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From: **Steve Leimberg's Asset Protection Planning Newsletter**

Subject: **Uniform Trust Code and Asset Protection in Non-Self Settled Trusts**

A considerable amount of discussion (both heat and light) has been generated in the past year concerning the Uniform Trust Code's ("UTC") effect on asset protection for the beneficiary of a non-self settled trust.

With significant changes to the common law promulgated by the Restatement (Third) of Trusts ("Restatement Third") which then are incorporated into the UTC, some estate planners are commenting that the UTC is more controversial than the Uniform Probate Code was when it was first adopted.

Estate planning authorities **Mark Merric**, **Douglas Stein**, and **Jane Freeman** provide Leimberg Information Services members with a summary of the many areas where the UTC decreases asset protection for non-self settled trusts.

Mark Merric is a national speaker on estate and asset protection planning. Mark is also a co-author of CCH's treatise on asset protection, *The Asset Protection Planning Guide*, and the ABA's treatises on asset protection, *Asset Protection Strategies Volume I*, and *Asset Protection Strategies Volume II*.

Douglas Stein has lectured nationally and locally on Medicaid planning, guardianship issues, charitable giving, qualified plans, asset protection and estate planning. Doug is also nationally published in *Probate & Property* and *Exempt Organizations* review.

Jane Freeman is a member of the National Academy of Elder Law Attorneys, Wealth Counsel, the Trust and Probate Section and the Taxation Section of the Colorado Bar Association, and the Legal Problems of the Elderly Committee.

UTC proponents proclaim this "continuum of discretionary trusts" to be the "modern" view of trust law. Opponents believe that the UTC and its "continuum of discretionary trusts" are major steps - but ones in the wrong direction, particularly in light of a settlor's right to choose whether their property passes to their beneficiaries free of the beneficiary's creditors. One author has said, "Because of the issues surrounding the UTC, planners should consider moving all trusts and the underlying liquid assets intended to be creditor-protected out of UTC states." Merric & Oshins, *Estate Planning*, August 2004, Vol. 31, No.8. At a minimum, commentators agree several sections of the UTC are controversial but few can be expected to be as controversial as Article 5, which sets forth creditor's rights. Richard Covey & Dan Hastings, *Practical Drafting*, October 2003.

Because of the importance of asset protection in estate, financial, and employee benefit planning, every member of the planning team should be aware of the potentially

sweeping implications of UTC impact and the increased importance of careful state law selection in the situs of a trust!

## **EXECUTIVE SUMMARY:**

In an historic move, the UTC and the Restatement Third abolish the common law distinction between discretionary and support trusts. These well recognized trusts, deeply rooted in common law, are replaced by a newly created trust theory known as a "continuum of discretionary trusts."

The new theory of a "continuum of discretionary trusts" is heavily weighed in favor of creditors to the detriment of beneficiaries. Prior to the enactment of the UTC and adoption of the Restatement Third this new and untested theory of a "continuum of discretionary trusts" had not been the law in virtually any state.

One of the key issues is whether it is prudent to change the discretionary-support distinction crafted by legislative and judicial wisdom over the last 125 years in favor of a totally new and untested theory, which has not been vetted by the bar at large. The issue becomes particularly important when there is no public outcry for such legislation.

## **SUMMARY OF SEVEN AREAS OF PROTECTION REDUCTION:**

Although there are many areas where the UTC reduces common law asset protection available to beneficial interests, seven of these areas are summarized below.

### **1. CREATION OF AN ENFORCEABLE RIGHT OR PROPERTY INTEREST**

Under UTC 504(d) and by means of the good faith requirement of UTC 814(a), the newly created and untested "continuum of discretionary trusts" theory will create a property interest out of almost all current beneficial interests. It is a long settled principal of debtor creditor law that a creditor can attach and foreclose against a property interest no matter how remote or contingent. As applied to trusts, spendthrift protection may provide some limited protection. Regardless of spendthrift protection, once a property interest or a right to property is created, collateral issues must also be addressed.

These issues include:

- I Whether the enforceable right creates an available resource for special needs trusts?
- I Whether the property interest becomes marital property or a factor to be calculated as part of an equitable division of marital property? Similarly, is the income from that property interest included in the imputation of income for determination of awards of child support or alimony?

1 Whether a bankruptcy trustee can stand in the shoes of the debtor/beneficiary, enabling the bankruptcy trustee to force a distribution or sell the property interest? While the novelty of the UTCs approach makes definitive answers to these issues impossible, it is conceivable, if not expected, that cases interpreting the UTC will depart from fundamental trust principals to a trust beneficiary's detriment.

## 2. **PROTECTION PROVIDED BY A "CONTINUUM OF DISCRETIONARY TRUSTS"?**

Proponents of the UTC changes argue that a "continuum of discretionary trusts" is more protective, because all trusts are deemed "discretionary." But is this really the case? Under common law, discretionary trusts gain their protection from the inability of a beneficiary to force a distribution. Because a beneficiary had no property rights and no right to force trust distributions, a creditor could not "stand in the shoes" of the beneficiary and force a distribution or attach a beneficial interest. Further, the beneficiary could continue to enjoy the trust proceeds if the trustee paid the beneficiary's expenses directly to the service provider without making a direct payment to the beneficiary. Consequently, virtually no creditor could recover from a discretionary trust even though the beneficiary continued to benefit from the trust. Under the UTC, a beneficiary most likely will gain a property right and therefore an enforceable right to a distribution, thereby destroying the common law protection of discretionary trusts. The "continuum of discretionary trusts" by all appearances functions like a "continuum of support trusts" under common law. Under common law, only support trusts relied upon spendthrift protection. Under the UTC, all trusts, whether discretionary or support, must rely solely upon spendthrift provisions for the availability of asset protection.

## 3. **THE "CONTINUUM OF DISCRETIONARY TRUSTS" AND EXCEPTION CREDITORS.**

Prior to the UTC, if a beneficiary held a discretionary interest in trust, there was virtually no avenue for creditor recovery. Since a beneficiary had no enforceable right to a distribution, neither did the creditor. With a support trust, only narrowly defined exception creditors (child support, certain government liens, etc.) could attach beneficial interests and force a distribution. The trustees of both discretionary and support trusts could pay the beneficiary's expenses directly. The UTC changes the rules. All exception creditors may attach both current and future distributions from what were formerly both discretionary and support trusts. No longer may the trustee directly pay any expenses on behalf of a beneficiary without recourse. Under the UTC, no longer can a settlor determine if the settlor's assets should be used to pay a beneficiary's debts. That role under the UTC resides with a judge. The judge also determines whether a beneficial interest, either an interest entitled to current distributions or a remainder interest, should be sold at judicial foreclosure sale. Finally, a former spouse may force distributions directly from a trust for the collection of alimony and child support. This begs the question: "How does a continuum of discretionary trusts provide any asset protection?" An exception creditor either attaches or does not attach a beneficial interest. The judge either allows the current or remainder beneficial interest to be sold at a judicial

foreclosure sale or not. Either way, a beneficiary cannot continue to enjoy the trust property. Further, a former spouse is allowed to directly recover from any trust, discretionary or support under common law, for child support or alimony. These newly created UTC remedies are independent of the newly created "continuum of discretionary trusts."

#### **4. THE "CONTINUUM OF DISCRETIONARY TRUSTS" AS A "CONTINUUM OF CONTINUING LITIGATION"**

The "continuum of discretionary trusts" theory is completely undefined by either the Restatement Third or the UTC. There is no definition of the most discretionary trust types or the least discretionary trust types. Further, the beginning, middle, and end of the continuum remain unidentified and undefined. There is no path upon which a practitioner safely can walk. The proverbial yellow brick road is fragmented and crumbling. A future wave of litigation is required to define the contours of the UTC's new spectrum. In the interim, uncertainty and conflicting results will be the norm. One area of concern is the viability of special needs trusts. Under the UTC, a beneficiary of a special needs trust will have the right to force a distribution from trust. Will income be imputed to an otherwise Medicaid eligible beneficiary thereby disqualifying the beneficiary from governmental aid? Case law from Connecticut, Ohio, and Pennsylvania has determined that when the judicial threshold for review of a discretionary trust is reduced to a standard similar to good faith, the beneficiary had an enforceable right constituting an available resource. *Metz v. Ohio Dept. of Human Services*, 762 N.E. 2d 1032 (OH App. 2001).

The same issue arises in the divorce context in determining alimony and child support. A beneficiary of a discretionary trust may be held to have an enforceable right to an amount of income per year. The income would then be imputed to the beneficiary for the determination of alimony or child support, regardless of whether any distributions are actually made. To date, the only case decided in this area which references the Restatement Third substantiates this result. *Dwight v. Dwight*, 756 N.E. 2d 17 (Mass. Ct. of App. 2001). The same analysis is equally applicable to a bankruptcy trustee standing in the shoes of the bankrupt who then may force a distribution on behalf of all creditors. In the context of imputing income, whether for a special needs trust, determination of child support or alimony, or in a bankruptcy context, the "continuum of discretionary trusts" may provide a little more asset protection for one type of discretionary trust over another type of discretionary trust.

Ultimately, the court's decision will be a function of the specific facts and circumstances surrounding each particular case. The challenge of such a fact based criteria is the creation of extreme drafting uncertainty for the practitioner. The existing law contains few of the uncertainties inherent in the UTC. Prior to the creditor favorable theory of "continuum of trust law" proposed by the Restatement Third and the UTC, the imputation of income from a discretionary trust in a divorce context was unheard of. Income was only imputed as an available resource in the area of special needs trusts when courts used a judicial standard of review approximating good faith or reasonableness. Coincidentally, good faith and reasonableness are the judicial standards of review adopted by the UTC

and Restatement Third. To date, the issue has not been raised in bankruptcy court. When compared to the time-tested discretionary-support distinction found in the common law, the "continuum of discretionary trusts" theory appears to be deficient.

The UTC and Restatement Third invite an unprecedented waive of new litigation and create considerable uncertainty in the estate planning process. The magnitude of the future litigation explosion may be comprehended when one thinks of all of the different language combinations attorneys use to create discretionary or support trusts. Under the UTC, the literal language of each of these combinations must be analyzed in the various jurisdictions. The lower and appellate courts must then determine the amounts and timing of distributions based upon the distribution language of each individual trust.

## **5. GREATER OR LESSER SPENDTHRIFT PROTECTION**

Subject to the limitations discussed in this commentary, only spendthrift protection remains for all trusts under the UTC. Prior to the UTC, the Restatement Second listed four exception creditors:

1. Alimony and child support;
2. Necessary expenses of a beneficiary;
3. Attorney fees for a beneficiary who makes a claim against the trust;
4. Any governmental claims.

Under the common law, an award of attorney fees to a beneficiary claimant against a trust was seldom approved by the courts. Beneficiaries or creditors standing in the beneficiary's shoes would have been encouraged to challenge the wishes of the settlor. It was determined to be sound public policy not to encourage litigation by these claimants. The UTC essentially adopted the same exception creditors. However, while under common law an exception creditor for attorney fees to a beneficiary or for a creditor standing in the shoes of the beneficiary were seldom approved, attorney fees have become a defined and enforceable exception creditor under the UTC. Governmental claims require that a state or federal statute must specifically mention recovery under UTC 503(c). For the moment, the UTC provides fewer exception creditors because federal and state governments have not yet had the opportunity to take action providing for statutory recovery from a trust. However as soon as government takes such action, the government claim exception becomes applicable to all trusts, whether categorized as discretionary or support under common law. The range of permitted exemption creditors under the UTC is further enlarged because the act explicitly permits extension in the number and scope of exception creditors by both the judiciary and the legislature. The reporters notes from the Restatement Third even encourage the judiciary to add further exception creditors.

## **6. ATTACHMENT OF BENEFICIAL INTERESTS BY ALL CREDITORS**

The inability of the trustee to pay the expenses of a beneficiary is much more expansive than one might think. Most special needs a trust pay the expenses of a beneficiary so that

a distribution is not considered an available resource and therefore does not adversely affect Medicaid eligibility. UTC 501 can be interpreted to permit all creditors to attach present and future distributions. UTC 501 provides that "[t]o the extent a beneficiary's interest is not protected by spendthrift provisions, the court may authorize a creditor or assignee of the beneficiary to reach the beneficiary's interest by attachment of present or future distributions to or for the benefit of the beneficiary . . . ." Under the Second Restatement, distributions received by a beneficiary are not protected by spendthrift provisions. The result is that spendthrift provisions protect assets only while held in trust and not held by the beneficiary. Therefore, if a spendthrift clause only protects assets that are held in trust, does UTC 501 allow attachment at the trust level by any creditor V not just an exception creditor? In other words, may any creditor attach assets at the trust level similar to a charging order in the context of a family limited partnership? In such a scenario the creditor merely has to wait for present or future distributions to satisfy its claim. If UTC 501 is so interpreted, UTC 501 almost completely defeats the asset protection benefits of using a trust, because distributions in essence are frozen with the possible minor exception of necessary expenses of the beneficiary as determined by a judge.

## **7. END ROUND FOR ALL CREDITORS?**

All creditors may attach "overdue" or "mandatory" distributions under UTC 506. Unfortunately, the terms "overdue" and "mandatory" remain undefined. Additional problems are created when one refers to the Restatement Third for interpretation of a mandatory distribution under the newly created theory of a "continuum of discretionary trusts" A judge must now interpret the distribution language of a trust to determine where the trust should be classified on this new unidentified "continuum of discretionary trusts" in order to determine whether a distribution is "overdue". Once the "overdue" or "mandatory" determination has been made, the judge must determine "how much" and "when" such distributions should have been dispersed to the beneficiary. This calculation becomes the amount that would become an overdue distribution if it had not previously been paid to the beneficiary and would now constitute a resource available to the creditor.

Alternately, distribution language such as "the trustee may make distributions, in the trustee's sole and absolute discretion, for health, education, maintenance, and support" may create a scenario where the judge concludes the trustee should periodically make distributions to the beneficiary in the future. Under this scenario, the imputed distributions would be subject to attachment by any creditor.

## **BOTTOM LINE**

Proponents of the UTC argue that only estranged spouses can attach and force distributions from spendthrift trusts for child support or alimony under the UTC. The distributions can be forced from both discretionary and support trusts. Therefore, an estranged spouse can force a distribution from any trust to satisfy an alimony or child support claim.

However, the UTC proponents fail to mention that

- (1) an estranged spouse making a claim for alimony or child support may seek payment of attorney fees from the trust;
- (2) all creditors may attach an undefined over-distribution;
- (3) a trustee may no longer pay the beneficiary's expenses directly;
- (4) possibly all creditors may attach a distribution at the trusts level and wait until the claim is satisfied;
- (5) the judge may order the judicial foreclosure sale of a current or remainder interests;
- (6) exception creditors may be easily expanded by legislation or the judiciary;
- (7) exception creditor status would now apply to all trusts, not just support trusts as under common law;
- (8) by creating a property right in the beneficiary such an interest may be classified as marital property, a factor to be used in the equitable division of marital property, or create the imputation of income to a beneficiary for child support or alimony
- (9) by creating an enforceable right to a distribution, beneficiaries of many special needs trusts will now have an available resource which results in the denial of benefits; and
- (10) by creating an enforceable right to a distribution, a bankruptcy trustee may be able to exercise this right on behalf of all creditors. Whether an estranged spouse may force a distribution from a discretionary trust to satisfy a claim for alimony or child support is merely one minor issue among a myriad of changes to the common law.

### **WHAT'S THE REAL ISSUE?**

Is saving children really the issue? In most states, persons delinquent in paying child support go to jail. Consequently, a beneficiary would be expected to make all reasonable requests of a trustee for a distribution to avoid jail time. While there may be isolated cases of a discretionary trust beneficiary being able to avoid the payment of child support, the UTC's position appears to be legislation which is not based upon any public outcry.

Further, the UTC position is in contravention of other existing public policies. It is settled public policy to allow settlors to dispose of their own property any way they deem fit.

Contrary to the assertion by promoters of the UTC that settlors of trusts want their trusts invaded for the child support or alimony obligations of their children, the authors have never found this to be the case. In fact, most clients insist that the trust be available only to their children, and the residue only, if any, be left to their grandchildren.

**HOPE THIS HELPS YOU HELP OTHERS!**

**Mark Merric Douglas Stein Jane Freeman**

**Edited by Steve Leimberg**

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For a detailed explanation of these issues and many more please see Estate Planning Magazine, Volume 31, No. 8, August, September, & October 2004; In particular, you'll find the article "UTC May Reduce the Asset Protection of Non-Self-Settled Trusts" by **Mark Merric** and **Steven J. Oshins** highly enlightening.

The commentary above is based on Chapter 3 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](http://www.InternationalCounselor.com).