The Uniform Trust Code

What Does It Really Do ?

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PART OF THIS ANALYSIS

Many of the asset protection issues discussed in this outline were published and explained in greater detail in a 42 page article published by Estate Planning Magazine, Volume 31, No. 8, August, September, & October 2004. This article is based on Chapter 3 (93 pages) of the treatise *Asset Protection Strategies, Volume II*, Alexander A. Bove, Jr., editor, Mark Merric Author, to be published by the American Bar Association. For more information about the book, please contact the American Bar Association at http://www.ababooks.org/ or (800) 285-2221. Also, for further information on the UTC, please see www.InternationalCounselor.com.

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- Asset Protection Strategies, American Bar Association (two chapters)
- Asset Protection Strategies Volume II, American Bar Association to be published Dec. 2004 (MM responsible for 1/5 of the text).

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B. Single State Trust Companies

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Why the UTC Failed In Several States

A. A Lesson From Other States

The UTC has engendered controversy in many of the states where it has been considered. Most notable is Arizona which passed an almost pure version of the UTC. Following a public uproar over issues of trust disclosure, discussion of the Act soon expanded to include consideration of a wide range of UTC problems raised by members of the Arizona Bar. After adoption, Arizona placed a two year moratorium on the adoption of the Act, and then subsequently repealed the UTC in its entirety.

The UTC has been extensively considered in Texas including review by seven Bar Association sub-committees. According to the drafters UTC Project web-page, Texas is choosing to "cherry pick" the UTC and is a state that is not quick to adopt uniform acts. It is the understanding of the authors of this presentation that there is a strong effort in Texas to affirmatively draft anti-Third Restatement provisions.

The Minnesota Bar studied and debated the UTC in 2001 and 2002. The UTC was found to be too great a deviation from the existing common law and therefore, not implemented.

Kansas was the first state to adopt the UTC but it made changes to Article Five which is the article dealing with creditor rights. In 2004 Kansas adopted additional amendments to the UTC. Wyoming adopted the UTC but chose not to make it retroactive.

UTC Background

- ü **Purports to be common law but significantly different in most respects from the Second Restatement and existing state laws**
- ü **Coordination between the UTC & Third Restatement of Trusts – contains 100 specific references as well as a general reference**
- ü **Background from the drafts of the UTC is available at *utcproject.org***
- ü **AARP has endorsed the UTC**

B. UTC Background

1. UTC Purported to Be Common Law

The UTC purports to be a general codification of the common law. As detailed in this outline, as well as admitted in the Third Restatement of Trusts and by the reporter for the UTC,[i] in many areas, the UTC is not a codification of existing law but rather a revision of the existing law by a group of scholars in line with what they believe the law ought to be. The significance of the changes is quite broad and, in the opinion of the authors of this presentation, ill-conceived.

2. UTC & Third Restatement

The UTC has not been adopted in any state long enough for any significant judicial interpretation. To understand the UTC, a reader must understand the Restatement Third of Trusts. The comments to the UTC contain over one hundred specific references to the Third Restatement. The UTC was drafted in "close coordination with the revision of the Restatement of Trusts." English, The Kansas Uniform Trust Code, 51 University of Kansa Law Review 311 (2003). The Restatement of Trusts is not simply a compilation and summarization of the law. The Restatement makes policy judgments about what is the better rule when there are conflicting cases. Also, unlike previous Restatements, the Third Restatement actually creates new and untested theories of trust law in several key areas.

i. English, THE UNIFORM TRUST CODE (2000): SIGNIFICANT PROVISIONS AND POLICY ISSUES, 67 Missouri Law Review 143 (Spring 2001) at page 144.

9 KEY AREAS OF CONCERN

I. **Decreased asset protection for trust beneficiaries of third-party trusts**

II. **Increase in trust litigation**

III. **Disclosure of trust assets regardless of Settlor's Intent**

IV. **Estate tax inclusion issues**

V. **Beneficiary revision of settlor intent**

VI. **Poor Drafting**

VII **Is the UTC Capable of Amendment?**

VIII. **Flight of Trusts**

IX. **Malpractice Issues**

C. Nine Key Areas of Concern

While numerous UTC code sections are involved, opponents of the UTC have concerns which may be divided into seven different categories.

1. Decrease in Asset Protection

For standard trusts such as where parents leave property to their children, the UTC greatly reduces the asset protection available for trust beneficiaries. This issue is separate and not to be confused with asset-protection for self-settled trusts.

2. Increase in Trust Litigation

Due to the increased number of persons who may sue a trustee, combined with new theories of undefined trust law and unprecedented remedies including the judicial foreclosure sale of beneficial interests, Jane Freeman, Esq. has categorized the UTC as "a lawyer's full employment bill – creating a true lawyer's bonanza."

3. Disclosure of Trust Assets

Regardless of the settlor's intent, the UTC requires disclosure of the trust terms and the trust assets to many persons whom a settlor would specifically not want to possess such information such as children's spouses, minor children, irresponsible children, and remainder charitable beneficiaries.

4. Estate Tax Inclusions

Richard Covey, Dan Hastings, and Jeffrey Pennell have all indicated that there are possible that there are estate inclusion issues under the UTC. The original and most likely most detailed analysis of this issue has been presented by Les Raatz's outline – Recalling the Tale of the Emperor's New Clothes. A copy of this outline may be downloaded at www.InternationalCounselor.com – under publications, articles, then Uniform Trust Code. Because of the real nature of this possibility, states should not consider adopting the UTC until the issues surrounding estate tax inclusion are resolved.

5. Beneficiary Revision of Settlor's Intent

The UTC provides significantly more latitude for beneficiaries to petition courts to rewrite trusts in terms contrary to the settlor's intent and stated terms than under current common law. Naturally, many clients are opposed to the idea that judges or children can circumvent their estate plan.

6. Poor Drafting

It is interesting to note that unless someone reads the backbone of the UTC, the Restatement (Third) of Trusts, the number of different interpretations of the same code sections is incredible. Even with using the Restatement Third for interpretation, the drafting behind the UTC leaves much to be desired. Naturally, a statute should stand by itself.

7. Poor Design

Due to the creation of new and untested trust law in at least one area, maybe a couple of more, and the adoption of many distinctly minority positions, the UTC and Restatement Third question the wisdom of over 125 years (maybe close to 400 years) of judicial wisdom. In this respect, many estate planners are of the opinion that the UTC is fundamentally flawed from a design perspective.

8. Flight of Trusts

As noted in Forbes, August 12, 2004 issue, the UTC was passed almost unanimously by the Arizona legislature in May 2003. "Arizona's legislature passed the UTC in May 2003 with the support of the state bar, then repealed it unanimously this April amid warnings that trust money would flee the state."

9. Malpractice Issues

Due to the potential significant decrease in asset protection that is available to a beneficiary in a UTC state as distinguished from a common law state, estate planners who fail to adequately disclose this to clients risk possible malpractice suits.

I. Decrease in Asset Protection Non-Self Settled Trusts

1. **Discretionary-Support Distinction Abolished**
2. **Increased Remedies**
3. **Long Term Expansion of Spendthrift Creditors?**
4. **All Creditors Forcing an Overdue Distribution – Based on a Standard?**
5. **Bankruptcy Trustee Forcing a Distribution Based on a Standard**
6. **Trustee/Beneficiaries = Self Settled Trust?**
7. **Beginning of the End for SNTs**
8. **Creditors Attaching GPAs**
9. **Spendthrift Protection Must Restrain Transfer**
10. **Divorce Issues**

I. Decrease in Asset Protection Non-Self Settled Trusts

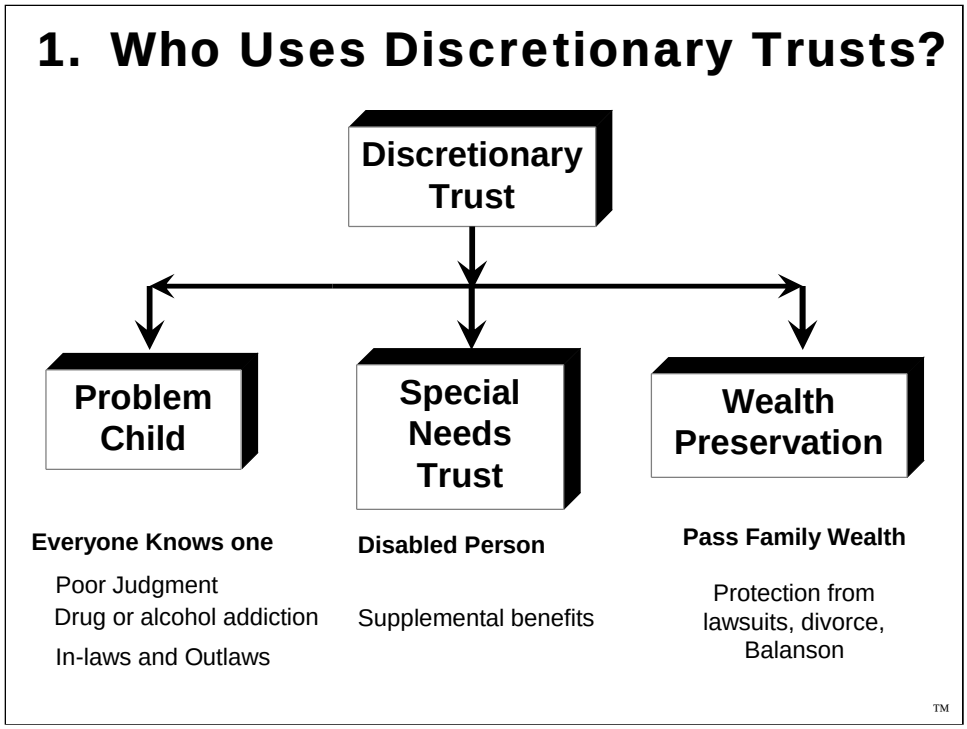
Opponents to the UTC have expressed significant many concerns regarding the UTC decreasing asset protection for beneficiaries of non-self settled trusts. While the authors realize that there are other concerns, this outline focuses on ten of these issues.

A. Discretionary Support Distinction Abolished

1. **Who uses discretionary trusts**
2. **Common Law**
3. **New Untested Law Created by the UTC**
   - Ø **Continuum of Discretionary Trusts**
4. **Reduced Standard of Review**
   - Ø **"Reasonableness or Good Faith"**
   - Ø **Minority view followed by less than a handful of states.**

A. Discretionary-Support Distinction Abolished

The distinction between a discretionary trust and a support trust has been a fixture in the common law for over 125 years. In order to understand the incredible diminution in asset protection that results from abolishing the distinction between between a discretionary and a support trust, first one must first understand what purposes discretionary trusts are commonly used. Second, one must understand the common law. Third, one must now learn understand the newly created favorable creditor theory of trust law known as "a continuum of discretionary trusts," which replaces the discretionary-support trust distinction. *In other words, prior to the enactment of the UTC or adoption of the Third Restatement, the position take abolish the discretionary-support distinction, was not the common law of any state.* Finally, to completely abolish the greater asset protection provided by a discretionary trust, the standard for the judicial review was reduced to "good faith" or "reasonableness." While the "continuum of trust theory" is a completely new and untested theory of trust law, reducing the standard of review to good faith or reasonableness is a minority view held by possibly a handful of states in very limited circumstances.



1. Who Uses Discretionary Trusts

a. Problem Children or Children with Problematic Spouses

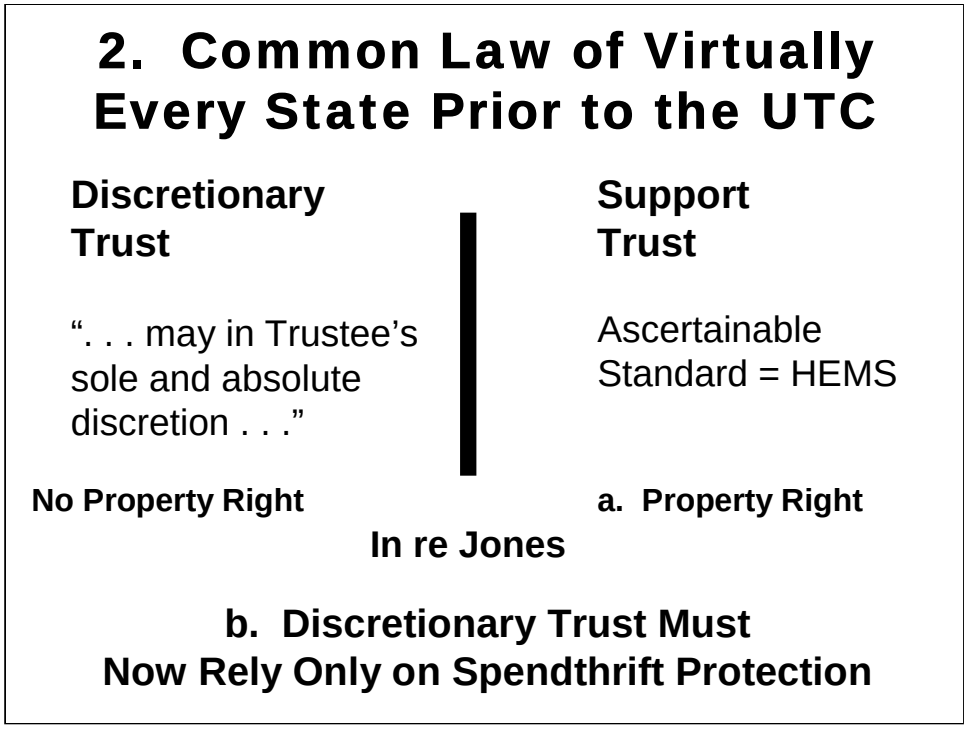
Unfortunately, many families have a child whom the parents do not trust to make good decisions. This is true even though the child may now be an adult. In these cases, the parent typically will transfer this child's inheritance to a trust. The trustee will be a close friend or relative or professional trustee that the settlor parents have confidence will make the "hard" decisions. The chosen trustee is willing to accept the "thankless" trustee position and make the hard decisions because the beneficiary has few rights to sue the trustee in court. If the settlor client had wanted the beneficiary to have greater rights to sue the trustee, the client would have created a support trust. Sometimes, it is not the child who is the "problem", rather the child's spouse is considered an "outlaw" instead of an "in-law" by the family. In this case, a discretionary trust may again be used as part of the planning process.

b. Special Needs Trust

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

c. Wealth Preservation

Wealth preservation trusts tend to be the higher value trusts, usually greater than $1 million in assets. For families of wealth, these trusts are the preferred option of choice. Frequently, national speakers discuss these trusts under the names of the "mega trust," "the beneficiary controlled trust," the "intentionally defective beneficiary controlled trust," "the dynasty trust," and the "discretionary dynasty trust."



2. Discretionary / Support Trust Distinction Abolished

The asset protection benefits afforded by a discretionary trust are completely independent of spendthrift protection and are based in essence upon a property analysis.[i] If a beneficiary does not have a property interest, a sufficient right to force a distribution, then a creditor has no greater right than the beneficiary. In other words, if a beneficiary has nothing to attach or force a distribution from, neither does the creditor. The beneficiary has nothing more than a mere expectancy.[ii]

The discretionary-support distinction which provides for the superior asset protection of a discretionary trust relies on (1) a two tier classification system (i.e., a discretionary vs. a support trust); and (2) different judicial review standards for each classification.

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[i] *Carlisle v. Carlisle*, 194 WL 592243 (Superior Ct. Connecticut 1994); *Lauricella v. Lauricella*, 565 N.E. 2d 436 (Mass. 1991). Rather than using a property analysis, some courts will find that the beneficiary's interest has no ascertainable value. *Miller v. Department of Mental Health*, 442 N.W.2d 617 (Mich. 1989); *Henderson v. Collins*, 267 S.E.2d 202 (Ga. 1980); *In re Dias*, 37 BR 584 (D. Idaho 1984). In essence, the analysis is the same. There is no interest or enforceable right that a creditor may attach because under this analysis the beneficial interest has no value.

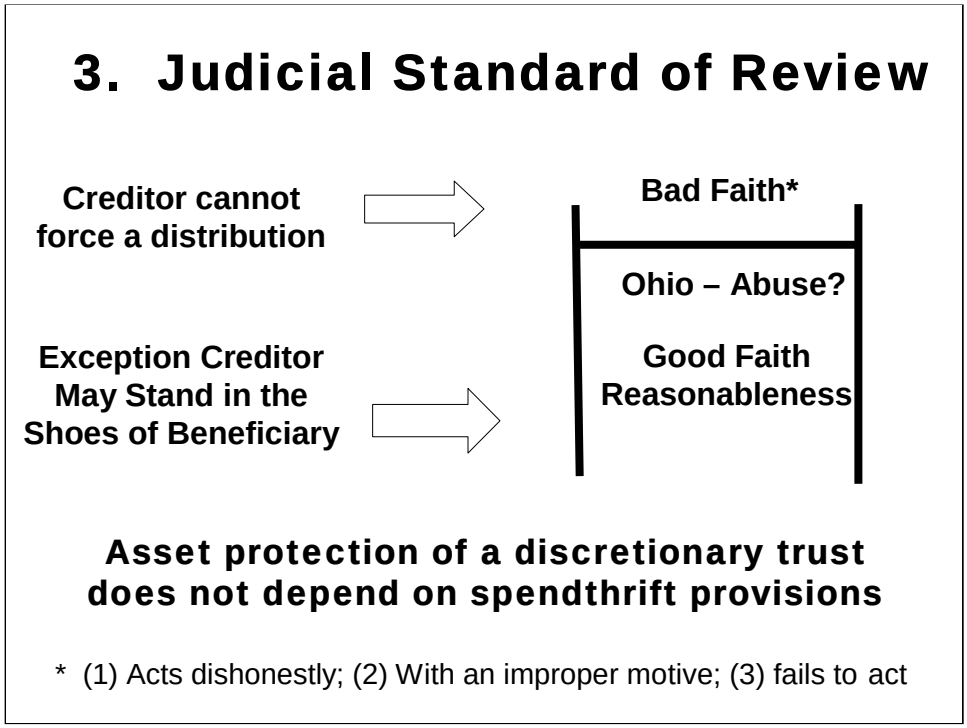
[ii] *U.S. v. O'Shaughnessy*, 517 N.W. 2d 574 (Minn. 1994); *In re Marriage of Jones*, 812 P.2d 1152 (Colo. 1991).

1. Beneficial Interest in Discretionary Trust Now a Property Right

Under the UTC and the Restatement Third, a beneficial interest in a trust is essentially now ***a property right.*** Pursuant to UTC §§ 504(d) and 814(a), the beneficiary of a discretionary trust now has a sufficient enforceable right to force a distribution. The UTC mentions the abolishment of this one hundred and twenty five year common law distinction in the comment to UTC § 504. The Restatement Third specifically states that there should be no discretionary/support trust dichotomy. Rather, both the UTC and the Restatement Third creates new law where it defines a continuum of discretionary trusts, from the most discretionary to that which would currently be categorized as a support trust.

2. Only Spendthrift Protection Remains for a Discretionary Trust

The result of equating a discretionary trust with a support trust for asset protection purposes is that now both types of trusts are limited to spendthrift protection.



3. Judicial Standard of Review

In order for all trusts to rely on spendthrift protection, the judicial standard of review for all trusts must be lowered to one of reasonableness or good faith – where a judge may now question a trustee's decision of what, when, and how much should be distributed.

a. Common Law

Under the common law a court would only interfere with a trustee's "sole and absolute" discretion in a discretionary trust if the trustee (1) acted dishonestly, (2) acted with an improper motive, or (3) failed to use his or her judgment.[i] For purposes of this presentation, the term "bad faith" is defined as these three conditions. A beneficiary had little if any standing to sue for a distribution or question the amount of a distribution, unless the beneficiary could prove one of the foregoing factors as the reason why the trustee failed to make a distribution.

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[i] *In Re Jones*, 812 P.2d 1152 (Colo. 1991) (citing Scott on Trusts §130 at 409 – 4th Edition 1989). Also see the detailed analysis of *Scott on Trusts*, §187 at page 15 – where it is noted that if the distribution standard includes enlarged or qualifying adjectives such as "sole and absolute discretion" combined with "no fixed standard by which the trustee can be determined is abusing his discretion. . . the trustees discretion would generally be deemed final." Further §187.2 states, "Even though there is no standard by which it can be judged whether the trustee is acting reasonably or not, or though by the terms of the trust he is not required to act reasonably, the court will interfere were he acts dishonestly or in bad faith, or where he acts from an improper motive."

In almost all states, there was no reasonableness or good faith standard for a discretionary trust that used qualifying adjectives of the trustee's "absolute," "unlimited," or "uncontrolled" discretion. In fact, Section 187 of the Restatement Second of Trusts held that such qualifying adjectives dispensed with the standard of reasonableness.[i]

b. High Threshold of Proof

Since the beneficiary had such a high threshold to meet to obtain a distribution, the beneficiary had virtually no enforceable right or property interest. ***This lack of an enforceable right is the fundamental cornerstone for the asset protection behind a discretionary trust.*** The principle is simple. A creditor cannot compel the trustee to pay anything because the beneficiary cannot compel payment.[ii] This is the common law asset protection difference between a support trust and a discretionary trust. A support trust has a reasonableness judicial standard of review, while the judicial review of a discretionary trust is typically limited to the trustee acting dishonestly, acting with an improper motive, or failing to use his or her judgment i.e., "bad faith".

One might view the threshold similar to that of an Olympic pole vault. Should the Olympic jumper exceed the threshold standard, his or her creditors cannot recover from the trust. However, if a lower standard is utilized, all exception creditors can clear the standard and stand in the shoes of the debtor/beneficiary.

c. Uniform Trust Code and Third Restatement

Both the Restatement Third and the UTC expand the approach used in Ohio that caused so many asset protection problems. The UTC makes it clear that a "good faith" standard applies regarding judicial review, and the Restatement Third makes it clear that a "reasonableness" standard applies.

While comment (b) of the Restatement Third states that "judicial intervention is not warranted merely because the court would have differently exercised its discretion," 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."[iii] The comment further goes on to state that "a court will also intervene if it finds the payments made, or not made, to be unreasonable as a means of carrying out the trust provisions."

The UTC does not impose a reasonableness standard, rather Section 814(a) provides a good faith standard. It states that "Notwithstanding the breadth of discretion granted to a trustee in the terms of the trust, including the use of such term as "absolute", "sole", or "uncontrolled", the trustee shall exercise a discretionary power in good faith in accordance with the terms and purposes of the trust and the interests of the beneficiaries." The Third Restatement of Trusts Section 50 comment (c) has a similar construction when it states that words such as "absolute," "unlimited," "sole," and "uncontrolled" discretion "are not interpreted literally." Rather, the trustee must still accomplish the purposes of the discretionary power. In essence, both the UTC and the Restatement Third use a relatively equivalent standard of review by a court, and this standard of review is much lower than the bad faith standard of prior law.

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[i] Restatement *(Second) Trusts*, Section 187 (1959) at pages 408-409.

d. Ohio – A Tale of What Not to Do

The following analysis of Ohio law is presented to demonstrate the problems that occur when the judicial standard of review is dropped to a definition of abuse, good faith, or reasonableness. In Ohio, it appears that the standard of review of a discretionary trust has been gradually shifting from "bad faith" to a "reasonableness" standard. In 1945, the Ohio Supreme Court held "Where the terms of a trust it is provided that the trustee shall pay to a beneficiary only so much of the income and principal, or either, as the trustee in his uncontrolled discretion shall see fit to pay, the beneficiary cannot compel the trustee to pay him any part of the income or principal."[i] That meant the beneficiary had little, if any, standing in court. However, by 1955, it appears that Ohio had shifted to a "good faith" standard.[ii] Adding more confusion, in 1962, *Culver v. Culver*,[iii] the Ohio Appellate Court stated that "Of course the courts have supervision over discretionary trusts; but the sole inquiry is whether the discretion exercised by the trustee has been abused; if the bank, in the exercise of good faith, failed to exercise its discretion, or having exercised it, was guilty of bad faith,[iv] then the courts can interfere, but not before." Here the court appears to be discussing both a good faith standard and an abuse standard stating that both apply.

In 1968, in a supplemental needs case, the Ohio Supreme Court held that even if a discretionary distribution standard utilized the qualifying adjectives of "sole and absolute" discretion, if the distribution language was coupled with an enforceable standard, it was an abuse of discretion if the trustee did not make minimum distributions to a destitute beneficiary. *Bureau of Support in the Department of Mental Hygiene and Correction v. Kreitzer*.[v] The court did not discuss either what abuse standard that Ohio had adopted: "bad faith,' "good faith," or "reasonableness" or what category of abuse the above situation would fall into. Rather, the court merely held that the fact pattern constituted abuse. Further, the court held because of the enforceable standard, the trust was neither purely a discretionary trust nor purely a support trust. In *Kreitzer*, the enforceable standard was "care, comfort, maintenance, and general well-being." The end result of this analysis was that the governmental agency was able to recover directly from the trust assets by forcing a distribution pursuant to a standard. This result would not occur in almost all common law states that retain the discretionary-support dichotomy.

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i *McDonald v. Evatt*, 62 N.E. 2d 164 (Ohio 1945).

ii *Caswell v. Lenihan*, 126 N.E.2d 902 (Ohio 1955); *Huntington Natl. Bank v. Aladdin Crippled Children's Hosp. Assn.*, 157 N.E.2d 138 (Ohio App. 1959).

iii *Culver v. Culver*, 169 N.E.2d 486 (Ohio App. 1960).

iv It is uncertain how the Court is using the term "bad faith" in this case.

v 243 N.E.2d 83 (Ohio 1968).

In 1978, the Ohio Supreme Court extended the concept of *Kreitzer* to allow a spouse to recover for child support from a discretionary trust which was coupled with a standard. Further, the Ohio courts for the most part consistently continued to apply the *Kreitzer* analysis, with the result that Medicaid and governmental agencies would recover from a discretionary trusts assets.[i] Adding further confusion to what review standard Ohio has for a discretionary trust are the unreported 1997 and 2001 cases of *In the Matter of Trust Created by Item III of Will of Zemuda*[ii] and *Buoscio v. Estate of Buoscio*[iii]. Here, the courts used the abuse standard of the trustee acting unreasonably, unconscionably, or arbitrarily. Finally, in 2001, an Ohio Appellate Court held that a discretionary trust was an available resource and it was proper that the beneficiary was denied Medicaid eligibility. *Metz v. Ohio Dept. of Human Services.*[iv] The Ohio Appellate Court reasoned that the beneficiary had an enforceable right under *Kreitzer*. Consequently, the Ohio Department of Human Services was correct in denying benefits, as the discretionary trust was an available resource under Ohio's definition of abuse.

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

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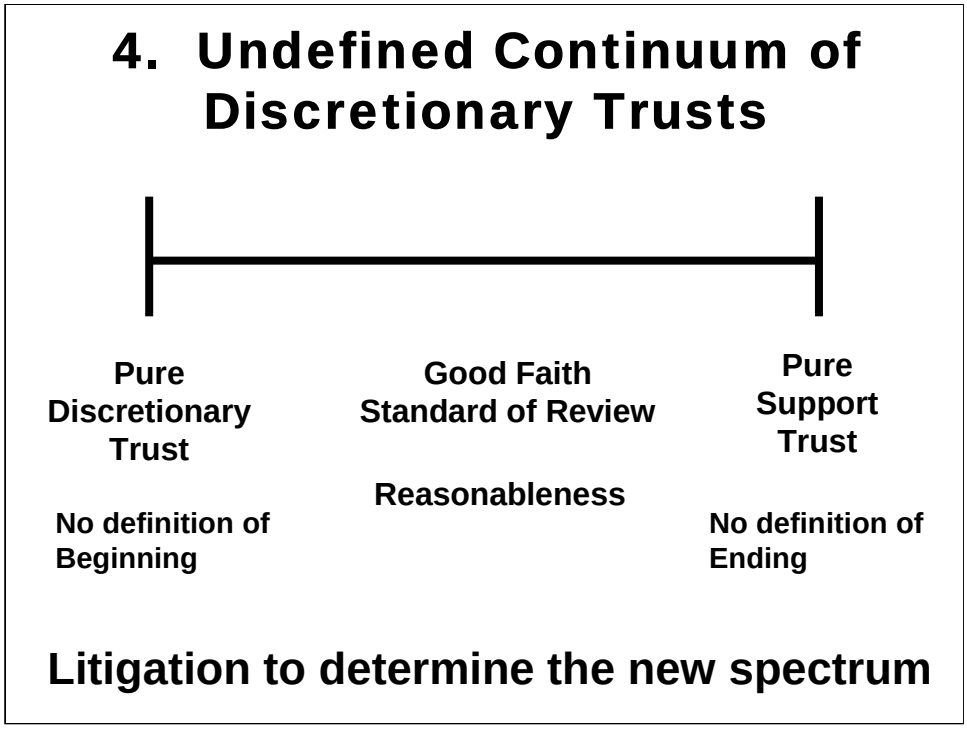
[i] The following are unreported appellate cases that follow the *Kreitzer* analysis: *Matter of Gantz*, 1986 WL 12960; *Samson v. Bertok*, 1986 WL 14819 (however, the creditor did not recover because it was not a governmental claim); *Matter of Trust of Stum*, 1987 WL 26246; *Schierer v. Ostafin*, 1999 WL 493940 (however, the creditor did not recover because it was not a governmental claim).

[ii] No. L-96-073 (Ohio App. 6 Dist. 1997).

[iii] 2001 WL 1123960 (Ohio App. 7 Dist).

[iv] 762 N.E. 2d 1032 (OH App. 2001).



4. Undefined Continuum of Discretionary Trusts

One might argue that under the UTC and Third Restatement all trusts should now receive greater asset protection because all trusts are now placed on a "continuum" of discretionary trusts. The authors disagree with this statement. The reason a creditor could not force a distribution from a discretionary trust was because the beneficiary could not force such a distribution. Because the beneficiary had very little standing in court under a bad faith review standard[i] the beneficiary was powerless to effect a change. Under the UTC the review standard has been changed to "good faith," and under the Third Restatement, the review standard has been changed to "reasonableness." The issue is not what designation is assigned to a trust (discretionary or support), the issue is whether the beneficiary has an enforceable right to force a distribution. Unfortunately, the case law from Ohio is demonstrative of this point. Once the beneficiary has an enforceable right or property interest, the following issues are concerns:

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[i] A beneficiary could only bring an action if the trustee acted dishonestly, with an improper motive, or failed to act. Further, under Restatement Second, a trustee can act unreasonably.

5. What Issues Are Now Presented?

- ü **What remedies are available to exception creditors or ordinary creditors?**
- ü **Will governmental aide be denied to SNTs?**
- ü **Whether a beneficiary's interest be considered marital property or a factor in equitable division?**
- ü **Whether a judge will impute income from a discretionary trust in a divorce?**
- ü **Whether all creditors may recover through a bankruptcy?**

5. What Issues Are Now Presented?

Once the 125 year common law distinction between a discretionary-support trust is abolished, the above issues become critical.

B. Increased Creditor Remedies Under the UTC

(Second Decrease in Asset Protection)

- ü **Prior to the UTC**
- ü **UTC**
  - **Increases the number of remedies**
  - **Greatly expands creditor rights in how a creditor may attach**
  - **Increases the number of interests that may be recovered from**

B. Increased Creditor Remedies Under the UTC

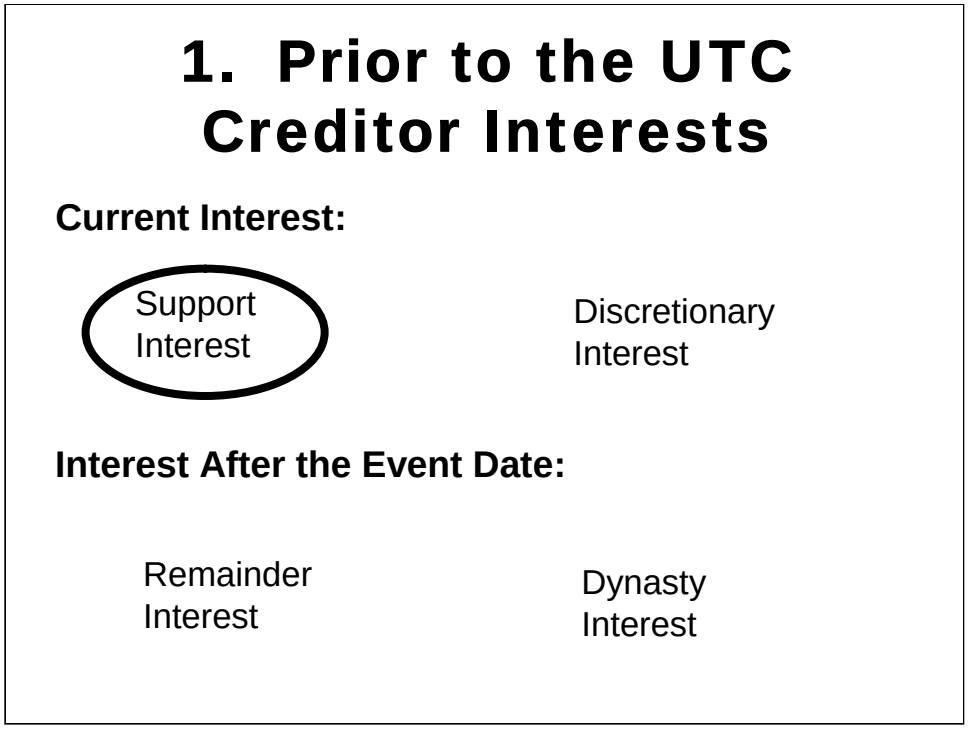
The second major area where the UTC decreases asset protection for non-self settled trust is the increased remedies under the UTC.

- Prior to the UTC

As discussed on the next page, in almost all states, remedies by "exception creditors" were quite limited. "Exception creditors" are defined as those who have some type of remedy against the trust assets regardless of spendthrift protection.

- UTC

The UTC increases both the number of remedies that a creditor may obtain, greatly expands creditor rights on how a creditor may attach a beneficiary's interest, and increases the number of interests a creditor may recover from.



1. Creditor Remedies Prior to the UTC

Before discussing the new remedies under the UTC and Third Restatement, this section provides a brief review of the remedies available under the common law. With a discretionary trust, a creditor had no right of recovery against any beneficial interest, because the beneficiary did not have a property interest, an enforceable right to compel payment under state law.[i] However, with a support trust, an exception creditor could attach the beneficiary's interest,[ii] and would be entitled to receive any future distributions from the trust that would have been made to the debtor/beneficiary.[iii] The *Restatement (Second) of Trusts* was silent on creditor remedies under state law. The *Restatement (Second) of Trusts* failed to give further guidance, stating that, "The rules of procedure by which a creditor can subject the interest of the beneficiary to the satisfaction of his claim are not with the scope of the Restatement (Second) of this Subject."[iv] The states have different methods for attachment of a beneficiary's interest. For example some states have an equitable remedy known as a "creditor's bill" or a "bill for equitable execution."

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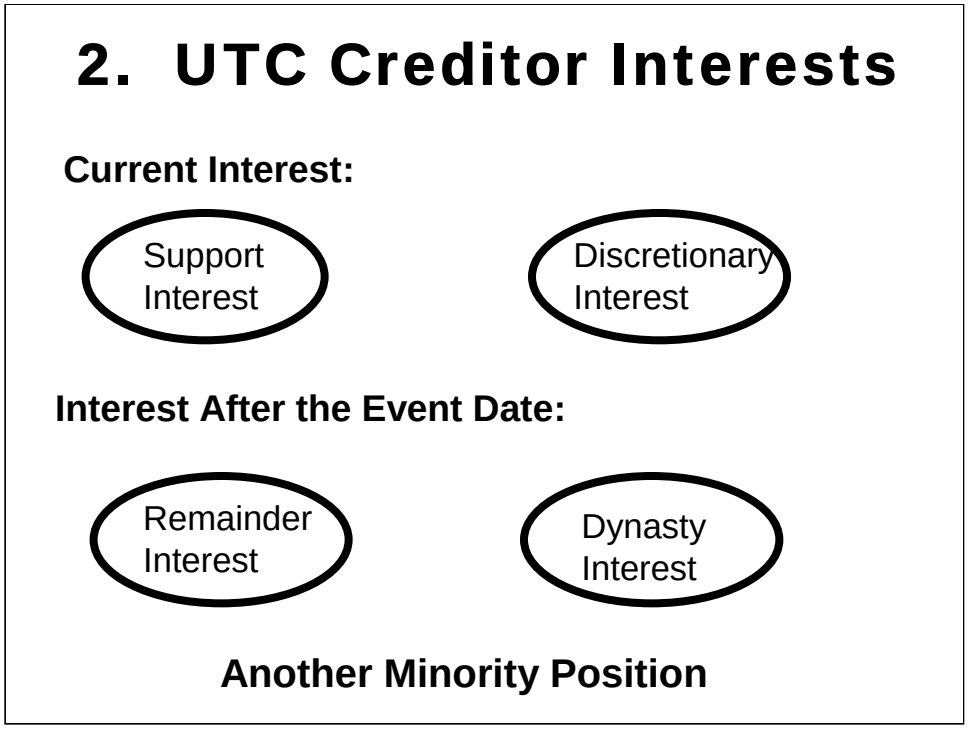
i *Restatement of Trusts (Second),* Section 155(1) and comment b thereunder.

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

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

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



2. UTC Creditor Interests

The UTC and Third Restatement allows exception creditors (and possibly all creditors) to attach all interests in a trust.

a. Current Interest

Under the UTC, it does not matter whether under common law the interest was classified as a support interest or a discretionary interest all interests may be attached by an exception creditor.

b. Remainder Interest or Future Interests

Under common law, few states allowed a creditor to attach a remainder interest. In fact, so long as the beneficiary interest would not vest within the immediate future (i.e., the next year), these interests would even survive a bankruptcy. Again, the UTC followed the minority view allowing all remainder interests to be attached by an exception creditor (and possibly all creditors). In other words, an exception creditor could attach a remainder interest today, wait over twenty years before it vested, and then recover from the vested interest.

3. Increased Remedies

- **Attaching the Beneficial Interest Until Claim is Satisfied**
  - **a. "Includes present and future distributions"**
    - **Another Minority Position**
  - **b. "No Payments For the Benefit Of"**
    - **Little case authority, but appears to be another change in the common law**

3. Increased Remedies Under the UTC

a. Present and Future Distributions

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

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

Many estate planners have indicated that with a discretionary trust, all the trustee need do to avoid attachment and still support the beneficiary is to pay the debtor/beneficiary's expenses directly, instead of making a distribution to the beneficiary.[i] Both the UTC and Restatement Third of Trusts end this possibility. Section 502 of the Uniform Trust Code provides that a creditor may attach "present or future distributions to *or for the benefit of the beneficiary*." Section 60 comment c. and Illustration 4. of the Restatement Third provides that, "If the trustee has been served with process . . ., the trustee is personally liable to the creditor for any amount paid to or applied for the benefit of the beneficiary in disregard of the rights of the creditor.

Rick Davis, chair of the Ohio Elder law division has noted that this is a particularly troublesome provision for special needs trusts. Many times, in order to avoid a distribution being considered an available resource, the trust pays for the expenses directly. It should be noted that in May of 2004, the Ohio Elder Law Section voted unanimously against the UTC.

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[i] *Duncan v. Elkins*, 45 A.2d 297 (NH 1946).

3. Increased Remedies

c. Forcing a Distribution

- **Child Support and Alimony**
- **However, see UTC § 506 – "end round" for all creditors**
- **However, Bankruptcy "end round"**

d. Judicial Foreclosure Sale

- **Current Interests**
  - Almost unheard of minority position
- **Remainder Interests**
  - Another Minority Position

c. Forcing a Distribution

At first blush, UTC § 504 appears to limit forcing a distribution to satisfying a creditor claim to the exception creditor of an estranged spouse or alimony. However, as discussed later in this outline, UTC § 506 provides a method where all creditors may force an undefined "overdue" distribution.

d. *Judicial Foreclosure Sale*

In the comments to UTC § 501, the UTC provides for the judicial foreclosure sale of all interests. Under common law, the sale of remainder interests was the minority rule, followed by only a few jurisdictions. However, again the UTC adopts a "minority view" position.

The judicial sale of a discretionary or support current beneficial interest was virtually unheard of. In this respect, the UTC has again adopted another extreme minority position.

4. Who May Attach at the Trust Level?

ü Exception Creditors

ü All Creditors

- Spendthrift Provisions Protect Trust Assets
- Distributions Not Protected
- May any creditor attach at the trust level
- Restatement Third -
- **This interpretation would almost defeat asset protection of beneficial interests by itself**

4. Who May Attach at the Trust Level

a. Exception Creditors

UTC § 501 provides that "To the extent a beneficiary's interest is not protected by a spendthrift provision, the court may authorize a creditor or assignee of the beneficiary to reach the beneficiary's interest by attachment of present or future distributions . . ." Any exception creditor under UTC § 503 may reach a beneficiary's interest by attachment of present or future distributions.

b. All Creditors

Unfortunately, the interpretation of UTC § 501 may well lead to the conclusion that all creditors may attach present or future distributions. First, UTC § 501 provides that "to the extent a beneficiary's interest is not protected by spendthrift provisions . . ." Second, pursuant to the Restatement (Second) of Trusts Section 152 comment j. any distributions received from a beneficiary were not protected by spendthrift provisions. See also *Lundgren v. Hoglund*, 711 P.2d. 809 (Mont. 1985); *Guidry v. Sheet Metal Workers, Int'l Ass'n*, 10 F.3d 700 (10th Cir. 1993). The result is that spendthrift provisions only protect assets while the assets are held in trust. Therefore, if spendthrift provisions only protect assets that are held in trust, does UTC § 501 allow attachment by any creditor? If UTC § 501 is interpreted this way, the UTC does not make a minor modification to common law **it part almost completely defeats asset protection value of trusts.** Any creditor could attach and merely wait for satisfaction of his or her claim. In this respect, a beneficial interest in trust would have less asset protection than even family limited partnership that allows for the judicial foreclosure sale of the partners interest. It should be noted that the Restatement Third does little to clear up the ambiguity in this area. The text of §56 e. refers to creditor and does not mention an "exception creditor" or discuss the effect of a spendthrift clause. However, illustration 1, mentions that no spendthrift clause is included in the trust.

5. Analogy to a Charging Order

- ü **Charging order**
- ü **Cannot force a distribution**
  - l **Child support & alimony**
  - l **But See UTC § 506 – "end round"**
  - l **Bankruptcy End Round**
- ü **May force the judicial foreclosure sale unless a "sole remedy" state**

Absent the state remedy of a "creditor's bill" or a "bill for equitable execution," an exception creditor can attach a current beneficiary's interest through a receiver. Therefore, a beneficiary may not receive a distribution until the creditor is paid. In many cases, the exception creditor could stand in the shoes of the beneficiary. In this way, the creditor could reach the underlying property by forcing a distribution pursuant to the distribution standard – health, education, maintenance, and support. For example, the exception creditor in *Sligh v .First National Bank of Holmes County,*[i] the exception creditor was allowed to garnish the trust assets for the entire claim of $313,677. However, based on the analysis above, an exception creditor had few rights (except possibly in the case of divorce) to proceed against an interest after an event date in a situation involving a remainder interest or a dynasty trust.

4. Charging Order Analogy

An analogy of the new creditor rights under both the UTC and Third Restatement can be made to the creditor remedies against a partnership interest. For example, when a creditor attaches a partnership interest, the creditor receives a "charging order." Essentially a charging order is an assignment of income. As soon as there is a distribution, the distribution belongs to the creditors.[ii] In most states, in the event the creditor's claim remains unsatisfied by the charging order, the creditor may force a judicial foreclosure sale of the limited partner's interest. Essentially this is the approach taken by both the Third Restatement and UTC. Please note that as discussed on the previous page it is uncertain whether any creditor may attach or only an exception creditor. If any creditor may attach, a family limited partnership will have more asset protection than a beneficial interest in trust.

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i 704 So. 2d 1020 (Miss. 1997).

ii Some have defined the term "charging order" in layman's terms as a right to a distribution when and if ever made (by the general partner).

C. Long Term Expansion of Exception Creditors

(Third Decrease in Asset Protection)

- ü Second Restatement Exception Creditors
- ü Uniform Trust Code Exception Creditors
- ü State Exception Creditors
- ü Possible New Exception Creditors

C. LONG TERM EXPANSION OF EXCEPTION CREDITORS

It is important to analyze the expected progression of increasing categories of exception creditors under the UTC and the Third Restatement. To understand how the UTC most likely will significantly expand exception creditors, the exception creditors under the Second Restatement of Trusts must first be reviewed. Then exception creditors under the Uniform Trust Code must be examined. Further, when states have been allowed to create their own legislative exception creditors, these potential exceptions must be analyzed. Finally, the Third Restatement's position that the judiciary can freely add exception creditors must also be examined. This is particularly important since the new law and minority positions adopted by the Third Restatement are the backbone of the UTC.

1. Second Restatement Exception Creditors

- ü Alimony and child support
- ü Reasonable needs of a beneficiary
- ü Attorney fees (not adopted by most states)
- ü Any federal or state governmental claim

1. Second Restatement Exception Creditors

Exception creditors are creditors who have a special preference, allowing them to attach a beneficial interest. Under many states laws, the exception creditor could then force a distribution pursuant to a standard.

The Restatement Second of Trusts listed the four exception creditors above. Most states adopted three of the four exception creditors – excluding attorney fees to protect a beneficial interest. While the judicial system may well do so at this time, it does not appear that Colorado has adopted alimony and child support as an exception creditor.

2. Exception Creditors Uniform Trust Code

- ü Alimony and child support
- ü Attorney fees
- ü Any federal or state governmental claim that specifically refers to attachment ***INCLUDING*** Medicaid and state government aid

2. Exception Creditors Uniform Trust Code

From an asset protection perspective regarding spendthrift protection, it initially appears that the UTC is an improvement over the Restatement (Second) of Trusts, since it reduces the number of exception creditors from four to three. The creditor exception for "necessary expenses of the beneficiary" at first glance appears to have been deleted. The exception creditors designated by the UTC are:

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

[i] *Uniform Trust Code*, Section 503, National Conference of Commissioners on Uniform State Laws 2001.

2. Exception Creditors Uniform Trust Code Continued

a. Exception creditors now apply to a discretionary trust

b. Exceptions may be Judicial or Statutory

- It took over 50 years for the common law to adopt three out of four exception creditors
- Compare this to state statutes

a. Claims by Exception Creditors Extended to Discretionary Trusts

Where under common law exception creditors had no claim against a discretionary trust, under the UTC or Restatement Third all exception creditors are allowed to directly attach the assets of a discretionary trust.

b. Exception Creditors May Be Judicial or Statutory

Some have argued that since the UTC list of exception creditors is smaller than the Restatement Second of Trusts, the UTC is more protective of support trusts. The authors would agree that, in the short term, this may be the case. However, the authors would note that since the Restatement Second was promulgated almost fifty years ago, only three of the four exception creditors have been adopted by the majority of state courts. However, when legislators are given the ability to determine exception creditors, the number of exception creditors appear to be much more expansive than promulgated by the judiciary. Therefore, the authors conclude that the temporarily greater asset protection provided to a support trust will be of relatively short duration.

Further, the UTC does not limit exception creditors to legislatively created exception creditors. Rather, the Third Restatement, gives judges broad latitude to continue to expand the list of exception creditors.

c. State Exception Creditors

- ü Tort creditor exception
  Sligh v. First National Bank of Holmes County
- ü Accumulated income greater than $25,000 per beneficiary
- ü Accumulated income greater than reasonable needs of a beneficiary

California	**New York**
Connecticut	**North Dakota**
Michigan	**South Dakota**

c. State Exception Creditors

The authors have significant concerns that the list of exception creditors easily may be expanded under the UTC. Under the UTC, the state legislature may do this by simply appending an unnoticed exception to part of any other bill that passes through the legislature.

i. Tort Creditor Exception

One example is the tort creditor exception. For many years, the trial bar has attempted to create a "tort creditor exception." The Mississippi Supreme Court actually adopted this view.[i] In *Sligh v. First National Bank of Holmes County*, the dissent noted that it was incorrect for the Mississippi Supreme Court to legislate this change to 125 years of well established trust law. The dissent stated that the change should be left to the legislature. It should be noted that approximately one year after the Mississippi Supreme Court rendered its landmark decision, the Mississippi legislature specifically overturned its Supreme Court by statute citing the anticipated loss of trust business that would migrate to other states with more favorable trust legislation.[ii]

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[i] *Sligh v. First National Bank of Holmes County*, 704 So 2d 1020 (Miss. 1997).

[ii] Many of the trust companies as well as the estate planning attorneys realized that much of the trust business would leave the state of Mississippi due to such a detrimental holding by the Mississippi Supreme Court. Therefore, both of these factions lobbied the legislature quite extensively to reverse the decision by statute. Miss. Code Ann. Section 91-9-503 (Family Trust Preservation Act 1998).

ii. Exception Creditor - $25,000 Accumulated Income

At first, the idea of allowing any creditor to access trust property to the extent that the trust accumulated over $25,000 of trust income per beneficiary appears completely ludicrous. This would mean that a judge would first need to determine how the income was computed, pure income or total return. Second, the judge would need to determine how beneficiaries are to be counted. Such a concept might be viable with regard to the current income beneficiaries of a support trust. However, the concept seems incredibly complex for a dynasty trust where all descendants hold a current beneficial interest. Regardless of how absurd such a spendthrift exception might appear, it was part of Oklahoma's proposed Uniform Trust Code.[i]

iii. Exception Creditor - Income in Excess of Beneficiary Support

Section 15307 of the California Probate Code provides that all income in excess of that necessary for a beneficiary's support and education is subject to the claims of judgment creditors. With a discretionary trust, the creditor could not reach any accumulated income, unless it was specifically set over to a discretionary beneficiary.[ii]

With a discretionary trust, a trustee could lower the discretionary distribution level to the beneficiary's support needs. A creditor would have no right of recourse against the accumulated trust income. However, both the UTC and the Restatement Third end the discretionary/support dichotomy. Under the UTC and Restatement Third, a creditor would be able to attach and force a distribution of any excess of the income over the reasonable needs of the beneficiary.

In addition to the Oklahoma statute for income accumulated in excess of $25,000 and the California exception based on income accumulated in excess of the reasonable support needs of a beneficiary, the following other states have provided exception creditor status:

- Connecticut – Similar to the California statute, where income is required to be paid to a beneficiary (because there is no express provision for accumulating income), then a creditor may attach the amount that is not expressly given to the beneficiary for the support of the beneficiary or the beneficiary's family.[iii] Under this Connecticut statute, a creditor could not reach the assets of a discretionary trust.[iv]

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i *Section 41 B. 2.* of the original act.

ii *Canfield v. Security-First National Bank of Los Angeles*, 87 P2d 830 (CA 1939).

iii Conn. Gen. Stat. § 52-321 (1991).

iv *Huntington v. Jones*, 43 A. 564 (Conn. 1899).

- Michigan – With respect to a trust that holds real estate, the rents and profits from the real estate may be reached by a creditor unless the trust provides that the rents and profits may be accumulated.[i] In *Coverston v. Kellog*,[ii] after determining the trust was not a discretionary trust, the court held that under this statute a former spouse was allowed to reach the income of this spendthrift trust for alimony and child support.

- New York – When a the trust agreement does not provide that the income may be accumulated, the income in excess of the amount necessary for both education and support of the beneficiary is subject to the claims of creditors.[iii]
- North Dakota – Similar to Michigan, with respect to a trust that holds real estate, the rents and profits from the real estate may be reached by a creditor unless the trust provides that the rents and profits may be accumulated.[iv]
- South Dakota - Also similar to Michigan, with respect to a trust that holds real estate, the rents and profits from the real estate may be reached by a creditor unless the trust provides that the rents and profits may be accumulated.[v]

It should be noted that the statutes above did not appear to affect the asset protection provided by a discretionary trust under common law. Creditors under these statutes simply could not attach or force a distribution from a discretionary trust. If a beneficiary has no enforceable right or property interest, then a creditor could not obtain a greater right than the beneficiary.

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i Michigan Compiled Laws § 555.13 (1988).

ii *Coverston v. Kellog*, 357 N.W.2d 705 (Mich. 1984).

iii *N.Y. Est. Powers & Trust Law* § 7-3.4.

iv *N.D. Century Code*, 59-03-10 (1995).

v *S.D. Codified Laws*, § 43-10-13 (1997).

d. Possible New Exception Creditors

Ü Federal Bankruptcy Exception

"The Federal Bankruptcy Trustee is an exception creditor pursuant to Section 503(c) of any state that has adopted this provision of the Uniform Trust Code."

Ü Third Restatement Encourages Further Exceptions

- "Allowing recover further protective purposes"
- "unfair for some, but not others"

d. Possible New Exception Creditors

i. Federal Bankruptcy Exception

The federal bankruptcy code may reference the Uniform Trust Code Exception Creditor list. Section 503(c) provides that "A spendthrift provision is unenforceable against a claim of this State or the United States to the extent a statute of this state provides." What if the federal bankruptcy code adds a section that states, "The Federal Bankruptcy Trustee is an exception creditor pursuant to Section 503(c) of any state that has adopted this provision of the Uniform Trust Code"?

In that extent, all a creditor need do would be to file an involuntary bankruptcy against the debtor (assuming the requirements for such a filing are met), and the creditor would have easy access to the trust assets. In essence, this would mean all judgment creditors – not just alimony, child support, necessary expenses of the creditor, federal claims, state claims, tort creditors –but anyone and everyone who had a debt greater than $11,625.[i] Should federal bankruptcy law ever allow recovery against a trust in a UTC state, *there is virtually **no** asset protection provided by the spendthrift provisions in a trust.* All credit card companies and any other creditors could easily recover from any spendthrift trust through this bankruptcy end run approach.

[i] 11 U.S.C. §303(b).

ii. Third Restatement Encourages Further Exceptins

The UTC does not proscribe the court's ability to add additional judicially created exception creditors. Further, the Restatement Third even encourages the practice of adding exception creditors. Comment a(2) specifically provides that "Special circumstances or evolving policy may justify recognition of other exceptions, allowing the beneficiary's interest to be reached by certain creditors in appropriate proceedings . . . possible exceptions in this case require case-by-case weighing of the relevant considerations and evolving policies."

In essence, this provision of the Restatement Third has given the courts a blank check to create exceptions upon the court's whim. So while the UTC exception list is incredibly troublesome from an asset protection perspective, interpretation of the UTC by the Restatement Third is much worse. Further, the Restatement Third goes on to say, "In some circumstances, to permit attachment despite the spendthrift restraint may not undermine, and may even support, the protective purposes of the trust or some policy of law." In this regard, the authors have never seen a situation where a client has asked that a trust be drafted to permit a creditor to recover from a beneficiary's interest. Therefore, it is perplexing how this could ever be considered a "purpose" of the trust. Additionally, the Third Restatement states that it may be unfair for some creditors to attach a beneficiary's interests, but not all creditors. Finally, the disdain the authors of the Third Restatement have for spendthrift protection of beneficial interests can best be summarized by reporter comment a under Section 58, "In review of the debate over the validity of spendthrift trusts, it is useful to begin with the irony apparent in sacrificing simplicity and convenience for creditors, and the orderliness in the priority and satisfaction of their claims, for the distinctly limited protection afforded the spendthrift-trust beneficiaries." It should be noted that originally spendthrift protection was absolute. Gradually, the common law developed three primary exception creditors[i] that were consistent with the terms of a support trust. Unfortunately, a purpose of the Restatement Third appears to be the gradual elimination of all spendthrift protection.

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[i] As previously noted, the "exception creditor" for attorney fees in regard to a beneficial interest in trust was seldom accepted by the courts.

D. Is the UTC the End for Third Party SNTs?

(Fourth Decrease in Asset Protection)

Ø How did third party SNTs originate ?

- l If a beneficiary could not force a distribution, neither could a creditor.
- l Discretionary trust

1. One big step and one little step

- l Big step – Eliminate the discretionary-support distinction
- l Little step – legislative addition of the state as an exception creditor

D. Is the UTC the Beginning of the End For Third Party SNTs?

1. <u>One Big Step and One Little Step</u>

In early cases and currently in many states, a discretionary trust serves as a SNT. A third party Medicaid or special needs trust is a trust where the parents or grandparents create a trust for the benefit of a handicapped child or other handicapped person. The analysis is simple - since the beneficiary has no right to reach the assets of the trust, neither does a creditor – including the government.

For states that pass the UTC, it is only a short step to eliminate third-party Medicaid or special needs planning. In order to gradually reduce or eliminate third party Medicaid or special needs trusts two steps must be accomplished:

> (1) The discretionary/support distinction must be eliminated so that all trusts rely on spendthrift protection; and
>
> (2) Then, all the federal government or state legislature needs to do to attach any trust, whether discretionary or support, is to provide by statute that the government can attach the beneficiary's interest.

With the rising costs of medical and custodial care, it is only a matter of time before most, if not all, states and the federal government will do this. Prior to the UTC or Third Restatement, states determined property law rights, and a discretionary trust was not a property interest. Both third-party Medicaid planning and special needs planning depend upon the dichotomy between discretionary and support trusts for their effectiveness.

2. The Available Resource Issue

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

- **Discretionary trust WITH standards will most likely no longer function as a SNT**
  - **Some planners recommend no detailed Special Needs language in SNT**
  - **Beneficiary has an enforceable right**
  - **Remember Ohio – a Tale of What Not to Do!**

2. Available Resource Issue

With third party SNTs, there is a two part analysis. First, will the third party SNT be considered an available resource? Second, may the governmental agency attach the beneficiary's interest? Most of the earlier cases viewed the beneficiary of a discretionary trust with little, if any, standing to force a distribution due to the bad faith standard of judicial review.

a. Discretionary Trust with Standards

If the state or federal government is added as an exception creditor, it is extremely likely that use of the third party SNT will be greatly curtailed if not eliminated. However, even if this does not occur, passage of the UTC has significant negative consequences for drafters who did not include special needs language.

Almost all drafters of discretionary trusts include a standard that is incapable of judicial interpretation such as "the trustee may, in the trustee's sole and absolute discretion, make distributions to the beneficiaries for health, education, maintenance, support, comfort, general welfare, well being, happiness, and joy." Third party SNT planners who recommend this approach argue that there is no need for special needs language in the SNT because the beneficiary had no enforceable right to the trust assets. However, under the UTC, the trustee must follow a "good faith" standard. The beneficiary would then have an enforceable right to sue for any of the items listed in the standard. One only has to remember what happened in Ohio under this type of analysis. When third party SNT were considered an available resource, benefits were denied and the government agency could attach the trust.

3. Public Policy Issues

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

b. Discretionary Trust without Standards

Since the Ohio decisions, many attorneys have suggested that a discretionary trust should not include distribution standards. By eliminating distribution standards, it would be difficult for a judge to conclude that a trust was anything other than a discretionary trust. The judge could not mistake a discretionary trust without any standards for a support trust. Further, it would be difficult for a judge to question the trustee's distribution decisions. Unfortunately, Section 50, comment (b) of the Restatement Third provides "It is not necessary, however, that the terms of the trust provide specific standards in order for a trustee's good-faith decision to be found unreasonable and thus constitute an abuse of discretion." If a standard is omitted, the court will still apply a reasonableness or good-faith judgment, "based on the extent of the trustee's discretion, the various beneficial interests created, the beneficiaries' circumstances and the relationships to the settlor, and the general purposes of the trust."[i]

3. Public Policy Issues

Once the government has been added as an exception creditor under Section 503, it appears that third party SNTs will be eliminated. It will not matter whether special SNT language is or is not is contained in the trust because any such trust in all likelihood will be void as a matter of public policy. Remember, the UTC Section 404 and the Third Restatement Section 29 give the court almost unbridled discretion to rewrite or void a trust that is either contrary to law or a public policy.

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[i] *Restatement of Trusts (Third)*, Section 50, comment d., adopted on May 16, 2001 by the American Law Institute, published 2003.

4. Elder Law Responses

- **In May of 2004, the Ohio elder law section voted unanimously against the UTC**
- **In Oklahoma, opposition by Lee Holmes, one of Oklahoma's lead SNT attorney's led to the UTC defeat**
- **UTC Response seems to indicate that they are uncertain whether they have created a problem**

E. All Creditors May Attach Overdue Distributions

(Fifth Decrease in Asset Protection)

- **UTC § 506**
- **Term Mandatory distribution is undefined**
  - **$100,000 per year annually**
  - **All income payable quarter annually**
  - **Trustee shall make distributions based on HEMS**
  - **Trustee may make distributions based on HEMS**

Does the good faith standard become an abuse of discretion?

E. All Creditors May Attach an Overdue Distribution

Pursuant to UTC §506, *all* creditors, not just exception creditors, can sue for an overdue mandatory distribution. If the trustee is required to pay all income annually, absent state law to the contrary, the trustee should not be able to withhold it. Unfortunately, the UTC does not define the word, "mandatory distribution." Therefore, it is uncertain whether a mandatory distribution would include common law support trust language and common law discretionary trust language.

For example, the distribution terms of the trust agreement may provide that a trustee shall make distributions for health, education, maintenance, and support. While this type of a distribution is not a mandatory distribution standard within the meaning of this chapter, it may well be some judge's interpretation that periodically a judge should make distributions pursuant to this standard and such distributions once made to the beneficiary could be attached by *any* creditor.

Further, one must note that under the UTC, a trustee must always make distributions pursuant to a "good faith" standard of review. Therefore, distribution language such as the trustee may make distributions, in the trustee's sole and absolute discretion, for health, education, maintenance, and support may also create a situation where a judge concludes that a trustee should periodically make distributions to a beneficiary. In such an event, these distributions would be subject to attachment by a creditor.

F. Does a Bankruptcy Trustee Stand in the Shoes of the Beneficiary?

(Sixth Decrease in Asset Protection)

- **Standard of Review is "*Good Faith*" or "*Reasonableness*"**
- **Beneficiary has an enforceable right to sue and force a distribution for abuse or under the standard UTC § 504(d) Abuse equated with good faith or reasonableness.**
- **Under Bankruptcy Code § 541, the bankruptcy trustee stands in the shoes of the debtor and may exercise any right under state law.**
- **Any creditor with a claim over $11,625 may file an involuntary bankruptcy** (as long as there are 12 or less creditors)
  - Otherwise any 3 creditors with claims aggregating over $11,625

F. Does a Bankruptcy Trustee Stand in the Shoes of a Beneficiary?

UTC § 504(d) states that a beneficiary is never limited "to maintain a judicial proceeding against a trustee for an abuse of discretion or failure to comply with a standard for distribution since the term "abuse" has been redefined to mean "good faith" under the UTC or "reasonableness" under the Restatement Third. Therefore even with a discretionary trust, the beneficiary now has a right to reach the underlying assets pursuant to a good faith or reasonableness standard.

Under § 541 of the Bankruptcy Code[i], upon the filing of a bankruptcy, the bankruptcy trustee is entitled to receive all of the assets of the debtor. Due to the revision of the review standard to good faith, all beneficiaries of discretionary trusts have an enforceable right or property interest under state law. Therefore, the discretionary beneficial interest is now part of the bankruptcy estate. Further, under § 541, the Bankruptcy Trustee stands in the shoes of the bankrupt for all purposes. This means that the bankruptcy trustee may now exercise the beneficiary's rights to force a distribution pursuant to UTC § 504(d). Further, Bankruptcy Code § 541(c) also voids any contract clause or other arrangement calling for the termination of rights. The result is that the rights that were supposed to end with the bankruptcy filing survive. Prior to the UTC and the Restatement Third, bankruptcy court involvement was not an issue with discretionary trusts because beneficiaries of discretionary trusts did not have sufficient rights to force a distribution.

It should also be noted, that in an action for involuntary bankruptcy, any creditor with a claim of $11,625[ii] or more can possibly use an end round approach to reach a beneficiary's interest.

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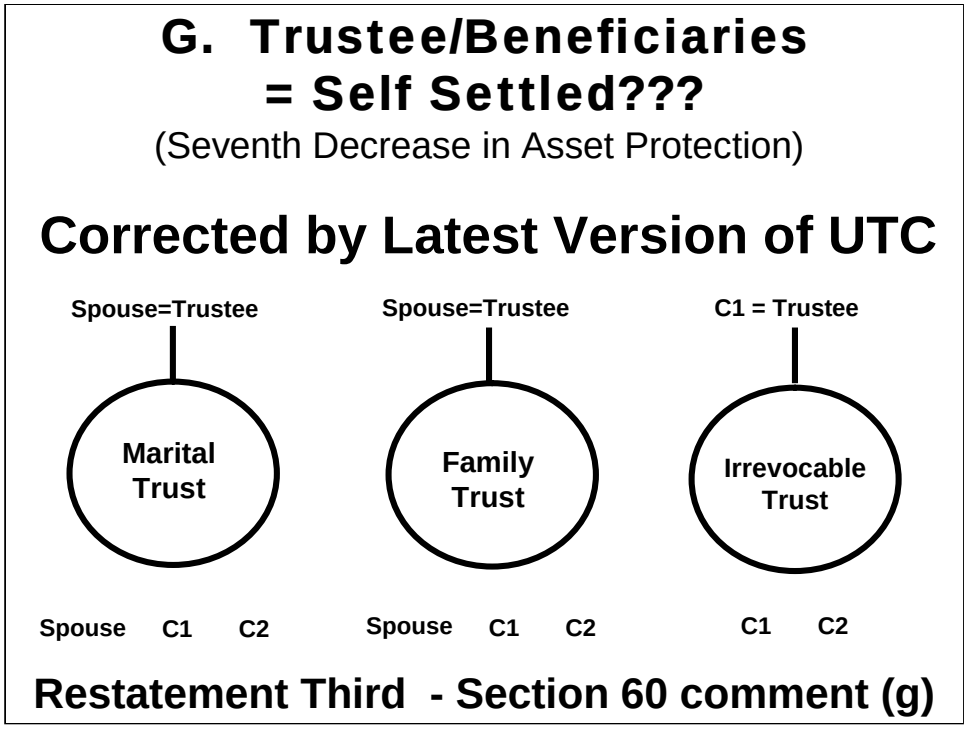
[i] 11 U.S.C. § 541.

[ii] 11 U.S.C. §303(b).



G. Standard Planning With Trustee Beneficiaries

1. The New Law Created by the Third Restatement

"When a beneficiary is a trustee of a discretionary trust, with authority to determine his or her own benefits," the beneficiary is treated as if the beneficiary were the settlor. Restatement Third Section 60 comment g. "In such a case, a rule similar to comment f applies, with creditors able to reach from time to time the maximum amount the trustee-beneficiary can properly take."

In other words, if a beneficiary is the sole trustee of a discretionary trust, a creditor may reach the maximum amount the beneficiary could distribute for himself or herself. Remember, under the UTC and Restatement Third, all trusts are classified as discretionary trusts, regardless of whether such trusts include an ascertainable standard or similar support language.

2. Spouses as a Sole Trustee or Child as the Sole Trustee

Many times a spouse is appointed as the sole trustee of a marital and/or the family trust. (Please note, due to possible IRC §2041 estate inclusion issues, many planners will only use a co-trustee with a spouse or make such an appointment when the children are adults.) In this case, any creditor may attach the spouse's interest in the trust. Further, a judge would need to determine what amount could be properly distributed under the new continuum of discretionary trust theory.

3. UTC Corrected This Issue in August of 2004

After opponents to the UTC pointed out this issue, NCCUSL addressed and corrected this issue in their August 2004 amendments for so long as the trustee-beneficiary's power is limited to an ascertainable standard.

H. Creditors Attaching General Powers of Appointment

(Eighth Decrease in Asset Protection)

- **Crummey Withdrawal Powers. What about the hanging Crummey?**
- **5 x 5 Powers**
- **General Power of Appointment Marital Trusts**
- **Non-exempt Portion of a Dynasty Trust**

H. Creditors Attaching a General Power of Appointment

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

1. Crummey Powers

With regard to Crummey powers, the ability of any creditor to attach is limited to the amount of the currently outstanding GPA. In this respect, any creditor my attach the unexercised portion of any Crummey power.

2. 5 x 5 Powers, GPA Marital Trusts, Non-exempt Dynasty Trusts

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

I. Divorce Issues

(Ninth Decrease in Asset Protection)

1. Marital Property Issue

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

2. Factor For Equitable Division in Divorce

3. Imputed Income for Alimony or Divorce

I. Divorce Issues

1. Marital Property Issue

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

2. Equitable Factor For Division of Marital Property

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

3. Imputed Income To Determine Alimony or Child Support

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

Dwight v. Dwight

(This is not a fairy tale)

- ü Court Must Review the Discretion of the Trustee in Every Case – Alimony and Child Support
  - l Son is divorced, a few years later . . .
  - l At death, Dad leaves property in trust for one of two sons
  - l Over 9 years, $7,000 distributed
  - l Son tells trustee he does not need money
  - l Trust increases from $434 k to $984 k
  - l Follows the Ohio – *Kreitzer* line of cases

5. *Dwight v. Dwight*

a. A Fairy Tale?

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

b. Facts

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

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[i] 756 N.E. 2d 17 (Mass. Ct. of App. 2001).

[ii] For an excellent analysis of *Dwight v Dwight*, please see *Another Look at "Dwight" and Spendthrift Trusts*, Alexander A. Bove Jr. and Melissa Langa the Massachusetts Lawyers Weekly, December 10, 2001.

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

(1) the broad purposes for which the trustee may make payments to the husband; and

(2) a statement the husband made to the trustee that he did not need any additional money.

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

c. Analysis Under the Third Restatement

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

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

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[i] *Uniform Trust Code*, Section 504, National Conference of Commissioners on Uniform State Laws 2001.

[ii] *Restatement (Third) of Trusts*, Section 50 comment b.; *Uniform Trust Code*, Section 814(a).

d. Control Analysis

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

e. *Should the Trust Pay Attorney Fees?*

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

f. Expands the Ohio Kreitzer logic of cases

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

J. Sale of Remainder Interests

(Tenth Decrease in Asset Protection)

- Spendthrift Provision Must Restrain Both
  - – **VOLUNTARY** and Involuntary transfer
- **Advanced Estate Planning Technique**
  - Spendthrift provision allows the sale of a remainder interest
  - In this way, an exempt GST trust may purchase a non-exempt remainder interest, and the non-exempt remainder interest will now be exempt.
- The UTC is retroactive and invalidates the spendthrift provision for all beneficiaries of trusts that employed this technique

J. Sale of Remainder Interests

1. Spendthrift Provision Must Restrain Voluntary Transfers

In many states, a spendthrift provision need only restrain involuntary transfers. This appears to be the majority rule. The UTC adopts the opposite approach. It requires a spendthrift provision to restrict both voluntary and involuntary transfers. Under the UTC, a current or remainder interest may not be sold or transferred, otherwise the spendthrift provision will be rendered useless.

2. Advanced Estate Planning Technique

An advanced estate planning technique advocated by many national speakers is for spendthrift provisions to allow the sale of a remainder interest. The purpose of this modification is to permit the remainder of a non-exempt GST trust to be purchased by a GST trust. After the purchase of the non-exempt remainder by the GST trust, the remainder would be converted to a non-exempt trust.

3. The UTC is Retroactive

If adopted, the UTC is retroactive. Therefore, trusts which relied on existing common law allowing the voluntary transfer of interests, the law would now be the opposite. This is particularly troublesome for irrevocable trusts that do not allow for amendment by the protector or the trustees, because now the spendthrift provision has been invalidated and all creditors may recover from the trust.

K. Summary of Asset Protection Issues

- **All Trusts**
  - Attachment by all creditors and wait until paid?
  - Bankruptcy trustee standing in shoes
  - Suing for an overdue distribution
  - Beneficiaries in a Divorce
  - Holders of GPAs
  - Sole Trustee/Beneficiaries
- Expansion of Exception Creditors
- Discretionary Trust
  - High Net Worth Individuals
  - SNT

K. Summary of Asset Protection Issues

It is uncertain whether all creditors may attach a beneficiary's interest directly at the trust level under the UTC. If this is the case, this change in the common law combined with the trustee no longer able to pay expenses of the beneficiary effectively eliminates most asset protection provided for beneficial interests under common law. However, it is clear that this change to the common law applies to exception creditors.

It also appears relatively certain that a bankruptcy trustee will receive all rights of a beneficiary prior to filing bankruptcy under UTC § 504(d). In this respect, a bankruptcy trustee should have the power to force a distribution to pay all creditors.

Regardless of whether a bankruptcy trustee may force a distribution for all creditors, any creditor may sue for an overdue distribution. Unfortunately, based on the background interpretation of the Third Restatement, it appears that a judge will determine imputed distributions from all trusts based on the new undefined continuum of discretionary trusts.

Similar to the imputation of income problem with an overdue distribution, a judge should also impute income from all trusts in the divorce context to determine child support and alimony. This imputation would be regardless of whether the beneficiary has ever received a dime from the trust. Further, the UTC may also have created a property interest in the beneficiaries, which depending on state law, would be eligible for marital division of property or considered as a factor in determining the equitable division of property.

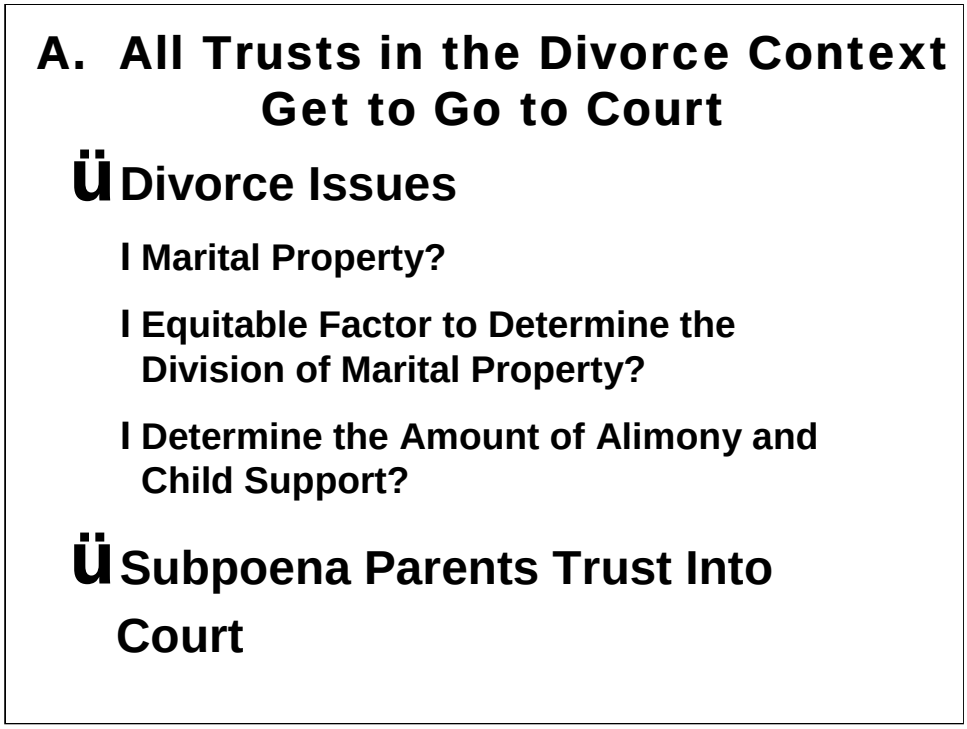
Holders of inter vivos GPAs may be attached and exercised by any creditor. Through the background interpretation of the Third Restatement, any creditor will be able to attach a trustee/beneficiary's interest.

II. Increase in Trust Litigation

- ü All Trusts in the Divorce Context
- ü All Trusts
  - l Overdue Distribution
  - l Attachment by Any Creditor
  - l Bankruptcy Issue
- ü Exception Creditor Analysis
- ü Expansion of People Who Can Sue the Trustee
- ü Providing the Fuel for the Litigation

II. Increase in Trust Litigation

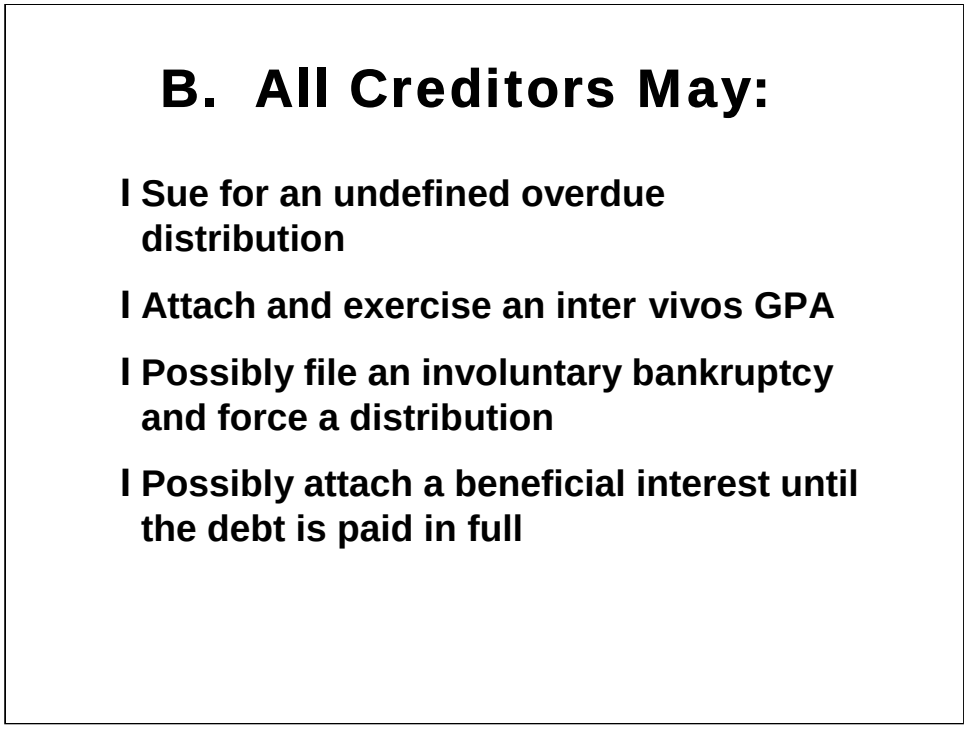
Traditionally, there has been little litigation in the trust area. However, it appears that the UTC seeks to change this with the additional situations as well as persons who can now sue the trustee. To add fuel to the fire, the UTC even provides a presumption that a judge may award attorney fees to a beneficiary (i.e. problem child), estranged spouse, or charity suing the trustee



A. All Trusts in the Divorce Context Get to Go to Court

Previously, virtually all trusts in the divorce context may well end up in prolonged litigation to determine whether a beneficial interest is a property interest eligible for division in a divorce, whether it is an equitable factor to be used in determining the allocation of marital property, and whether income should be imputed for the purposes of determining the amount of alimony or child support. Naturally, divorce attorneys everywhere should be ecstatic over the provision of the UTC and the Third Restatement.

There is another issue that has received very little attention. Parents are going to be distraught over involvement in their children's divorces. Similarly, they will be upset receiving subpoenas from their estranged son or daughter-in-laws attempting to discover the terms of their trusts and the assets held by the trusts. Further, will an estranged son-in-law or daughter-in-law be able to recover attorney fees from the parent's under UTC § 503(b), if parents resist discovery?



B. All Creditors

Prior to the UTC decreasing the asset protection for non-self settled trusts, most of the above issues were not an avenue for creditor recovery. Now, all of these cases may burden the court system.

C. Lengthy Judicial Process For an Exception Creditor

- Attaches beneficial interest – current discretionary, support or remainder interest
- Judge determines whether part of beneficial interest may be distributed to debtor for family
- Creditor seeks distribution pursuant to abuse (i.e., good faith)
- Judges, by new case law, must define the new "continuum of discretionary trusts"
- Creditor seeks to foreclose on the interest

C. Lengthy Judicial Process For an Exception Creditor

Under the UTC and Restatement Third, it appears that a judge will need to decide all exception creditor issues. For example, assume an exception creditor who is not a spouse or child files an action. First, the court must allow attachment of the interest under UTC §501. Second, the court must determine if or how much the beneficiary needs for the reasonable support of his or her family assuming the judge is so inclined. Third, the judge must determine whether the trustee is abusing his or her discretionary power by not making a distribution which would go to the creditor. Remember, the term "abuse" means that the trustee is not making distributions in "good faith." In making this decision, the judge must determine where the trust falls on the continuum of trusts (which is completely undefined by the UTC and the Restatement Third and discussed below). The judge then must be to determine the intent of the settlor. Specific language stating that the settlor's intent was to provide supplemental benefits may work for or against the client here. The judge may decide such specific intent has the purpose to defeat a state statute allowing the government as an exception creditor. If so, the judge may void the trust under the public policy exception. On the other hand, the judge may decide such specific intent language furthers the public policy of the state. Finally, the judge must decide whether the beneficiary's interest should be sold at a judicial foreclosure sale.

D. Expansion of People Who Can Sue

- **Problem Children**
  - **Prior law no enforceable right with a discretionary trust**
  - **Usually a standard incapable of judicial interpretation**
  - **Now an enforceable right**
- **All holders of powers are considered beneficiaries**

E. Poor Drafting Behind the UTC Statute

D. Providing Fuel to Encourage Further Litigation

1. Problem Child

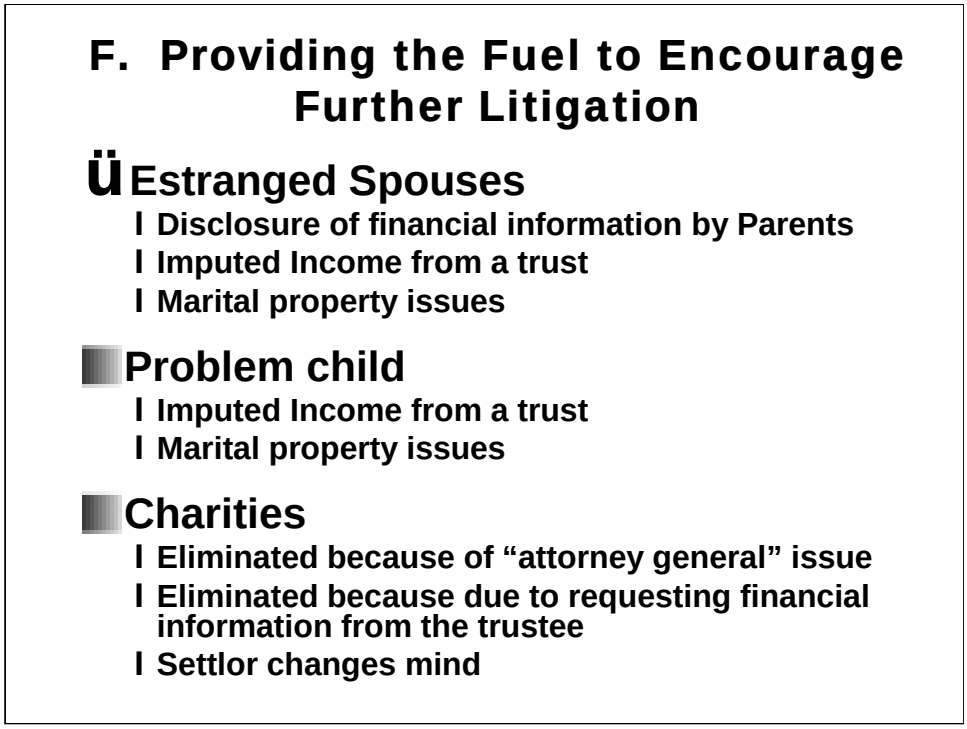
Many times a parent will create a discretionary trust for a child who has mental problems or substance abuse problems. The parent wants the trustee to make hard decisions that the parent would were the parent still alive. The parent realizes that if the problem child is given an enforceable right to sue in court, he or she would do just that – repetitively file actions in courts for greater distributions. This is why the parent choose to create a discretionary trust instead of a support trust. Under the UTC, the child receives an enforceable right to sue pursuant to any distribution standard contained in the trust. Even if a distribution standard is not included, the court will create one of its own. In this situation, the UTC is not a creation of new trust law, nor is it an adoption of a minority position, but rather a complete reversal of common law to the opposite intent of the settlor.

2. All Holders of a Power of Appointment

Not only are the circumstances expanded where a beneficiary may sue the trustee, but the number of people who may sue the trustee under a fiduciary standard is expanded to include all holders of any type of a power of appointment.

E. Poor Drafting Behind the UTC Statute

Many estate planners have commented that poor drafting has led to multiple interpretations of the UTC. Naturally, this also will have an effect on the burdening the judicial system with unnecessary litigation.



F. Providing the Fuel to Encourage Further Litigation

The UTC gives a judge much greater discretion in awarding attorney fees to a beneficiary, or one standing in the shoes of a beneficiary, who sues the trustee. In essence, the UTC creates a situation where problem children and charitable remainder beneficiaries may sue to challenge the client trust maker's wishes, and the client in essence gets to fund the litigation.

Under the Second Restatement, when attorneys sued a trust for fees to protect a beneficial interest, the attorney fee exception was seldom adopted by the courts. Again the UTC takes the exact opposite position of common law by codifying the exception for attorney's fees.[1] The comment under Section 503, states that, "This exception allows a beneficiary of modest means to overcome an obstacle preventing the beneficiary's obtaining services essential to the protection or enforcement of the beneficiary's rights under the trust." However, remember almost all discretionary trusts were created so that the beneficiary had virtually no right to challenge the trust. Hence, the terms "sole," "absolute," "unfettered," and "uncontrolled" discretion were used to mean exactly what they said. However, under the Uniform Trust Code and Restatement Third, a reasonableness standard (or good faith standard) is now imposed on the trustee. Does the attorney fee exception under the Uniform Trust Code now mean the trust is obligated to pay for a challenge by the beneficiary when such challenge was against the settlor's wishes Further, does this mean an exception creditor may challenge a discretionary trust when suing under the distribution standard and the trust is obligated to pay for it? Unfortunately, with the first situation this may easily be the case and, with the second situation neither the statutory language of the UTC nor the comments are clear. Therefore, determination of this issue is not possible, pending future litigation to resolve this issue.

III. Financial Disclosure Issues Regardless of Settlor Intent

A. Controversial Nationally

- Ø The ***Quiet Trust***
- Ø **Utah delegated notice to a third person**
- Ø **North Carolina let settlor intent rule**
- Ø **Ohio eliminated the remainder notification**

B. Why Clients Care

- Ø **Trust Babies Being Dependent**
- Ø **Mom Does Not Get Along With One of the Children**

III. Financial Disclosure Issues Regardless of Settlor Intent

Many clients do not want a beneficiary to know the nature or size of trust assets until it is time for such beneficiary to receive a trust share. In this respect, there are generally two types of beneficiaries: (1) current beneficiaries - those who may receive a distribution currently and (2) remainder beneficiaries. Regardless of settlor intent, the UTC requires disclosure to all qualified beneficiaries.

A. Trust Babies Being Dependent

Most, if not all, settlor clients wish for their children to become financially independent regardless of the trust assets they are to receive. In other words, clients do not want their children to depend upon the trust assets for their future. Similarly, most clients do not wish for children to know the size of the trust until the client feels that the time is appropriate. The current Colorado statute provides for this flexibility. The UTC defeats the wishes of the client settlor for privacy. *For irrevocable trusts there is no method to opt out of the notice provisions.*

B. Mom Does Not Get Along With One of the Kids

Many times, the primary, if not sole purpose, that a trust is created is so that mom and dad may avail themselves of the both applicable exclusion amounts. Further, it is not uncommon for one of the kids to be temporarily at odds with one or both of the parents. Assume Dad passes away, the QTIP and bypass trust are created. At this time, Mom and daughter are at odds, and daughter is currently unwilling to work and may have substance abuse problems. Will mom, daughter, and the trustee find themselves in court attempting to decipher the new undefined "continuum of discretionary trusts?" Will the daughter's trial attorney seek for the recovery of attorney fees under UTC § 503(b)? What about the malpractice issues for attorneys who fail to advise clients about these type of issues? Please note, that under common law if the daughter only had a discretionary interest, most of these issues could have been avoided.

C. Fewer Charities Named Remainder Beneficiaries

- Financial information provided to remainder charitable beneficiaries
- State Attorney General is a qualified beneficiary?
- Moving charitable trusts and assets out of UTC states
- Removing charities residing in UTC states as beneficiaries

C. Fewer Charities Named as Remainder Beneficiaries

The UTC requires notice to all qualified beneficiaries, which includes any remainder beneficiary. This is true even for charitable remainder beneficiaries. *This also means that a charity that may have no current interest in the trust for ten, twenty, or even thirty years would have access to the financial information.* David Harowitz, an attorney from Arizona, has already reported clients eliminating testamentary charitable beneficiaries when they learned that the charities could receive financial information about the trust.

1. State Attorney General is a Qualified Beneficiary

Under the UTC, the state attorney general becomes a qualified beneficiary entitled to request financial information from the trust. Most clients are extremely concerned about giving the government blanket authority to inquire into their or the trust's financial matters, particularly without a court order.

2. Moving Charitable Trusts and Assets Out of UTC States

The most viable solution to counter the UTC is to move both the charitable trust and the underlying assets out of a UTC state. In Oklahoma, one of the heads of a major University's department for charitable giving personally expressed this concern to attorney, Guy Jackson.

3. Removing Charities in UTC States as Beneficiaries

Unfortunately, the long arm jurisdiction of the UTC is so broadly stated, the mere presence of a charitable beneficiary in a UTC state could give the UTC jurisdiction over a charitable trust that had left the UTC state. Therefore, in some cases, once the charitable trust and underlying assets are moved out of a UTC state, removing charities that reside in UTC states as a beneficiary may be considered as part of the planning process.

IV. Estate Tax Inclusion Issues

- IRC 2036 & IRC 2036 Inclusion Issues
- Under § 411, without a court approval, settlor and beneficiaries may terminate a trust
- Personally, we like the UTC position on this issue
  - However, a ruling from the Service should be obtained before adoption

IV. Estate Tax Inclusion Issues

Apparently, the UTC was not fully analyzed regarding the possible estate tax inclusion issues under IRC §2036 and §2041. Professor Jeff Pennell stated on the ALI-ABA Advanced Estate Planning Practice Update satellite video in June of 2004 that the answer is unclear on the estate tax inclusion issue. Also Richard Covey and Dan Hastings in an article regarding the UTC stated that estate taxation due to UTC Section 411(a) was "plausible." *Practical Drafting – April 2004* The concerns and analysis based on estate tax inclusion under IRC §2036 and §2038 were originally discussed and developed by Les Raatz and Susan Smith in Arizona. For a detailed discussion of these estate tax inclusion issues, please download Les Raatz's outline at www.InternationalCounselor.com under Publications then Articles. After Les Raatz presented these issues to the tax planning section of the Arizona Bar, they voted unanimously to reject the UTC.

On the other hand, a Professor Dodge has provided an analysis arguing against estate tax inclusion. Those for and against the UTC have presented arguments for and against estate tax inclusion. If leading professionals on both sides strongly disagree, further guidance should be obtained from the Internal Revenue Service prior to considering implementation of the UTC.

Personally, the authors hope the UTC proponents are correct on this point. This way we may all begin drafting "revocable-irrevocable trusts." Depending on the situation, the assets are excluded from the settlor's estate should the settlor not need them, but the settlor may reach the assets by getting the family to work in harmony should the settlor need them.

V. Rewriting the Settlor's Wishes

- ü UTC 400-415
- ü Trustees or beneficiary
- ü Consent of all beneficiaries (including unborn) and settlor
- ü If settlor is deceased the beneficiaries can revoke the trust
- ü Court can revoke an irrevocable trust

V. Rewriting the Settlor's Wishes

The UTC has again changed common law in this area. At common law, only the Settlor could revoke a trust and then only if the trust was revocable. The UTC has change the common law by presuming that all trusts, even irrevocable trusts, can be revoked. If revocation was limited to situations where the Settlor consents, this may be a change that we all would agree to. However, the UTC extended revocation to situations where the Settlor is dead. Furthermore, a trust can be revoked even if there is a spendthrift clause, which common law previously regarded as a material purpose of the trust.

Presumably, if there are unborn beneficiaries a guardian ad litem would need to be appointed to determine if revocation should take place.

A. Trustee Requesting Termination of a Trust

Most problematic is the ability of a trustee or the court to terminate a trust. A trustee can ask that a trust be revoked or a court may act sua sponte to terminate a trust. This is often contrary to settlor intent and is contrary to the plain meaning of "irrevocable."

B. Spendthrift Provision No Longer a Material Purpose of the Trust

Despite the presence of a spendthrift clause a court can terminate a trust because a spendthrift clause is not a material trust purpose. This poses significant problems because a creditor may be able to convince a judge to agree to revoking a trust. Since a beneficiary can petition a court to revoke a trust (and if the sole beneficiary they can revoke the trust) and because a creditor may step into the shoes of a beneficiary the creditor has all of the rights of a beneficiary. This would include revocation of the trust. This problem may be particularly acute in a bankruptcy situation where the bankruptcy trustee stands in the shoes of the bankrupt, for virtually all purposes.

C. Rewriting the Terms – Even if Trust is Unambiguous

Particularly problematic is a court's ability to rewrite the terms of the trust after the settlor's death even if the trust is unambiguous. While proof of mistake must be shown, this is contrary to case law. Even if a Settlor is honestly mistaken about a fact, this should not permit the court to change the unambiguous terms of a trust. For example if a competent client believes that his daughter is trying to poison him and makes no provision for her in his trust why should a court be allowed to change the clear terms? The issue is not what the court thinks the facts are, the issue is what the settlor with the settlor's own money thinks the facts are. Further, the UTC does not limit the "mistake" to fact or law but also to a statement of expression. This will lead to few statements of Settlor intent and further increase the difficulty in administering trusts under the UTC.

VI. Flight of Trusts
Will History Repeat Itself?

- Portability of Trusts
- Forum Shopping
- Flight of Capital

VI. Flight of Trusts – Will History Repeat Itself?

- **Mississippi -** In 1997, the Mississippi Supreme Court reversed over a century years of common law by allowing a tort creditor exception to spendthrift provisions. *Sligh v. First National Bank of Holmes County*, 704 so. 2d 1020 (Miss. 1997). Many of the trust companies as well as the estate planning attorneys realized that much of the trust business would leave the state of Mississippi due to the holding by the Mississippi Supreme Court. Therefore, both of these factions lobbied quite extensively to reverse the decision by statute. Miss. Code Ann. Section 91-9-503 (Family Trust Preservation Act 1998).

- **Arizona –** In May of 2003, the Arizona Legislature almost unanimously passed the Uniform Trust Code. In April of 2004, despite support for the UTC by the Arizona Bar, the UTC was repealed by unanimous vote – "amid fears that trust business would flee from the state." - Forbes Magazine – August 12, 2004.

- **WealthCounsel Seminar** – July 2004 – Tom Ray, Esq. one of the principals of WealthCounsel, which is an estate planning organization with over 550 members, mentioned he was considering moving even standard marital and family trusts formed in Missouri (a UTC state) to non-UTC states. Generally, most commentators noting the flight of capital issue have discussed high net worth trusts moving out of UTC states. However, these commentators may have underestimated the issue. Many participants at other seminars have voiced similar comments to those expressed by Tom Ray regarding moving trusts out of UTC states.

A. Portability of Trusts

- **All qualified beneficiaries must be given 60 days notice of move and consent to move**
- **Choice of law and Trust Administration defined as separate issues - § 107 & § 108**
- **Would require separate trust provisions to change choice of law and trust administration**
- **Even with specific language a qualified beneficiary may argue statutory 60 day notice and lack of consent**
- **Uncertain whether modification under § 108 will be effective under most significant relationship test of § 107**
  - **"Strong" public policy exception**
  - **Hague Convention reference to protect rights of creditors**

A. Portability of Trusts

As a default provision, the UTC requires a 60 day notice and the consent of all qualified beneficiaries to change the place of trust administration.

1. Choice of Law and Trust Administration – Separate Issues

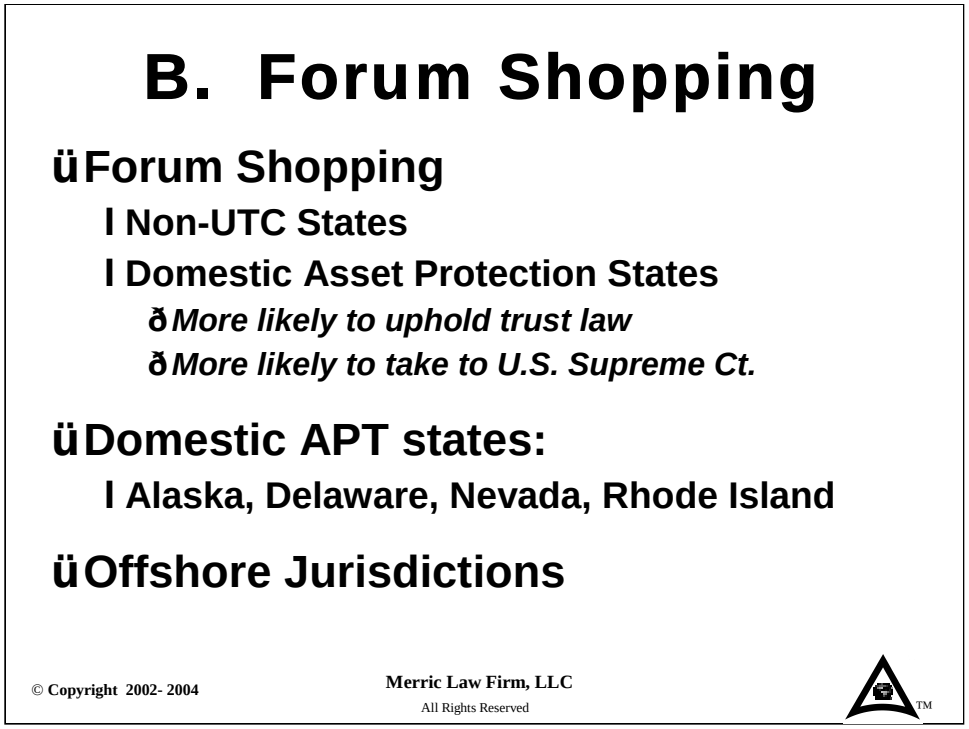
The UTC defines choice of law and place of administration as two separate issues. However, many irrevocable trusts which allow a trustee to change the governing law of the trust refer only to choice of law. Unfortunately, the two concepts are interrelated. A trustee is usually chosen in a jurisdiction where the choice of law is to apply, otherwise often there will not be sufficient nexus. By changing the trustee and amending the trust, the choice of law and administration of the trust are usually changed. In order to change both the administration of the trust and the choice of law of the trust without the default rule applying, separate trust provisions regarding each issue would need to be in each trust.

2. Specific Language May Not Be Sufficient

Even if two separate provisions are included in an irrevocable trust allowing the change of both the law of the trust and the administration of the trust, it is uncertain whether a beneficiary will still have a statutory right to notification and approval.

3. Even if Specific Language Sufficient, It May Not Be Effective

Further, even if an irrevocable trust specifically provides for change both the place of administration without qualified beneficiary consent and the choice of law, such provisions may not be effective due to the "most significant relationship test" and "strong public policy" arguments under UTC §108, which cannot be waived pursuant to UTC §105(12).



B. Forum Shopping

The authors strongly believe that the defects in both the UTC and Restatement Third from an asset protection perspective as applied to non-self settled trusts are so great that estate planners in a UTC state should seriously consider forum shopping and using the laws of another state or nation for their high net worth or specialized estate planning trusts. From a domestic perspective, an estate planner will have two options: (1) a non-UTC state; or (2) a domestic asset protection state. The authors would suggest that a domestic APT state may prove to be a better choice. In the event a conflict of law issue arises between a non-UTC state and a domestic APT state, many judges in non-UTC states may not be as concerned with upholding their own state law as a judge in a domestic APT jurisdiction. Second, it appears much more likely that a domestic APT state would have a strong public policy reason to see the conflict of law issue through to the U.S. Supreme Court. For domestic asset protection trust states, estate planners should consider Alaska, Delaware, Nevada, and Rhode Island. It should be further noted, that if the trust is not a grantor trust and is accumulating income, an offshore jurisdiction most likely will not be a valid option due to the application of the "throw back" rules in computing tax.

C. Flight of Capital

üFlight of Liquid Assets

- Most significant relationship test
- Factor test
- Possible primary factors
  - ð *Trustee*
  - ð *Location of the assets*
  - ð *Where the trust was originally formed*

C. Flight of Capital

Unfortunately, the conflict of law clause in the UTC and Third Restatement allow a judge to use the "most significant relationship" test if the law chosen under the trust violates a strong public policy of the forum state.[i] It is highly questionable whether such a nebulas conflict of law provision would be upheld by the U.S. Supreme Court. However, a factor test involving issues of the residence of the trustee, the location of assets, where the trust was originally formed, the residence of the settlor, and the residence of the beneficiaries may be more determinative. In this respect, the more factors in favor of the non-UTC jurisdiction the more likely the choice of law clause in the trust will be upheld. Further, two of the factors the residence of the trustee and the location of the assets may be weighed more heavily than the other factors. For this reason, in the event the estate planner has decided that forum shopping is the best alternative, it would be generally wise to move all liquid assets out of UTC states to the non-UTC jurisdictions.

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[i] *Uniform Trust Code*, Section 107.

Trusts moving out of State

Robert D. Gillen, Esq.

Letter, February 6, 2004

"Even more alarming regarding the flight of Arizona trusts and capital was when I was asked by an attorney for a large multi-state bank if I would assist their clients in creating trusts outside of Arizona or changing situs of the trusts from Arizona to other states."

Similar to the flight of trusts leaving Mississippi after its Supreme Court decision on allowing a tort creditor to recover against a trust, trusts leaving UTC jurisdictions is not an unexpected consequence. Not only are the authors aware of many of their own clients stating that they would leave UTC jurisdictions, but at least one major bank did not want to put up with the UTC. It was this banks intention to avoid the UTC by transferring their trust business out of Arizona to non-UTC states. Fortunately, Arizona repealed the UTC in its entirety and such a migration of trusts never began .

VII. Poor Drafting

- ACTEC – List Serve
- Nothing more than a skeleton statute
- "If estate planners can easily come to multiple meanings of the same text, imagine what a judge untrained in trust matters will do?"
- Poor drafting is beyond DEADLY when poor decisions from other states may be relied on for interpretation of your states laws. UTC § 1101.

VII. Poor Drafting

The UTC is beginning to receive sharp criticism for the poor drafting contained in the statute. Some discussion of this has been on the ACTEC listserv and the ABA listserv. Simply stated, if multiple estate planners read the statute and come up with multiple meanings, the drafting leaves much to be desired.

As noted in the ABA's treatise on asset protection Volume II Chapter 3 to be published in December of 2004, the UTC is nothing more than a skeleton statute that makes over 100 specific references to the Third Restatement and a preferential reference to the Third Restatement over common law in the comment to UTC § 106. For example, the Third Restatement is virtually required to interpret most of Article 5 of the UTC to provide any consistent meaning. A statute that requires extensive reference to a 700 page treatise for interpretation of the plain meaning of the statute leaves much to be desired.

Unfortunately, poor drafting is not limited to Article 5, but appears to run throughout the statute. The consequence of the faulty drafting is a large amount of unnecessary litigation.

The problem of creating bad and unintended law is further multiplied when, in many areas, the Uniform Trust Code in many areas is becoming not so "uniform." In other words, as more and more concerns are raised by opponents of the UTC, there are more and more different major state modifications to the UTC. Many states such as Wyoming, Kansas, Missouri (and possibly in the future Connecticut, Ohio, North Carolina, South Carolina) claim to have made substantial modifications to the UTC. Now, in many states, we will have judges with little trust law background applying irrelevant decisions of other UTC states under UTC § 1101. Naturally, the most likely result is more bad trust law.

VIII. Is the UTC Capable of Amendment?

- **Poor Design**
- **The UTC "flies straight in the face of current trust law."- David Harowitz**
- **"Amending the UTC is like trying to turn an Edsel into a Porshe." – Mark Merric**
- **Sure it can be amended by a complete rewrite of 40-60 pages of a ninety page act**

  – Doug Stein
- **Remember, one must also address 100 pages of UTC comments, as well as 100 specific references into the Third Restatement**

VIII. Is the UTC Capable of Amendment?

The issue of poor drafting implies that the UTC may possibly be fixed. The issue of poor design implies that it may well be better to start with a completely different model.

As noted in discussions with the proponents of the UTC, a key concern is that the UTC has created new and untested law, reversing over 125 years of judicial wisdom, and has taken many distinctly minority positions as the preferred view, again reversing the wisdom of most courts in these areas. It is the UTC's changes to the common law that has broad out the concerns from the opponents of the UTC. Unfortunately, the issue appears to be much deeper than amending the many areas where the UTC does not follow common law.

The UTC was built from and is fundamentally based on the "new view" of trust law as promulgated by the authors' of the Restatement (Third) of Trusts. The Third Restatement admits that it was written to "to enable the living – especially judges – to adapt the settlor's expressed purposes to contemporary circumstances." The result of this new view of trust law is the public uproar over the UTC. For the most part, current trust law is built on the "golden rule" – "The settlor with the gold rules how it shall be administered and enjoyed." The UTC takes the opposite position holding that judges or beneficiaries have the ability to rewrite the settlor's intent through litigation. Further, the common law has generally prevented creditors from attaching a beneficiary's inheritance. Again, the UTC appears to take the opposite approach, making a beneficiary's interest widely available.

A further practical problem is presented. Even if one is going to make massive revisions to the UTC, the UTC is interpreted by close to 100 pages of comments. Now, if the UTC were adopted with modifications, each comment as well as each reference into the Third Restatement must be specifically refuted or agreed to.

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IX. Malpractice Issues

A. The Claim: Failure to Disclose of the Substantial Decrease in Asset Protection

B. Common Examples

- **Divorce – trust considered division of marital property**
- **Imputed income for alimony & child support on a discretionary trust –** *Dwight v. Dwight*
- **Judicial foreclosure sale of a beneficiary's interest**
- **Bankruptcy of a beneficiary**

IX. MALPRACTICE ISSUES

In the area of third party trusts (i.e., non-self settled trusts), both the UTC and the Third Restatement create the new continuum of discretionary trust law. Further, in several key areas, distinctly minority case opinions are adopted as the preferred view. The result is decreased asset protection for beneficial interests discussed in this outline. There are additional issues outside the scope of this outline.

A. The Claim

Would a client end up in a better position had the client settled a trust in a non-UTC jurisdiction? In the event the case went as far as the U.S. Supreme Court, many commentators have expressed different views which law a judge would apply under conflict of law principles. However, this is not the issue in the beneficiary's mind. In the beneficiary's mind, the issue is whether the settlor been adequately informed and would the beneficiary possibly have had a better chance in saving some or more of his or her beneficial interest in some other jurisdiction.

B. Common Examples

- Estranged son or daughter in law awarded part of the trust as a division of marital property.
- Son or daughter is imputed income from a discretionary trust to determine child support or alimony.
- Child sues mom for distributions on a family trust
- An exception creditor sells a debtor/beneficiary's interest at a judicial foreclosure sale for pennies on the underlying value.
- An ordinary creditor attaches all distributions on a beneficial interest until the claim is satisfied in full.

IX. Malpractice Issues

C. The Motive For Non-Disclosure

- The Gravy Train Revisited

D. Malpractice Per Se?

- Generally, any non-UTC state will have better creditor law
- $2,000 to $3,500 a year fee to manage a passive interest (i.e., LLC or P/S interest)
- Is the real issue, how much did the client lose

IX. MALPRACTICE ISSUES

C. The Motive For Non-Disclosure of Non-UTC States

Generally, most estate planners recommend forming trusts where the estate planners are licensed. Seldom does an estate planning attorney advise a client to form a trust outside of the state that they practice in. This may be for the following reasons: (1) prior to the UTC, most state laws regarding asset protection of a trust beneficiary's interest were relatively similar; (2) estate planners did not wish to co-counsel and share attorney fees using a state where they were not licensed; or (3) estate planning attorneys would upset existing referral relationships from instate trust companies and financial advisors by recommending the trust and underlying assets move out of state. All of these motives may be referred to something known as "the gravy train."

D. Malpractice Per Se

While many practitioners will take the position that it is not malpractice per se not to notify the client and or the beneficiaries of all of these issues, this may well not be the client's or a beneficiary's position if a substantial amount of assets are lost to a creditor when compared to the most likely more favorable result under prior common law or the laws of a Non-UTC state. The client's view may be particularly well supported when the incremental cost to use an out of state trust company to manage a partnership or LLC interest is as low as $2,000 to $4,000 annually.

WINNERS AND LOSERS

A. Winners

The group that will most likely benefit the most from passage of the Uniform Trust Code is the trial attorneys. There will be increased litigation in an area with traditionally very little litigation risk, because a theme of the UTC is to give beneficiaries a greater right to change the settlor client's intent through litigation. One prominent estate planning attorney has noted that the UTC is a "lawyer's full employment bill – creating a true lawyer's bonanza." – Jane Freeman.

Multi-state banks may benefit from the UTC. As noted by Robert Gillen, Esq., multi-state banks can easily shift business out of UTC states to states with more favorable trust legislation. However, will estate planners advise clients to continue with the same bank in a different location?

Non-UTC states naturally are also great winners. However, many estate planners may further advise clients to move to the more asset protective jurisdictions previously discussed. Alaska, Delaware, Nevada, and Rhode Island may be better jurisdictions in which to re-domicile trusts.

Losers

- Losers
  - Single State Trust Companies
  - Financial Planners
  - Estate Planners
    - *Business leaves state*
    - *Complications of planning*
    - *Malpractice Issues*
  - State Fiscal Losses
  - Burdening the Judicial System
  - Beneficiaries of SNTs
  - Beneficiaries of Estranged Spouses and Other Creditors

LOSERS

B. Losers

In state trust companies are major losers under the UTC, because of the anticipated loss of business. Clients are outraged that they will pay additional unnecessary attorney and trustee fees under the UTC. Finally, local estate planning attorneys are upset that clients lose fundamental estate planning alternatives and local attorneys must now co-counsel with non-UTC attorneys and move business out of Colorado. Further, because of the flight of trusts from UTC states to non-UTC states, UTC states lose the income tax revenue from assets fleeing a UTC state. Finally, the UTC state picks up the tab for additionally burdening its already overburdened judicial system.