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Can The Uniform Trust Code Be Fixed?

By Mark Merric and Dan A. Collins

Mark Merric is the manager of Merric Law Firm, LLC (Denver, Colo.). Dan Collins is the Principal of Dan A. Collins & Associates, P.A. Dan Collins is a member of the South Carolina UTC Committee and endorses the South Carolina approach. Mark Merric has worked with members of the Ohio UTC, the North Carolina UTC and the South Carolina UTC committees. However, he has not found a UTC statute that he finds approaches the benefits previously available under most states' common law. Both Mark Merric and Dan Collins frequently speak nationally on a variety of estate planning topics.

Introduction and implementation of the Uniform Trust Code (“UTC”) has thus far proved to be more controversial than the Uniform Probate Code when it was first introduced. The problem driving the controversy is that the UTC uses the Restatement (Third) of Trusts (“Restatement Third”) as the backbone model for its design as well as for its interpretation.

Unlike preceding Restatements, the Restatement Third takes many minority positions in the common law (sometimes distinctly minority positions). More troubling, in a few areas it actually creates new and untested law. The result is that in many settled areas of trust law, the backbone of the UTC is not founded on a majority view of judicial wisdom developed over the last one hundred years; instead, the UTC and the Restatement Third are founded on the opinions of the drafting committees of what they would like the law to become.

In the October 2003 issue of Practical Drafting, Richard Covey and Dan Hastings note that while several sections of the UTC are controversial, few can be expected to be as controversial as Article 5, which sets forth creditor’s rights. The following list details some reasons why Article 5 is so controversial:

- The creation of a new theory of creditor recovery for all trusts known as the “continuum of discretionary trusts,” while at the same time abolishing the one-hundred and twenty-five year common law distinction between a “discretionary trust” and a “support trust.”

- Reducing the threshold of discretionary trust protection to that of spendthrift protection.
- Increased remedies that reduce spendthrift protection for all trusts.
- In many cases, most likely converting the assets of a special needs trusts to an available resource, resulting in the loss of need based benefits for these trusts.
- In many states, all trust interests, both income (i.e., current beneficial interests) and remainder interests, most likely will be considered marital property, or at least may be a factor in the determination of equitable distribution of marital property.
- The potential imputation of income from all trusts to determine child support or alimony.
- Spouses and other exception creditors allowed to recover attorney fees from the trust, encouraging litigation at the expense of the trust.
- Inter vivos general powers of appointment may be attached and exercised by any creditor.
- Exception creditors allowed judicial foreclosure on both current beneficial interests as well as remainder interests.
- Increased litigation likely to result from the newly created continuum of discretionary trusts and the changes to settled common law.
- Increased malpractice exposure for attorneys and trustees for failing to advise fully about the differences between trust law in UTC and non-UTC jurisdictions, particularly as related to the decrease in asset protection for beneficial interests under the pure version of the UTC. (For further discussion of this issue see Merric, Gillen, and Freeman, *Malpractice Issues and the UTC*, ETPL (December 2004)).

Several articles have been published exploring these and other problems with the UTC. This article discusses how the South Carolina UTC committee proposes to solve some of these problems and attempts to deal with others:

- South Carolina amended UTC §501 to provide, first, that only *exception creditors* may attach the interest of a beneficiary in a trust protected by a *spendthrift* provision.
- The South Carolina UTC committee appears to be the only state UTC committee that has directly addressed this issue. The South Carolina approach shows strong insight in the need for affirmative language in the UTC, if enacted, to correct the problem, rather than merely omitting §501 and praying that a judge does not inadvertently mistake the Restatement Third for common law in this area.
- More importantly, §501 of the South Carolina UTC provides that the interest in a *discretionary trust* may not be reached by creditors. The South Carolina comment further explains that discretionary *trusts* do not have to rely on

- spendthrift* language in order for present or future distributions to be exempt from creditor attachment.
- In the South Carolina comments, an attempt is made to keep the dichotomy found in the Restatement Second between support trusts and discretionary trusts.
 - South Carolina's effort would be greatly strengthened by language in the South Carolina statute stating such. A secondary, but less preferable option is the addition to its state comment affirming that it is retaining this distinction under common law. This would reduce the possibility that a South Carolina judge may erroneously conclude that South Carolina had adopted the newly created continuum of discretionary trusts. Further, potential creditor issues remain if a property interest is created beneficial interests in a trust. (For a further discussion of these issues see Merric and Oshins, *Effect of the UTC on Spendthrift Trusts*, 31 ETPL 375 (Aug. 2004); 31 ETPL 411 (Sept. 2004); and 31 EPTL 478 (Oct. 2004). Also see Merric, Stein, and Berger, *The Uniform Trust Code: A Continuum of Discretionary Trusts or a Continuum of Continuing Litigation*, J. Prac. Est. Plan. (Dec/Jan 2004).)
 - Many of these property issues occur in the divorce context if a trust interest is classified as property. Depending on state law, the beneficial interest may be eligible for division as marital property or a factor (i.e., economic circumstance) in determining an equitable division of marital property. Mitigating the creation of a property interest issue in the dissolution of marriage, South Carolina law currently provides that any property inherited in trust is neither marital property nor a factor (i.e., economic circumstance) for determining the equitable distribution of marital property.
 - S.C. §501 of the UTC appears to limit the judicial foreclosure sale of discretionary interests by exception creditors. The judicial foreclosure sale of a current beneficial interest is another position that has virtually no support in common law that was adopted by both the UTC and Restatement Third. Further, there was little support for the judicial foreclosure sale of remainder interests, particularly under the Restatement Second.
 - South Carolina amended UTC §503 to provide that the only exception creditor is a claimant for child support.
 - Unfortunately, this exception creditor rule now applies to all trusts, both discretionary and support trusts. On a positive note, this may have cleared up and possibly strengthened S.C. law regarding the limiting of exception creditors that could attach a support trust. On a negative note, this exception creditor rule as applied to discretionary trusts may well have left open the imputed income arguments for child support. (For a further discussion of this issue Merric, Stevens & Freeman, *The Uniform Trust Code – A Divorce Attorney's Dream*, Journal of Estate Planning, J. Prac. Est. Plan. (Oct/Nov 2004). Also, see the available resource issue discussed immediately below.)

- South Carolina further amended §503 by the addition of a separate paragraph denying recovery even to the single exception creditor against a special needs trust, supplemental needs trust, or similar trust established for a disabled person.
- The authors differ about the efficacy of this provision. Mark Merric is concerned that a purely discretionary trust under common law will not be protected by S.C. UTC § 503(c). Merric also sees a conflict in the South Carolina statute by stating that there is an available resource that a judge may reach for the purpose of child support, but not for determining whether there is an available resource for governmental aid. (For a further discussion of these issues, see Merric and Stein, *The UTC Threatens Special Needs Trusts*, Tr. & Est. (Nov. 2004).)
- South Carolina adopted the 2004 Amendment to UTC §504 which provides that a creditor of a beneficiary who is also a trustee or co-trustee may not reach the beneficial interest if the beneficiary-trustee's discretion is limited by an *ascertainable standard*. This rejects the Restatement Third approach and demonstrates that merely excluding UTC provisions from enactment may not be effective to avoid application of Restatement Third, which the UTC extensively looks to for interpretation.
- We cannot stress enough the importance of affirmative language specifically disclaiming the Restatement Third positions that are contrary to the enactor's intent. Including specific disclaimers of relevant Restatement Third positions in the text of the statute is also an effective method of preventing judge-made new law in these areas.
- South Carolina did not adopt subparagraphs (b)(1) and (2) of UTC §505 and the corresponding paragraph (b) of UTC §603. These UTC sections make *powers of withdrawal* subject to attachment.
- If adopted, these provisions would have effected a significant change in South Carolina law and settled trust law everywhere, which has consistently recognized that appointive assets are not generally subject to the claims of the donee power holder's creditors. Further, there is no precedent for treating the holder of a *power of withdrawal* as the "settlor" of the trust with respect to the property subject to the power of withdrawal. South Carolina correctly identified that there is virtually no support for the UTC and Restatement Third's approach holding that an inter vivos general power of appointment may be attached and exercised by any creditor. While the South Carolina approach does not specifically state in the South Carolina UTC that a creditor could not attach an inter vivos GPA, it has strong case law to that effect. Other states should consider including an express statutory provision that inter vivos powers are not subject to attachment.
- South Carolina amended UTC §506 by adding an additional paragraph which defines a *mandatory distribution*. The South Carolina comment explains that the definition was added to prevent §506 from being interpreted to require distributions from a discretionary trust defined in UTC §504.
- UTC §506 is a gaping whole that allows all creditors to attempt to attach any beneficiary's interest, including a discretionary interest. A judge is then to

determine the amount of the distribution based on the undefined continuum of discretionary trusts. To the authors' knowledge, South Carolina and Ohio are the only UTC committees that have addressed this issue.

Conclusion

The authors analogize enacting the UTC to building a vehicle. The fundamental component is the *chassis*, which determines whether you have a limousine or a truck. The *chassis* of existing trust law is the Restatement Second of Trusts, complimented by existing common law developed over years of decisions. *Stare decisis* is a familiar friend that should not be so quickly abandoned when all that may be needed are changes to modernize existing trust law, not supplant it. In other words, why change the *chassis*, which is what the UTC in fact does in many instances. The definitions, structure, new theories of law, and minority opinions incorporated in the UTC are derived from the Third Restatement, which unfortunately in many key areas is not the common law of most states. This new chassis results in a different vehicle. It is no longer a limousine. If it looks like a truck, rides like a truck, and sounds like a truck, it probably is a truck. Different estate planners take different positions on whether major overhauls to the UTC can maintain the limousine chassis of the Second Restatement, and bring the UTC back to common law. Dan Collins takes the position that much of this has been done through the South Carolina act. Mark Merric takes the position that like the Ohio UTC, the South Carolina UTC is a step in the right direction, but many issues, some which are discussed below, still need to be addressed.

The proposed Ohio UTC has the advantage of explicitly keeping the discretionary-support distinction under common law and recognizes that the fundamental cornerstone to the protection of a discretionary trust is the high threshold of judicial review – a judge will only review a trustee's discretion if the trustee acts (1) dishonestly; (2) with an improper motive; or (3) fails to act. While the Ohio UTC is the only UTC or proposed UTC statute that has retained the superior asset protection provided by a truly discretionary trust, the current proposed Ohio UTC limits this advantage to a very narrowly defined group of "wholly discretionary trusts", and the proposed Ohio UTC does not address many of the issues discussed in this article.

On the other hand, the South Carolina statute attempts to keep the discretionary-support distinction, but rather than directly stating it in the code, it attempts to do this in the comments. Further, the high threshold of judicial review for a discretionary trust has been dropped to good faith. (UTC § 814(a).) The lowering of the judicial threshold may well lead to imputed income arguments, such as creating an available resource in the SNT context as well as imputing income in the case of child support or alimony. The lowering of the judicial threshold of review for a discretionary trust combined with referencing the Restatement Third for interpretation may create property interests in all beneficial interests. While not a current problem in S.C., these interests may be classified as marital property and become eligible for division in divorce. Finally, it is uncertain whether S.C. prevents an exception creditor from judicially foreclosing on a support interest or a remainder interest.

Both the Ohio UTC and the South Carolina UTC rely on the estate planner's friend *stare decisis* by making many modifications to the UTC in an attempt to retain the benefits of common law and hundreds of years of judicial wisdom. Unfortunately, the task is not easy. The multitude and the magnitude of deviations in the UTC from common law make amending the UTC more analogous to a committee attempting to change a truck into a limousine.