is essentially entitled to no protection against third-party creditors, even when the person creating the trust is not the trustee and the trustee has full discretion for distribution. *See, e.g., McLean v. Central States*, 762 F. 2d 1204 (4th Cir 1985).[19] In a sense, common law on self-settled trusts is 180 degrees different from the protection afforded by third-party created trusts.

Ironically, state statutes creating domestic asset protection trust statutes have countered this common law by enacting protection against third-party creditors in certain situations. Delaware's statute is one of the more thoughtful in this regard[20] and exempts a beneficiary's interest in a correctly established Delaware self-settled trust from all legal and equitable means instituted by a creditor (including garnishment, which is a very important exclusion, discussed in the context of the *Berlinger* case, *infra*). [21]

The basis for this protection is a statute, and therefore, the courts' unraveling of these strategies goes down one of a few roads. First, that the statute is violated. [22]

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[19] See also Restatement (3rd) of Trusts, section 58, and UTC, section 505. *See, e.g., Rush University v. Sessions*, 2012 IL 112906.

[20] See the excellent summary of the Delaware statute and this area, in general, by the fine writer and practitioner, Dick Nenno, "Court-Created Exceptions to Spendthrift-Trust and Other State Law Protections," published in many places and available through the web and likely by request directly to Wilmington Trust Company.

[21] 12 Del. C. section 3536 (a).

[22] Hopefully we don't have to cover what this means. In crafting these trusts, be careful with the state statutes and stay away from gray.

Second, the beneficiary's rights are too great, tantamount to the right of revocation.[23] For example, a withdrawal right at a certain age, a general power of appointment, or the right to become a trustee with an unascertainable standard trust, is equivalent to rights of revocation.

Third, the court can argue that the exceptions to the application of the domestic asset protection trust statute are appropriate. For example, under a state statute (on self-settled trusts), the exceptions to the creditor protection of a third-party created trust could equally apply to a self-settled trust: spousal or child support order, or federal or state tax judgments.

Fourth, fraudulent transfers, i.e. transfers to a trust when creditors are out there or should be known to be out there, will not be protected. Those transfers may or may not include tortious acts, depending on the state in question.

Fifth, that the state's public policy is violated. This can be done either under the auspices that the self-settled trust did not have sufficient contacts with the governing law, *e.g.,Huber v Huber, Case No 1-41013 (2013)* (Court invalidated protective feature of an Alaska sitused trust, under Washington law, in part because it held that Alaska did not have sufficient contacts with the trust to truly constitute or allow for it to be the governing law; a bit of a specious argument if you ask me). Or, the court can merely hold that full faith and credit does not require following another state's law because public policy is violated. *Mortensen, infra* (State of Washington held to have "strong public policy against self-settled asset protection trusts" and "will apply Washington law in determining the Trustee's claim regarding validity of the Trust." The result was treating trust transfers as void).

Conclusion

If the computer is not on, it cannot be hacked. Use trusts (however created) to create a layer of creditor protection, and let the hackers give it their best shot.

[23] *See, e.g.,* 12 Del. C. section 3536.