

The Uniform Trust Code: “A Continuum of Discretionary Trusts” or “A Continuum of Continuing Litigation”?

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Mark Merric, Douglas Stein and Michelle Berger analyze the impact of the Uniform Trust Code and the Restatement (Third) of Trusts, on discretionary and support trusts. It is clear that the U.T.C. and Restatement greatly decrease the asset protection historically afforded by most of these trusts under the common law. As important is the extreme uncertainty in drafting and planning rendered by these developments.

This article discusses the expected increased litigation created under the Uniform Trust Code (U.T.C.), and is based in part on the Leimberg Information Services, Inc. article, *The Uniform Trust Code and Asset Protection in Non-Self Settled Trusts*, Asset Protection Newsletter #53, September 14, 2004. This article highlights the reasons for the projected increase in litigation under the continuum of discretionary trusts created by the U.T.C. While the authors concentrate on Article 5 of the U.T.C., it is but one of the many U.T.C. Articles that requires significant analysis. The authors agree with the authors of *The Uniform Trust Code—Part I*, Practical Drafting, that Articles 4 (court termination or modification), 5 (creditors' rights), 6 (power of court to require or dispense with bond), 7 (court

adjustment of trustee compensation), 8 and 9 (certain disclosures to beneficiaries), and 10 (effect

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of exculpatory provision) are also likely to be controversial.¹

Considerable ink has been spilled analyzing the unprecedented decrease in asset protection afforded to most beneficiaries of trusts under the Uniform Trust Code (U.T.C.)² and its interpretive companion, the Restatement (Third) of Trusts (“Restatement Third”).³ While this article briefly touches on these issues, its main focus is the newly expanded industry created by the U.T.C., namely, trust litigation. Much of this litigation is caused by the decrease in asset protection afforded trusts due to increased rights of recovery by creditors under a novel new trust concept known as the “continuum of discretionary trusts.” In addition, an increase in litigation can be expected because beneficiaries are given a greater power under the U.T.C. to rewrite trusts after the grantor’s death.

To assist the reader in creating a framework within which to analyze this “new wave” of litigation in the trust area, this article is divided into the following components:

- I. The Newly Created “Continuum of Discretionary Trusts” Under the U.T.C.
- II. Will Every Special Needs Trust (SNT) Go to Court?
- III. Will All Creditors Pursuing a Debtor/Beneficiary’s Interests Go to Court to Determine What an Overdue or Mandatory Distribution Is?
- IV. Will Every Divorce Case with a Trust/Beneficiary Go to Court?
- V. Providing the Fuel to Further the Litigation Fire
- VI. Why Overturn 125 Years of Judicial Wisdom?
- VII. Conclusion

I. The Newly Created “Continuum of Discretionary Trusts” Under the U.T.C.

The U.T.C. creates a continuum of discretionary trusts whereby all trusts are classified as discretionary trusts and the support trust/discretionary trust dichotomy is obliterated. Unfortunately, when compared to the common law distinction between a discretionary trust and a support trust, the term “continuum of discretionary trusts,” under both the U.T.C. and the Restatement Third, appears to be a misnomer.

Under common law, discretionary trusts gained their asset protection from the inability of a beneficiary to attach an interest or to force a distribution,⁴ not from a spendthrift clause. Because a beneficiary had no property rights and no right to force trust distributions, a creditor could not “stand in the shoes” of the beneficiary and attach a beneficial interest or force a distribution.⁵ Further, generally, the beneficiary could continue to enjoy the proceeds of a discretionary trust if the trustee paid the beneficiary’s expenses directly to the service provider, even if a separate creditor of the beneficiary remained unpaid. Consequently, virtually no creditor recovered from a discretionary trust even though the beneficiary could continue to benefit from the trust.

In a historically unprecedented move, both the U.T.C. and the Restatement Third abolish the common law distinction between discretionary and support trusts.⁶ Abolishing the discretionary trust/support trust dichotomy requires all discretionary trusts to rely on

the decreased asset protection provided by a spendthrift clause to avoid attachment by a creditor. In this respect, the continuum of discretionary trusts functions much more like a continuum of support trusts. Further, new remedies provided by the U.T.C. erode the limited asset protection provided by most spendthrift provisions.

Overview of Beneficial Interests That May Be Attached

Prior to the U.T.C., only an exception creditor could attach an interest in a support trust. However, even if the creditor attached the interest, there was no guaranty that they could force a distribution from the trust based on the support standard.⁷ Further, courts rarely, if ever, permitted a creditor to foreclose against a remainder interest through a judicial foreclosure sale.⁸

If a state enacts the U.T.C., the discretionary trust/support trust dichotomy will be destroyed and all beneficial interests in a trust will be subject to attachment. No trust in a U.T.C. jurisdiction can rely on the well-defined and clearly contoured protections of the common law. Instead, the only protection afforded a trust under the U.T.C. will be that provided by a spendthrift clause, if it is included in the trust.⁹ Therefore, the only remaining questions under the U.T.C. and the Restatement Third are, who can attach the interest, who can judicially foreclose the beneficial interest and who can attach and force a distribution directly from the trust.

Increased Remedies Under the U.T.C.

Attachment of Beneficial Interests. Under the U.T.C., it is clear that exception creditors may attach a beneficiary’s present and future distributions at the trust level.¹⁰ In many,

if not most, states, this represents a significant change from the common law, where *no* creditor could attach a distribution at the trust level.¹¹ Furthermore, U.T.C. §501 prevents a trustee from directly paying any expenses of a beneficiary if there is an outstanding exception creditor.

Exception creditors under the U.T.C. are defined as child support, alimony, attorneys' fees for services rendered to protect a beneficial interest (including those of an estranged spouse or any other exception creditor suing in the shoes of the beneficiary) and any federal or state claim, to the extent provided for by a future statute.¹² For the moment, the U.T.C. provides fewer exception creditors than the current common law because federal and state governments have not had the opportunity to enact legislation that provides for statutory recovery from a trust. However, due to the budgetary crunch every state is experiencing, it is only a matter of time until such legislation is enacted, and the government claim exception becomes applicable to all trusts, whether categorized as discretionary or support under common law. The range of permitted exception creditors under the U.T.C. may be still further enlarged because the act explicitly permits additions to the number and scope of exception creditors and their claims by both the state's judiciary and legislature. The reporter's notes from the Restatement Third even encourage the judiciary to add further exception creditors.

U.T.C. §501 may be interpreted to permit any creditor, not just an exception creditor, to attach a distribution or a remainder interest at the trust level. This is because U.T.C. §501 refers to distributions, and since the publication of the Restatement (Second) of

Trusts, distributions have not been protected by spendthrift provisions.¹³ The interpretive guide to the U.T.C., the Restatement Third, provides little clarity on this point. The text of §56e. of the Restatement Third refers to "a creditor" and not an exception creditor. Thus the Restatement Third implies that *any* creditor could attach a trust interest. However, illustration 1, mentions that no spendthrift clause is included in the trust, therefore, the Restatement Third *may* only apply to an "exception creditor."

Due to the lack of guidance provided by the Restatement Third, and the latent ambiguity in the U.T.C., a judge may reasonably interpret U.T.C. §501 to include *any* creditor, and thereby almost completely undermine any spendthrift protection afforded by a trust. This interpretation seems consistent with the interpretation of U.T.C. §501 by Professor Rounds, the current author of *LORINGS, A TRUSTEE'S HANDBOOK*.¹⁴ Essentially, under such an interpretation, all trust distributions will be frozen, because a trustee can no longer make any payments to or for the beneficiary. However, a court may consider the support needs of a destitute beneficiary and the beneficiary's family.¹⁵ In the worst case scenario, it is easily envisioned that no distributions can be made to or expenses paid for a disabled beneficiary from a third-party supplemental needs trust because the government is a creditor, and any such distribution or payment would constitute an available resource, thereby disqualifying the special needs trust (SNT) beneficiary from governmental aid.¹⁶

Judicial Foreclosure Sale of a Beneficiary's Interest. Under the U.T.C., exception creditors may force the sale of all beneficial interests.¹⁷ This includes both current

income interests and remainder interests. This is a dramatic departure from common law. Under common law, a judicial foreclosure sale of a current beneficial interest is virtually unheard of. Further, in most states, a remainder interest is almost never permitted to be sold.¹⁸

Forcing a Distribution. Finally, under the U.T.C., a spouse may attach a current distribution interest, from a trust categorized as either a discretionary or support trust under common law, and force a distribution for child support or alimony.¹⁹ Again, as related to a discretionary trust, this is virtually unheard of under the common law, because a beneficiary of a discretionary trust has no enforceable right or property interest.²⁰ With a support trust under common law, the states are split. Some states permit attachment of an interest for child support and others do not.²¹

Does the Continuum Protect Anything?

An exception creditor can choose to either attach a beneficial interest or not, and a judge can either permit the current or remainder beneficial interest to be sold at a judicial foreclosure sale or not. Either way, a beneficiary cannot continue to enjoy the trust property as the grantor intended. These newly created U.T.C. remedies are independent of the newly created continuum of discretionary trusts. So how does the continuum of discretionary trusts provide any creditor protection? Unfortunately, it appears that the continuum of discretionary trusts only provides a small amount of asset protection under the "imputed income argument."

What Is the Continuum?

Before discussing the imputed income issues, the "continuum" must

be explained (see Diagram 1). All trusts (*i.e.*, common law discretionary *and* support trusts) now lie on a continuum from the most discretionary trust to the least discretionary trust—which would most likely be a support trust under common law. Also, as previously noted, as far as judicial remedies are concerned, the term “continuum of discretionary trusts” appears to be a misnomer—it is much more analogous to a continuum of support trusts under common law, because all beneficial interests are only protected by spendthrift protections (assuming a spendthrift provision is in the trust document).

Unfortunately, the “continuum of discretionary trusts” theory is undefined by either the Restatement Third or the U.T.C. There is no definition of the most discretionary trust types or the least discretionary trust types. Further, the beginning, middle and end of the continuum remain a mystery. A tidal wave of litigation is required to define the contours of the U.T.C.’s new spectrum of discretionary trusts. However, until litigators have engorged themselves on the ambiguities and conflicts inherent in the U.T.C., practitioners will be forced to act in a void, and will be unable to lend certainty to their clients, who so desperately desire it.

The Matrix of Possible Interpretations Under the Continuum

In this projected tidal wave of new litigation, judges must now

determine where a trust lies on the continuum based on the following factors: (1) the purpose of the trust; (2) the trust language; and (3) extrinsic evidence. A judge may assign any weight to any one of the factors to determine where he thinks the trust should be classified on the continuum. This begs the question: Is the continuum of discretionary trusts capable of consistent judicial interpretation? As noted above, the discretionary distribution language is not the only factor a judge may, or even should, consider. Two courts may interpret the same language in equally reasonable, but directly contradictory ways.

Even assuming a court limited its analysis to the terms of the trust, it is questionable whether the continuum of discretionary trusts is judicially feasible. The magnitude of the litigation explosion associated with interpreting trust language can only be comprehended when one contemplates the multitude of different language combinations attorneys use to create distribution standards.²² Under the U.T.C., the literal language of each of these combinations must be analyzed in the various jurisdictions. The lower and appellate courts must then determine the amounts and timing of distributions based upon the distribution language of each individual trust and where the trust lies on the continuum. Finally, holdings from other states must also be used in interpreting the U.T.C. locally, thus

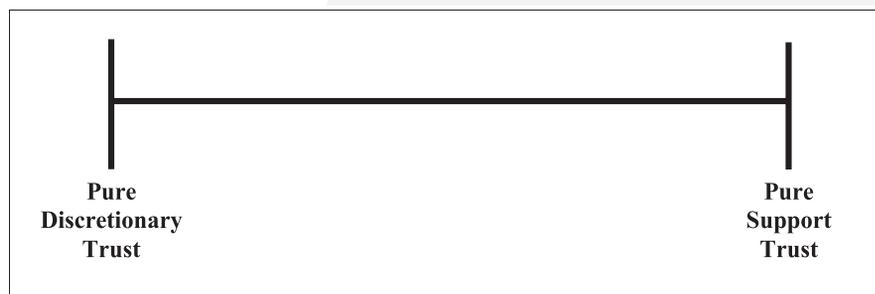
adding a whole new layer of complexity.²³ Excepting the purpose of the trust and extrinsic evidence, it becomes highly questionable if the distribution language can be consistently judicially interpreted to provide any guidance to planners on how to draft trusts or how judges will interpret certain language.

Illustration of the Imputed Income Rule

The following example helps to illustrate the ambiguity created by the U.T.C. and the resultant consumption of judicial resources. Assume that a grantor has three children: two daughters and one son. The son had a troublesome marriage and has since divorced. Dad’s (*i.e.*, the “grantor’s”) will leaves one-third of his estate to his son in a discretionary trust. No reason is given for the trust; however, Dad told his estate planning attorney that the reason for the trust was the son’s divorce. The other two-thirds are left outright, free and clear of trust, to the two daughters. During the nine-year period from when the trust was created to the appellate decision, only \$7,000 had been distributed from the trust, and on one occasion, the son told the trustee that he did not need any distributions. Several years after dad’s death, the son’s estranged spouse learns of the trust and files an action for alimony based on imputing distributions from the trust to the son.

Prior to the U.T.C., the analysis of the above fact pattern in virtually every state was incredibly simple. The discretionary trust does not create an enforceable right or a property interest; it is a mere expectancy. Due to the high threshold for the judicial standard of review for a discretionary trust,²⁴ a beneficiary does not have a right

Diagram 1 Undefined Continuum



to force a distribution, and no creditor has a right to force a distribution. Therefore, the estranged spouse is not able to invade the son's gift from his parents in trust. In this regard, seldom if ever, did an estranged spouse challenge a discretionary trust under common law to impute income for the payment of alimony.

Under the U.T.C. and the Restatement Third, a different result is expected. First, the judge must decide the purpose of the trust. Recall that in this fact pattern, the grantor has died, and will not be able to testify as to why the trust was created. Also, this trust, like most trusts, did not state a purpose²⁵; rather, the purpose must be divined from the language of the trust as well as extrinsic evidence. Further, what if the trust had stated that the purpose of the trust was to provide for the grantor's son without the interference of any estranged spouse? Couldn't a judge easily find that such a purpose was against a strong public policy,²⁶ because there is a statute that authorizes the payment of alimony? In the above example, if the judge concluded that the trust was created to defeat the payment of alimony, because one child received his inheritance in trust and the others outright, a judge could simply rewrite the trust to comport with public policy.

However, under the continuum of discretionary trusts, a judge does not need to resort to a public policy argument. Instead, U.T.C. §504(d) provides a recognized right that a beneficiary may force a distribution, and U.T.C. §814(a) lowers the judicial threshold of review to good faith, which is essentially the common law standard for a support trust. Therefore, *all* beneficiaries have an enforceable right, which most likely will be

classified as a property interest,²⁷ to demand a distribution based on where a judge decides the trust lies on the undefined continuum of discretionary trusts. Since a beneficiary has an enforceable right, the judge may simply *impute* the amount of income that a beneficiary could demand from the trust, and this amount could be used to determine the amount of alimony. While this analysis may seem far-fetched, this was precisely the result in *Dwight v. Dwight*,²⁸ which cites the Restatement Third as authority that the spouse is an exception creditor of a discretionary trust.

On first reading of *Dwight*, most attorneys were unable to reconcile the holding of this case with that of any other discretionary trust case.²⁹ Since under common law, a beneficiary does not have an enforceable right, no other discretionary trust case had imputed income in the domestic relations context. In essence, the holding of *Dwight* implied that the father had a bad purpose in creating the trust, to wit: avoiding alimony claims against his son. The son's statement to the trustee that he did not need the money implied that he could get to the trust assets whenever needed, even though the trustee was independent and the son did not have a removal/replacement power over the trustee. Unfortunately, *Dwight* makes sense and is consistent with the intent of the continuum of discretionary trusts theory espoused by the U.T.C. and the Restatement Third, where judges, without guidelines, determine the validity of the purpose of the trust and where a beneficiary has an enforceable right to distributions from a discretionary trust. In essence, both the U.T.C. and the Restatement Third provide a frame-

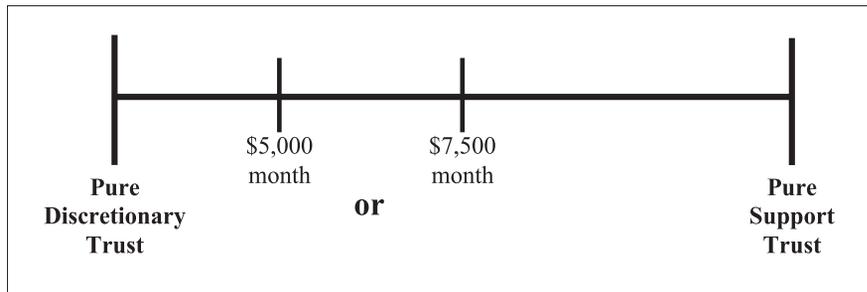
work for aberrational holdings,³⁰ such as *Dwight*, to become the rule rather than the exception.

Based on the remedies discussed earlier, it is highly questionable whether the continuum of discretionary trusts protects anything. Even without resorting to the continuum of trusts theory, a creditor or exception creditor may attach a trust interest or foreclose against the beneficial interest, and a spouse may force a distribution from any trust to satisfy an obligation for child support or alimony. None of these remedies are dependent on the continuum of discretionary trusts. It is only when one examines the imputed income theories that the continuum of discretionary trusts provides *any* protection.

Under the continuum of discretionary trusts, the judge looks at the purpose of the trust, all of the trust language and any extrinsic evidence to determine where a trust falls on the undefined continuum of discretionary trusts (Diagram 2). Once a judge determines where the trust falls on this continuum, a beneficiary has a right to demand a distribution from a discretionary trust for such amount.³¹ For example, in *Dwight*, the judge looked at the purpose of the trust, all of the language of the trust, and the extrinsic evidence to determine how much income should be imputed for alimony purposes.

As an example, suppose that a judge determines that the purpose of the trust is not an improper purpose or against public policy. Then, depending on how discretionary the trust language is, a judge may determine that a lesser amount should be distributed to the beneficiary. However, the amount to be distributed still will depend on (1) the purpose of the trust; (2) the trust language; and (3) any extrinsic evidence. As a result, the judge may

Diagram 2 Continuum of Imputed Income



decide the beneficiary has a right to demand \$7,500 per month or with a more discretionary trust, a beneficiary may be able to demand only \$5,000 per month.

Under this explanation, the bizarre results of the continuum of discretionary trusts finally begin to materialize. The rule appears to be, the more discretionary the trust language, the less income is imputed to the beneficiary. So, under the U.T.C., must one draft a purely discretionary trust (*i.e.*, no ascertainable standard) unless the grantor believes that the trust assets should be available to the beneficiary's creditors. Unfortunately, every beneficial interest and every grant of trustee powers involved in a trust is subject to the "imputed income" argument, and must now go to court. It is for this reason that the undefined and amorphous continuum is probably incapable of consistent judicial interpretation.

The *Dwight* case did not detail how the judge determined that just over \$30,000 per year of alimony was computed from the imputed trust income. If one assumed that the alimony was based on a factor of one-third of the imputed trust income, the imputed income from the trust would be \$90,000. If one used a factor of one-fourth of the trust income, the imputed income of the trust would be \$120,000. Surprisingly, the fair market value of the trust was only \$984,000. Us-

ing a one-third or one-fourth factor implies that the trust was generating between 10 and 12.5 percent of income annually. Further implied in the *Dwight* decision is that all such income should be imputed to the child beneficiary, without regard to the grandchildren's vested beneficial interests.

The son would most likely have had a better result in *Dwight* if he had received the property outright and then invested it in long-term capital gains property. However, prior to the result in *Dwight*, many, if not most, estate planners would have relied on hundreds of years of common law, to advise the son's father to create a discretionary trust for the son like the one created in *Dwight*. Should the result in *Dwight* become the law in a jurisdiction where the U.T.C. has been adopted, there are some opinions that an estate planner may be liable for malpractice or negligence for advising a discretionary trust in these circumstances.³²

II. Will Every SNT Go to Court?

The effectiveness of third-party SNTs is based on the inter-relationship between the classification of a trust as a discretionary trust under state law and the applicability of certain federal statutes pertaining to qualifications for receiving govern-

ment benefits.³³ If the beneficiary of an SNT does not have an enforceable right to a distribution, then a governmental agency cannot attach or force a distribution, and the SNT is not deemed to be an available resource of the beneficiary. When the Ohio courts decided to reduce the threshold for judicial review of a discretionary trust to a standard lower than a trustee's (1) dishonesty; (2) improper motive; or (3) failure to act, the beneficiary obtained a right to force a minimal distribution and therefore, the state could attach the beneficiary's interest.³⁴ Further, the ability of the beneficiary to force a distribution was deemed an available resource.³⁵

Ohio is not the only court to follow this reasoning. Under Iowa law, a court is now able to review a trustee's discretion to determine the "minimal distribution amount" a beneficiary, as well as an exception creditor standing in the beneficiary's shoes, has the right to demand.³⁶ Using a slightly different analysis, Pennsylvania courts have generally held that if a discretionary trust, which included a distribution standard, was created for one beneficiary and such sole beneficiary was not receiving governmental benefits at the time of creation of the trust, then the grantor intended that the principal of the trust be an available resource to the beneficiary.³⁷ The common thread among these cases is that when the threshold for judicial review is lowered below the common law standard of bad faith, the beneficiary receives an enforceable right. Once the beneficiary receives such an enforceable right, a proceeding must be brought so the court can impute how much income is available to a beneficiary or a creditor standing in the shoes of the beneficiary.

In sum, the common law standard requiring that a trustee not act in bad faith means that the trustee may not act arbitrarily, dishonestly or improperly.³⁸ This is indeed a very high threshold that must be met before judicial review of the trustee's conduct is available to the beneficiary. Once the standard of trustee conduct is altered and the threshold of review is lowered toward good faith, decisions like those in Ohio, Iowa and Pennsylvania, outlined above, most likely will become the norm.

By abolishing the discretionary trust/support trust distinction and lowering the judicial threshold of review to good faith, the U.T.C. codifies and expands the problematic results found in Ohio, Iowa and, to a lesser extent, Pennsylvania. The U.T.C. requires significant litigation in almost every trust context so a court can determine how much a beneficiary may demand as a distribution based on the purpose of the trust, the trust language and any extrinsic evidence.³⁹ In sum, rather than construction and reformation proceedings being the source of most trust litigation, the U.T.C.'s codification of the newly created continuum of discretionary trusts will most likely be the primary source of such litigation in the SNT context.

From the practical side of judicial administration, a Connecticut appellate judge noted that, "The enforceability of a special needs trust cannot, as a practical matter, depend on a case-by-case analysis of the extent to which any particular trustee would likely exercise trust discretion properly."⁴⁰ Unfortunately, that is precisely what the U.T.C. and the Restatement Third require.

III. Will All Creditors Pursuing a Debtor/Beneficiary's Interests Go to Court to Determine What an Overdue or Mandatory Distribution Is?

All creditors may attach "overdue" or "mandatory" distributions under U.T.C. §506. Unfortunately, the U.T.C. does not define the words "mandatory" or "overdue." Estate planners may interpret the terms "overdue" or "mandatory" as distributions under the terms of a trust, which occur when the trustee has no discretion regarding the amount or timing of a distribution to a beneficiary. For example, where a trust states that "the trustee shall distribute all income, quarter annually to my spouse," such language unquestionably requires a mandatory distribution. However, language such as, "the trustee may, in the trustee's sole and absolute discretion, make distributions to the beneficiaries on schedule two for health, education, maintenance, and support" is less clear and it may be more difficult to determine when a distribution must be made from such a trust.⁴¹ Consequently, under the latter example, it may be difficult to determine when a creditor can force a distribution.

Trusts which have the classic HEMS language (distributions for health, education, maintenance and/or support) are most vulnerable to litigation because these determinations are factual in nature and reasonable people can and do disagree. Under the U.T.C., HEMS distributions may require court intervention to interpret when a

distribution is overdue. However, even trusts authorizing the trustee to make distributions, in the trustee's sole and absolute discretion, for health, education, maintenance, support, comfort, general welfare and happiness are vulnerable. A judge most likely interprets that the trustee has an obligation to make a distribution somewhere on the continuum for each separate discretionary standard listed.⁴²

Further complications in the interpretation of what is a "mandatory" or "overdue" distribution occur because the U.T.C. is basically built on the shoulders of the favorable creditor recovery provisions of the Restatement Third. Under the continuum of discretionary trusts, a beneficiary always has a right to force a distribution for "abuse" even when the trust has a discretionary standard for distributions, because the U.T.C. no longer permits the common law definition of a discretionary trust.⁴³ Rather, the U.T.C. now imposes a good-faith requirement on all trustees.⁴⁴ As previously noted, a beneficiary has a right to a distribution based on (1) the purpose of the trust; (2) the trust language; and (3) any extrinsic evidence, under a good-faith distribution standard. Although the Restatement Third uses the term "reasonableness" instead of "good faith," these terms are, for the most part, synonymous.

Applying these principles, the interpretive guide to the U.T.C., the Restatement Third, states, "If a beneficiary has only a right to the trust income or a right periodically to receive *ascertainable* or *discretionary* (but see § 60) payments, the court will normally direct the trustee to make the payments directly to the creditor."⁴⁵ The Restatement Third, Section 60 e., also states, "The rights of a *discretionary*

beneficiary's assignee or creditor are also entitled to judicial protection from abuse of discretion by the trustee." In other words, an overdue distribution under the Restatement Third includes the amount that should have been distributed based on the beneficiary's enforceable right to a distribution.

Diagram 3 illustrates how difficult this standard is to interpret. If a trustee fails to make a discretionary distribution because a beneficiary has a creditor problem, a judge must determine that the trustee did not act in good faith, and the beneficiary should have received a distribution. Once the court imputes a distribution, then the amount of the distribution that the beneficiary should have received must be determined.

If the litigation created by determining what is an overdue distribution is not enough, U.T.C. §501 states, "In exercising its discretion to limit relief, the court may appropriately consider the support needs of a beneficiary and the beneficiary's family."⁴⁶ In other words, once a judge decides how much and when distributions should be made from a discretionary trust, a judge must then decide whether the beneficiary should be entitled to retain part of this distribution for their and their family's support. However, the U.T.C. fails to address how the amount to be retained by the beneficiary is computed. The necessary guidance is lacking,

and therefore not only is a wave of litigation required to define the contours of a distribution standard (as further modified by the purpose of the trust and any extrinsic evidence), but further litigation is required to determine whether and how much a beneficiary should be permitted to retain of the deemed distributions for their and their family's reasonable needs.

IV. Will Every Divorce Case with a Trust/Beneficiary Go to Court?

The U.T.C. and its interpretive companion, the Restatement Third of Trusts, implies that all beneficial trust interests, current as well as future interests, are property against which a spouse has an enforceable right.⁴⁷ However, generally, under state law, an interest is considered a property interest only if it may be sold or is otherwise an enforceable right.⁴⁸

Since a spendthrift provision is boilerplate in most discretionary trusts, the interest cannot be sold. However, whether all current trust interests (e.g., income interests) will be classified as property interests is less clear. A remainder beneficiary holds an enforceable interest to receive the property at some time in the future. Therefore, remainder interests are almost uniformly clas-

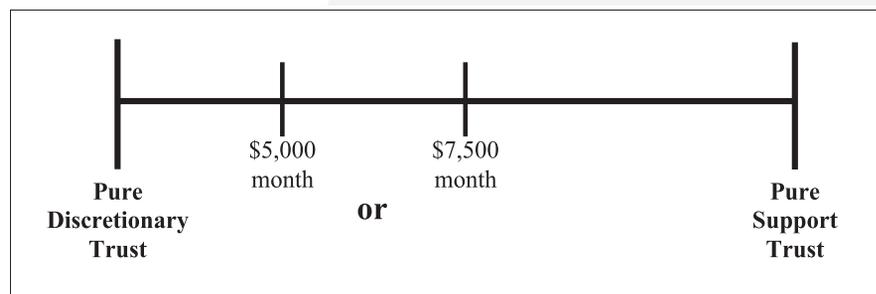
sified as a future property interest⁴⁹ under state law.

Under the U.T.C. and the Restatement Third, it appears that most current beneficial trust interests will also be classified as a property interest for the following reasons:

- The U.T.C. gives all trust beneficiaries an enforceable right to force a distribution.⁵⁰
- The U.T.C. allows a court to review the trustee's discretion for good faith.
- The U.T.C. abolishes the common law distinction between a discretionary trust and a support trust.

In the event the current distribution interest (e.g., income interest) is classified as marital property, it would be property eligible for division in a divorce. Even if such property interests were not classified as marital property, they would still be considered a factor used to determine the equitable division of the marital property in favor of the nonbeneficiary spouse. Similar to pension plans, all interests in trusts, including current income interests and remainder interests may well need to be valued to determine the extent of marital property or may be used as a factor in determining the economic circumstances of each spouse. However, the actual valuation of a discretionary income interest is part science, part art and part crystal ball.⁵¹

Diagram 3 Continuum of Imputed Income



V. Providing the Fuel to Further the Litigation Fire

In addition to creating an unprecedented wave of litigation, the U.T.C. provides the fuel to spur further litigation. U.T.C.

§503(b) specifically allows “a judgment creditor who has provided services for the protection of a beneficiary’s interest in the trust.” This is the attorneys’ fees exception. Under common law, an award of attorneys’ fees to a beneficiary claimant against a trust was seldom approved by the courts partially because beneficiaries or creditors standing in the beneficiary’s shoes would have been encouraged to challenge the wishes of the grantor. This would be particularly true in the case where a grantor had created a discretionary trust for a problematic child.

Suppose for example, that a discretionary trust was created where the beneficiary child is an alcoholic or has a drug dependency problem. In many cases, the grantor would select a good friend to be the trustee so that he or she would make the same “hard decisions” that the grantor would have made. With some trusts, the grantor may have included detailed instructions for how the trustee should act. In other cases, the grantor may merely have put his or her faith in the friend trustee, because he or she knew that the trustee would, for the most part, make the same difficult decisions the grantor would. Generally, the grantor’s friend would not accept the trustee appointment if he or she felt that there would be constant litigation with the problematic beneficiary child. Now under the U.T.C., problematic children may even receive attorneys’ fees for directly challenging the settlor’s wishes. The same is true for an exception creditor standing in the shoes of a beneficiary, particularly an estranged spouse.

VI. Why Overturn 125 Years of Judicial Wisdom?

Under the newly created continuum of discretionary trusts, special needs trusts are threatened and must now go to court to determine where each trust falls on the continuum. Once a judge reviews the purpose of the trust, the distribution language, the trust language and any extrinsic evidence, a judge decides where the SNT lies on the amorphous continuum. From the trust’s position on this undefined continuum, the judge then determines how much income should be imputed to the beneficiary, which may disqualify the beneficiary from receiving any governmental benefits.

In the divorce context, many trust beneficiaries will likely end up in court to determine whether a remainder or income interest is marital property. In states that are not community property states, all trusts may end up in court to determine whether the value of a remainder or income interest should be a factor or economic circumstance used in the determination of the equitable division of marital property. Finally, in all states, it may be necessary to determine whether income should be imputed to the beneficiary for child support or alimony under the continuum of discretionary trusts. The complex valuation issues of current beneficial interests as well as remainder interests will require the expenditure of significant judicial resources.

Litigation is also required to determine if there are overdue distributions under U.T.C. §506. Creditors have an incentive to litigate every case because of the ambiguous standards set forth in

the U.T.C. and the lack of clarity surrounding the continuum of discretionary trusts. If successful, the court must then compute how much income should be imputed to the beneficiary. This computation is also ambiguous since there is no guidance in either the U.T.C. or the Restatement Third. Finally, once a determination is made as to the amount of imputed income, the court must then decide how much should be retained by the beneficiary for their and their family’s support. In sum, the lack of guidance as well as the possibility that the continuum is incapable of judicial interpretation is an invitation to litigation. Further, if the U.T.C. is interpreted to permit all creditors to attach distributions at the trust level, every creditor must go to court to perfect their claim.

Proponents of the U.T.C. advocate that the purpose of the U.T.C. is to save the children by providing an exception creditor for child support. However, most states already provide that people delinquent in child support go to jail, which is a significant deterrent to not paying child support. Consequently, a beneficiary can be expected to make reasonable requests of a trustee for a distribution to avoid incarceration. Failure of a trustee to heed these requests may constitute “bad faith.” Hence, while there may be a few isolated cases of a discretionary trust beneficiary avoiding child support, those cases are the exception.

The U.T.C. position is in contravention to other existing public policies. It is settled public policy that people are free to dispose of their property any way they deem fit. Contrary to the assertion of the U.T.C. proponents that trust grantors want their trusts invaded for the child support or alimony obligations of their children, the

authors have never found this to be the case.

The Restatement Third does not lay any claim to saving the children. Rather, the Reporter for the Restatement Third recognizes that the Restatement Third takes a position directly contrary to the settled case law and that they disagree with the discretionary/support distinction.⁵² In the Reporter's opinion, the distinction between "discretionary" and "support" trusts is "artificial," and therefore should be replaced with the newly created "continuum of discretionary trusts." The Reporter then proceeds to supplant the judicial wisdom of virtually every American court with his opinion of what the law should be. It is in this respect that the Restatement Third breaks new ground and fails to re-state the current state of the law. What the Reporter fails to consider is that the continuum of discretionary trusts is equally artificial. Thoreau said it best, when he wrote that all man made laws are "artificial."

VII. Conclusion

Regrettably, in a few areas pertaining to creditor's rights, the U.T.C. and the Restatement Third

do not restate the current law, but rather they charter a new course through unknown waters. The well reasoned common law developed over hundreds of years is further undermined by both the Restatement Third and the U.T.C. by adopting distinctly minority opinions. The result is that jurisdictions that follow the Restatement Third and adopt the U.T.C. require significant litigation in almost all cases to determine if a distribution is overdue, the amount of the overdue distribution, and how much, if any of the distribution should be retained by the beneficiary. The challenge with such fact-based decision-making criteria is the creation of extreme drafting uncertainty for the practitioner, as well as inconsistency in court decisions. The existing law contains significantly fewer uncertainties than those that are inherent in the U.T.C. or the Restatement Third. Prior to the creditor favorable theory of the "continuum of trust law," although complete certainty was lacking, the law was well settled in many areas and the results were reasonably predictable. When compared to the time-tested discretionary trust/support trust distinction developed by common law, the "continuum

of discretionary trusts" theory appears to be drastically deficient.

Further, the U.T.C. and the Restatement Third invite a tidal wave of new litigation. The magnitude of this future litigation should be unprecedented in the history of trust law. While this article focused on just the litigation created under the continuum of discretionary trusts, the following list details several others of the many areas where the U.T.C. expands litigation:

- Encouraging the creation of further exception creditors
- Classifying all holders of powers of appointment as beneficiaries
- Beneficiaries attempting to rewrite trusts after the grantor's death
- Malpractice issues for drafting attorneys and trustees
- Conflict of law cases as trusts seek to escape U.T.C. states
- Forcing all revocable trusts to go through probate to ensure the running of the statute of limitations for creditor claims

Given these facts, one must ask whether the U.T.C.'s and the Restatement Third's new theory of creditor recovery is a continuum of discretionary trusts or merely a continuum of continuing litigation.

ENDNOTES

¹ Covey and Hastings, *The Uniform Trust Code—Part I*, PRACTICAL DRAFTING, Oct. 2003.
² Merric and Oshins, *Effect of the U.T.C. on Spendthrift Trusts*, 31 ETPL 375 (Aug. 2004); Merric and Oshins, *U.T.C. May Reduce Asset Protection on Non-Self Settled Trusts*, 31 ETPL 411 (Sept. 2004); Merric and Oshins, *How Will Asset Protection of Spendthrift Trusts Be Affected by the U.T.C.*, 31 ETPL 478 (Oct. 2004); Mark Merric, Carl Stevens and Jane Freeman, *The Uniform Trust Code: A Divorce Attorney's Dream*, J. PRACTICAL ESTATE PLANNING, Oct.–Nov. 2004, at 33; Merric and Stein, *The U.T.C. Threatens Special Needs Trusts*, TRUSTS & ESTATES (Nov. 2004); Merric and Stein, *The Uniform Trust Code and Asset Protection in Non-Self Settled Trusts*, Steve Leimberg's Asset Protection Newsletter #53, and Merric, Stein, and Gillen, *The Effect of*

the U.T.C. on ILITs, Steve Leimberg's Estate Planning Newsletter #733, available online at www.leimbergservices.com; MARK MERRIC, II ASSET PROTECTION STRATEGIES, at Ch. 3 (Alexander A. Bove, Jr., ed. forthcoming 2005), to be published by the American Bar Association. For more information about this book, please contact the American Bar Association at www.ababooks.org/ or (800) 285-2221. Also, for further information on the Uniform Trust Code go to www.InternationalCounselor.com.
³ Both committees of the Restatement Third and the U.T.C. worked together to form the basis for these two promulgations. English, *The Uniform Trust Code (2000): Significant Provisions and Policy Issues*, 67 MISSOURI L. REV. 143, at 144 (Spring 2001). Also, in some areas, the U.T.C. is nothing more

than a skeleton statute, where the tendons are the U.T.C. comments, which are further supplemented by over 100 specific references into the Restatement Third as well as a general interpretive reference in the comment to U.T.C. §107. In this respect, the Restatement is the real meat in many areas of interpretation.
⁴ *In re Marriage of Jones*, 812 P.2d 1152 (Colo. 1991); G. BOGERT, TRUSTS AND TRUSTEES, §228 (2d ed. 1979); *O'Shaughnessy*, 517 N.W.2d 574 (Minn. 1994); RESTATEMENT (SECOND) TRUSTS, §155, comment b. (1959).
⁵ Rather than using a property analysis, some courts will find that the beneficiary's interest has no ascertainable value. *Miller v. Dep't of Mental Health*, 432 Mich. 426, 442 N.W.2d 617 (1989); *Henderson v. Collins*, 245 Ga. 776, 267 S.E.2d 202 (1980); *In re Dias*, 37

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- BR 584 (D. Idaho 1984). In essence, the analysis is the same in that there is no interest or enforceable right that a creditor may attach, because under this analysis there is no value to the beneficial interest.
- ⁶ RESTATEMENT (THIRD) OF TRUSTS, §60, comment a.; U.T.C. §504, comment.
- ⁷ For an in-depth discussion of these issues, see Merric and Oshins, *Effect of the U.T.C. on Spendthrift Trusts*, 31 ETPL 375 (Aug. 2004); Merric and Oshins, *U.T.C. May Reduce Asset Protection on Non-Self Settled Trusts*, 31 ETPL 411 (Sept. 2004); MARK MERRIC, II ASSET PROTECTION STRATEGIES, at Ch. 3 (Alexander A. Bove, Jr., ed. forthcoming 2005), to be published by the American Bar Association. For more information about this book, please contact the American Bar Association at www.ababooks.org/ or (800) 285-2221.
- ⁸ *Id.*
- ⁹ *Id.*
- ¹⁰ U.T.C. §501.
- ¹¹ *Brasser v. Hutchison*, 37 Colo. App. 528, 549 P.2d 801 (1976); *In re Guinn*, 93 P.3d 568 (Colo. App. 2004); *In the Matter of: Bass v. Denney*, CA-5, 171 F.3d 1016 (1999) (“A universal canon of Anglo-American trust law proclaims that when the trustee’s powers of distribution are wholly discretionary the beneficiary has no ownership interest in the trust or its assets ...”); *In re Shurley*, CA-5, 115 F.3d 333 (1997) (“No part of a spendthrift trust or estate can be taken on execution or garnishment by creditors of the beneficiary.”)
- ¹² U.T.C. §503.
- ¹³ RESTATEMENT (SECOND) OF TRUSTS, §152, comment j. See also *Lundgren v. Hoglund*, 219 Mont. 295, 711 P.2d 809 (1985); *Guidry v. Sheet Metal Workers Int’l Ass’n*, CA-10, 10 F.3d 700 (1993).
- ¹⁴ LORING, A TRUSTEE’S HANDBOOK, §5.3.3, at 171 (Rounds ed. 2004).
- ¹⁵ U.T.C. §501, comment.
- ¹⁶ For a further discussion of this issue, see Merric and Stein, *The Uniform Trust Code, A Threat to Special Needs Trusts*, TRUSTS & ESTATES (Nov. 2004).
- ¹⁷ U.T.C. §501, official comment.
- ¹⁸ For an in-depth discussion of these issues, see Merric and Oshins, *Effect of the U.T.C. on Spendthrift Trusts*, 31 ETPL 375 (Aug. 2004); Merric and Oshins, *U.T.C. May Reduce Asset Protection on Non-Self Settled Trusts*, 31 ETPL 411 (Sept. 2004).
- ¹⁹ U.T.C. §504(c)(1).
- ²⁰ *Jones*, *supra* note 4; *O’Shaughnessy*, *supra* note 4; *BOGERT*, *supra* note 4.
- ²¹ “Ignoring the cases involving self-settled trusts and the cases involving only mandatory accrued income otherwise payable to a beneficiary, a majority of the cases decided without a statute rejected an exception for alimony and support of a former spouse.” *Trust Income or Assets as Subject to Claim Against Beneficiary for Alimony, Maintenance, or Child Support*, 91 A.L.R.2d 262; Also, cases on child support were about evenly split. *BOGERT*, THE LAW OF TRUSTS AND TRUSTEES, §224, at 465 (2d rev. ed. 1992); *Begleiter*, *In the [Iowa Trust] Code We Trust—Some Trust Law For Iowa at Last*, 49 *DRAKE L. REV.* 165, at note 276 (2001).
- ²² For example “A trustee shall distribute income and principal for the beneficiaries’ health education maintenance and support as the trustee shall determine.” “A trustee may distribute income and principal for the beneficiaries health education maintenance and support as the trustee shall determine.” “A trustee shall distribute income and principal for the beneficiaries’ health education maintenance and support as the trustee shall determine in their absolute and sole discretion.” These are but a few common examples of language that a court must interpret. It is important to also note that a trust may contain several different distribution standards for the same beneficiary.
- ²³ U.T.C. §1101.
- ²⁴ A court will only review the trustee’s discretion on a discretionary trust for (1) dishonesty; (2) improper motive; or (3) failure to act. It is this high threshold of judicial review for a discretionary trust that is the foundation of a discretionary trust. For a further discussion of this issue, see Merric and Oshins, *Effect of the U.T.C. on Spendthrift Trusts*, 31 ETPL 375 (Aug. 2004); Merric and Oshins, *U.T.C. May Reduce Asset Protection on Non-Self Settled Trusts*, 31 ETPL 411 (Sept. 2004).
- ²⁵ It should be noted that there is a growing trend for special needs trusts to state a purpose as to why they were created.
- ²⁶ Both the U.T.C. and the Restatement Third allow a judge to completely rewrite a trust based on the theory that the purpose of the trust is against public policy. U.T.C. §§105(a)(3), 107(1), 404 and 410(a). Unfortunately, neither the U.T.C. nor the Restatement Third provides any limitations to this “blank check” given for judicial rewrite. Others have expressed extreme concern with the lack of guidance in this area. *Begleiter*, *supra* note 21, at note 137; Craig Reeves on the Missouri Bar Listserv addressing the issue of how a judge could rewrite an SNT to reach the underlying assets.
- ²⁷ For a detailed analysis of this issue in the divorce context, see Merric, Stevens and Freeman, *supra* note 2.
- ²⁸ *Dwight v. Dwight*, 435 Mass. 1107, 761 N.E.2d 964 (2001).
- ²⁹ Alexander A. Bove Jr. and Melissa Langa, “*Dwight*” and *Spendthrift Trusts*, THE MASSACHUSETTS LAWYERS WEEKLY, Dec. 10, 2001.
- ³⁰ For a further analysis of this aberrational logic in giving a beneficiary an enforceable right to a discretionary trust, see the RESTATEMENT (THIRD) OF TRUSTS, §60 e. Note when reading §60 e., that the term “abuse” has been redefined to mean “reasonable-ness” under the Restatement Third. Section 50 comment (b) states that “a court will not interfere with a trustee’s exercise of a discretionary power when that exercise is reasonable and not based on an improper interpretation of the terms of the trust.” See also RESTATEMENT (THIRD) OF TRUSTS, §60, Reporter’s notes to comment a.
- ³¹ RESTATEMENT (THIRD) OF TRUSTS, §60 e.
- ³² For a further discussion of these issues, please see Merric, Gillen, and Freeman, *Malpractice Issues and the Uniform Trust Code*, ETPL (forthcoming Dec. 2004).
- ³³ For a further discussion of this issue, see Merric and Stein, *The U.T.C. Threatens Special Needs Trusts*, TRUSTS & ESTATES (Nov. 2004).
- ³⁴ *Bureau of Support in the Department of Mental Hygiene and Correction v. Kreitzer*, 16 Ohio St. 2d 147, 243 N.E.2d 83 (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.
- ³⁵ *Metz v. Ohio Dept. of Human Services*, 762 N.E.2d 1032, at note 31 (Ohio App. 2001).
- ³⁶ *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 the unpublished opinion of *McCabe v. McKinnon*, 2002 WL 31757533 (Iowa App. 2002).
- ³⁷ *Estate of Taylor v. Department of Public Welfare*, 825 A.2d 763 (Pa. 2003); *Shaak v. Pennsylvania Department of Public Welfare*, 561 Pa. 12, 747 A.2d 883 (2000); *Estate of Rosenberg v. Department of Public Welfare*, 545 Pa. 27, 679 A.2d 767 (1996); *Commonwealth Bank and Trust Co.*, 528 Pa. 482, 598 A.2d 1279 (1991).
- ³⁸ *Chenot v. Bordeleau*, 561 A.2d 891, 894 (R.I. 1989) (trustee’s discretion will not be overturned by the court if the trustee acts in good faith). *Meyers v. Department of Social & Rehabilitation Servs.*, 254 Kan. 467, 866 P.2d 1052, 1059 (1994), *aff’d*, 853 P.2d 701 (1993) (discretionary trustee can be forced to distribute only where it is established that trustee abused its “discretion by acting arbitrarily, dishonestly, or improperly”).
- ³⁹ For a detailed discussion of the SNT issues, see Merric and Stein, *The U.T.C. Threatens Special Needs Trusts*, TRUSTS & ESTATES (Nov. 2004).
- ⁴⁰ *Parkhurst v. Wison-Coker*, 848 A.2d 515 (Conn. 2004).
- ⁴¹ It is noteworthy that under Nevada law a trustee can act in his or sole discretion, and will not be interfered with for any reason.

ENDNOTES

Nev. Rev. Stat. §166.110 (1991).

⁴² This is in essence what the Ohio, Iowa and Pennsylvania courts did in the SNT context. U.T.C. §504(d).

⁴³ U.T.C. §814(a).

⁴⁴ RESTATEMENT (THIRD) OF TRUSTS, §50, comment e.

⁴⁵ The Restatement Third suggests that two different standards might apply, one for the beneficiary and a second for the creditor. The Restatement Third §60 e. goes on to say, “On the other hand, a trustee’s refusal to make distributions might not constitute an abuse as against an assignee or creditor even when, under the standards applicable to the power, a

decision to refuse distributions to the beneficiary might have constituted an abuse in the absence of the assignment or attachment.”

⁴⁶ Even in the case of a discretionary trust, under common law, a beneficiary has the right to sue the trustee for a distribution if the trustee is (1) acting dishonestly; (2) acting with an improper motive; or (3) failing to act. However, due to the high threshold a beneficiary has to surmount for judicial review of the trustee’s distribution decision, the beneficiary generally does not have a “sufficient” enforceable right to question the reasonableness of the trustee’s decision.

⁴⁷ *In re Balanson*, 25 P.3d 28 (Colo. 2001).

⁴⁸ For a further discussion of the issues of contingent or indefinite remainder interests please see MARK MERRIC, II ASSET PROTECTION STRATEGIES, at Ch. 3 (Alexander A. Bove, Jr., ed. forthcoming 2005), to be published by the American Bar Association.

⁴⁹ U.T.C. §504(d).

⁵⁰ For a detailed analysis of this issue see Meric, Stevens and Freeman, *supra* note 2.

⁵¹ RESTATEMENT (THIRD) OF TRUSTS, §50, Reporter Comment a.; *Restatement (Third) of Trusts, Problem of Discretion in Discretionary Trusts*, 61 COLUMBIA L. REV. 1425 (1961).

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