How Will Asset Protection of Spendthrift Trusts Be Affected by the UTC?

The changes made by the new Uniform Trust Code are likely to reduce significantly the asset protection of non-self-settled trusts. This third part of a three-part article analyzes the UTC and its implications.

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The Uniform Trust Code

Presently, nine states—Kansas, Maine, Missouri, Nebraska, New Hampshire, New Mexico, Tennessee, Utah, and Wyoming—plus the District of Columbia have enacted the Uniform Trust Code ("UTC"). The UTC is under review in numerous other states. Arizona enacted the UTC in May 2003, but within a year, due to the public outcry and estate planning attorneys' strong opposition, it was repealed by unanimous vote of both the House and the Senate. The UTC was also defeated in the Colorado legislature and was killed in a Senate Committee in Oklahoma despite the support of both Bars.

After intensive study in Texas, Minnesota, and Indiana, some minor portions of the UTC were adopted, but most of the UTC's provisions were rejected. The Texas Bar is currently drafting anti-Restatement (Third) of Trusts ("Restatement Third") legislation. One of the principal reasons the UTC was repealed in Arizona and is receiving strong resistance in several other states is the radical departure that the UTC and Restatement Third take from common law regarding the traditional asset protection afforded by discretionary dynasty trusts as well as spendthrift trusts in general.

For well over 400 years, trust law has been based on the property concept that a donor may make a gift subject to whatever restrictions he wishes. While there are some limited public policy exceptions to this rule (such as restrictions on marriage), the common law has generally allowed trusts to follow the settlor's intent. The UTC and the Restatement Third are both built on the opposite assumption.

With respect to discretionary trusts, the UTC and Restatement Third rest on the assumption that the beneficiaries should have a much greater right to challenge the settlor's wishes through litigation than prior law has allowed. The UTC and Restatement Third overturn 125 years of well-established trust law by equating the asset protection features of a discretionary trust with those of a support trust. For this reason, in the area of traditional asset protection through non-self-settled trusts, should a state legislature adopt the UTC or a court decide to follow the Restatement Third, a completely separate analysis of asset protection is provided below.

Understanding the UTC. The UTC and the Restatement Third are interrelated. The comments from the UTC contain over 100 specific references to the Restatement Third's text, comments, and reporter notes. Additionally, the comment under section 106 of the UTC implies that the Restate-

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ment Third should be given a preference even over common law when interpreting the UTC.

The committees of both the Restatement Third and the UTC worked hand in hand to draft a few areas of new trust law. While there are minor differences in the asset protection issues between the two pronouncements, for the most part the two pronouncements read as though they were written by the same authors. With respect to traditional asset protection, the Restatement Third is for the most part not a restatement of trust law at all. Rather, it is a new and untested approach to trust law. The same is true for Article 5 of the UTC, which appears to be an abbreviated version of the Restatement Third, sections 50 and 56-60.

If one reads Article 5 of the UTC without reading corresponding Restatement Third sections, one might easily conclude that the UTC is incredibly confusing and poorly drafted. However, if one reads the Restatement Third first, Article 5 of the UTC—even though it is still poorly drafted—begins to make some sense. Therefore, to understand Article 5 of the UTC, a practitioner may wish to first read the aforementioned sections of the Restatement Third.

The cornerstone of the common law discretionary trust. Under common law, a court would interfere with a trustee's "sole and absolute" discretion of a discretionary trust only if the trustee (1) acts dishonestly, (2) acts with an improper motive, or (3) fails to use his or her judgment.[1] A beneficiary had little, if any, standing to sue for a distribution or to question the amount of a distribution unless the beneficiary could prove one of the above factors was present. In almost all states, there was no reasonableness or good faith standard for a discretionary trust that used qualifying adjectives such as the trustee's "absolute," "unlimited," or "uncontrolled" discretion. Section 187 of the Restatement Second provides that such qualifying adjectives dispensed with the standard of reasonableness.

Because the beneficiary had such a high threshold to meet, the beneficiary had virtually no enforceable right (i.e., property interest). *This lack of an enforceable right is the fundamental cornerstone for the asset protection of a discretionary trust.* The principle is simple. A creditor cannot compel the trustee to pay anything because the beneficiary cannot compel payment.[2] This is the common law asset protection difference between a support trust and a discretionary trust. A support trust has a judicial standard of review of reasonableness, 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., a "bad faith" standard).

Ohio—A tale of what not to do

The following analysis of Ohio law demonstrates the beginning of the problems that occur when the judicial standard of review is dropped to Ohio's possible definition of abuse, good faith or reasonableness. In Ohio, it appears that the standard of review of a discretionary trust has gradually been shifting from a bad faith concept to more of a reasonableness standard.

In 1945, the Ohio Supreme Court held that "[w]here the terms of a trust 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."[3] This would mean that the beneficiary would have little, if any, standing in court. However, by

[1] Different courts define the term "bad faith" slightly differently. As used in this article, "bad faith" means the trustee (1) acts dishonestly, (2) acts with an improper motive, or (3) fails to use his or her judgment. In Re Jones, 812 P.2d 1152 (Colo., 1991) (citing *Scott on Trusts,* section 130 at p. 409 (4th ed. 1989)). Also see the detailed analysis in *Scott on Trusts,* section 187 at p. 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 trustee's discretion would generally be deemed final." Furthermore, section 187.2 provides, "[e]ven 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 where he acts dishonestly or in bad faith, or where he acts from an improper motive." This analysis by *Scott on Trusts* remains consistent through the 2003 supplemental volume. *Bogert* in *The Law of Trusts and Trustees* (2nd ed. 1980, Supplement through 2003) also seems to hold relatively the same definitional analysis as *Scott.* Section 560 of the Supplement at page 183 states that if a settlor has given a discretionary power (without qualification), the court is reluctant to interfere with the trustee's use of the power. Hence, in the absence of one or more of the special circumstances mentioned hereinafter, the court will not upset the decision of the trustee. These special circumstances (at page 196) are (1) a trustee fails to use his judgment, (2) an abuse of discretion, (3) bad faith, (4) dishonesty, and (5) an arbitrary action. Regarding the issue of "arbitrary action," *Bogert* provides that if the trustee has gone through the formality of using his discretion, but has not deliberately considered the arguments pro and con, and thus has made a decision for no reason at all, his conduct may be characterized as arbitrary and capricious, as amounting to a failure to use his discretion. In this respect, *Bogert* suggests that the "arbitrary" action is a subset of a trustee failing to act. Also, both *Scott* and *Bogert* note that a few states have statutes where unless the trust agreement contains language such as the "sole and absolute discretion" of the trustee, the trustee may not act arbitrarily. *Bogert,* 2003 Supp. at 199, n. 85; *Scott,* section 187.2, p. 39, n. 12; Cal. Prob. Code § 1608, enacted 1986 c.820; Mont. Code § 72-23-306 (1983); N.D. Cent. Code § 59-02-12; S.D. Codified Laws § 55-3-9 (1967).

[2] Restatement (Second) of Trusts ("Restatement Second"), section 155, comment b.

[3] McDonald v. Evatt, 62 N.E.2d 164 (Ohio, 1945).

1955 it appears that the standard in Ohio was shifting to one of "good faith."[4]

Adding more confusion, in 1962, the Ohio Court of Appeals in *Culver v. Culver*[5] stated that "[o]f 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,[6] then the courts can interfere, but not before." Here, the court appears to be stating that both a good faith standard and an abuse standard apply.

In 1968, in *Bureau of Support in the Dept. of Mental Hygiene and Correction v. Kreitzer*[7] (a supplemental needs case), the Ohio Supreme Court held that even though a discretionary distribution standard used 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. The court did not discuss what abuse standard Ohio had adopted or into what category of abuse the above situation would fall. Rather, the court merely held that the fact pattern constituted abuse.

The court also ruled that because of the enforceable standard, the trust was neither purely a discretionary trust nor purely a support trust. The standard was "care, comfort, maintenance, and general well-being." The result of this analysis was that the governmental agency was able to recover directly from the trust assets by forcing a distribution pursuant to the standard. This would not be the case in almost all common law states that retain the discretionary trust/support trust dichotomy.

In 1978, the Ohio Supreme Court extended the concept of *Kreitzer* to allow a spouse to recover for child support from a discretionary trust that was coupled with a standard. Moreover, 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 trust's assets.[8]

The unreported 1997 and 2001 cases of *In the Matter of Trust Created by Item III of Will of Zemuda*[9] and *Buoscio v. Estate of Buoscio*[10] added further confusion to what standard of review Ohio has for a discretionary trust. In these decisions, the courts used a standard of abuse, requiring that the trustee not act unreasonably, unconscionably, or arbitrarily. Finally, in 2001, the Ohio Court of Appeals held in *Metz v. Ohio Dept. of Human Services*[11] that a discretionary trust was an available resource and that the beneficiary was properly denied Medicaid eligibility. The Ohio appellate court reasoned that the beneficiary had an enforceable right under *Kreitzer*. As a result, the court found that the Ohio Department of Human Services was correct in denying benefits because the discretionary trust was an available resource under Ohio's definition of abuse.

In the 1989 case *In re Estate of Winograd*,[12] the Ohio Court of Appeals used a "reasonableness" standard in reviewing 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.[13]

The reason a beneficiary is happy to receive his share of an inheritance in trust is that if the beneficiary needs the funds, the trustee may distribute all the trust funds to him. This is one of the key ideas behind a beneficiary-controlled trust. 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 in *Winograd* held that the trustee abused his discretion by distributing all the income to the primary beneficiary.

The court reached this conclusion even though the trust contained specific language stating 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 the primary beneficiary's descendants second in making distributions. Unfortunately, Ohio is not alone in destroy-

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[4] Caswell v. Lenihan, 126 N.E.2d 902 (Ohio, 1955); Huntington Nat'l Bank v. Aladdin Crippled Childrens Hosp. Assn., 157 N.E.2d 138 (Ohio App., 1959).

[5] 169 N.E.2d 486 (Ohio App., 1960).

[6] It is uncertain how the court is using the term "bad faith" in this case.

[7] 243 N.E.2d 83 (Ohio, 1968).

[8] The following unreported appellate cases 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).

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

[10] 2001 WL 1123960 (Ohio App. 7 Dist).

[11] 762 N.E.2d 1032 (Ohio App., 2001).

[12] 582 N.E.2d 1047 (Ohio, 1989).

[13] For more information about the beneficiary-controlled trust concept, see R. Oshins and S. Oshins, "Protecting and Preserving Wealth into the Next Millenium," 137 Tr. & Est. (Sept. and Oct. 1998).

ing one of the fundamental aspects of a beneficiary-controlled trust. The Restatement Third also takes the same position as the appellate court in *Winograd*.[14]

UTC and Restatement Third

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

While comment b of section 50 of the Restatement Third provides that "judicial intervention is not warranted merely because the court would have differently exercised its discretion," section 50, comment b further provides 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." The comment continues, "[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." (Emphasis added.)

The UTC does not impose a reasonableness standard. Rather, section 814(a) provides a good faith standard. According to that section, "[n]otwithstanding the breadth of discretion granted to a trustee in the terms of the trust, including the use of such terms 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 Restatement Third, section 50, comment c, makes a similar statement when it notes 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 provides a much lower threshold for a beneficiary than does the bad faith standard of prior law.[15]

When drafting discretionary trusts, many attorneys also include a broad standard for making distributions. According to the Restatement Third, an abuse of discretion depends on "the proper construction of any accompanying standards, and on the settlor's purpose in granting the discretionary power." In other words, if a discretionary trust provides that the trustee may make distributions in the trustee's sole and absolute discretion for health, education, maintenance, support, comfort, general welfare, happiness and joy, each separate standard listed may need to be examined to determine whether the trustee's discretionary decision to distribute or not was reasonable.

On the other hand, the Restatement Third also goes to great lengths to prevent attorneys from drafting out of this problem. Many attorneys suggest that a discretionary trust should not even include a distribution standard. By eliminating any distribution standard, it would be unlikely that a judge would conclude that the trust is anything other than a discretionary trust since the judge could not mistake the trust as a support trust. Moreover, it would be unlikely that a judge would question the trustee's distribution decisions.

Unfortunately, section 50, comment b of the Restatement Third provides "[i]t 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."[16]

Once the threshold for the judicial standard of review has been reduced to reasonableness or good faith, the beneficiary—in almost all cases—should have an enforceable right to a distribution. This being the case, may a creditor stand in the beneficiary's shoes under the UTC or the Restatement Third? Even if a creditor may not stand in the beneficiary's shoes, may a governmental agency deny benefits by considering a discretionary trust as an available resource (similar to the *Metz* case in Ohio)? Would the discretionary trust be considered an equitable factor in determining child support, alimony, and possibly an equitable division of marital property? Finally, should a beneficiary be imputed income from a trust for purposes of computing child support and alimony? All these issues are discussed in the following material.

Asset protection for discretionary and support trusts now the same?

The traditional trust analysis explained in detail the enhanced

[14] Restatement (Third) of Trusts ("Restatement Third"), section 50, comment c., last paragraph.

[15] For purposes of this article and under case law, the term "bad faith" is not defined as the antithesis of a good faith standard.

[16] Restatement Third, section 50, comment d.

degree of asset protection provided by a discretionary dynasty trust.[17] The asset protection under common law afforded by a discretionary dynasty trust is based on a property analysis (i.e., whether there is an enforceable right). On the other hand, for a support trust, the asset protection is based on spendthrift protection, subject to the four exception creditors.

In addition to changing the standard of review, both the UTC and the Restatement Third again change 125 years of established trust law by eliminating the discretionary trust property analysis. The Restatement Third makes it clear that asset protection will be based solely on the same spendthrift protection analysis.[18] In other words, there is no property analysis for a discretionary trust under the Restatement Third or the UTC.[19] For a number of reasons, this is quite a dramatic change from an asset protection perspective.

First, third-party Medicaid trust planning or special needs trust planning is based on meeting the definition of a discretionary trust under state law. Although a governmental agency, as an exception creditor, may recover from a support trust, a governmental agency cannot recover from a discretionary trust. Unfortunately, under the UTC and the Restatement Third, the change in the standard of judicial review, equating a discretionary trust to a support trust, and the probable expansion of exception creditors as discussed below, may soon make it possible for a governmental medical agency to recover directly from a discretionary trust.

Second, claims of the U.S. or state governments, including the IRS, have never been enforced against a discretionary trust. The reason is that a beneficiary has no right of recovery. Therefore, a creditor does not receive greater rights than the beneficiary.

Third, except for *Dwight v. Dwight*,[20] a Massachusetts Court of Appeals case which appears to have relied on a draft of the Restatement Third for its holding, a former spouse has no right of recovery against a discretionary trust, even for alimony or child support.

Fourth, attorney's fees incurred on behalf of a beneficiary suing a discretionary trust for a distribution would most likely not be recovered from the trust. Consequently, under the Restatement Third and the UTC, virtually all of the asset protection of a discretionary trust is lost, and the discretionary trust is forced to rely on the much lesser protection afforded by a spendthrift trust.[21]

A flowchart for both discretionary and support trusts under this analysis is shown in Exhibit 1.

Continuum of discretionary trusts more protective? One might argue that under the UTC and Restatement Third, all trusts should now receive greater asset protection because all trusts are now on a "continuum of discretionary trusts." However, this conclusion is incorrect. The reason that a creditor could not force a distribution from a discretionary trust was that the beneficiary could not do so. This stemmed from the fact that the beneficiary had very little standing in court under the bad faith standard of review.

Under the UTC, the standard has been changed to good faith, and under the Restatement Third the review standard has been changed to reasonableness. The issue is not what title (i.e., the term "discretionary") is assigned to a

17 See Merric and Oshins, "Effect of the UTC on the Asset Protection of Spendthrift Trusts," 31 ETPL 375 (Aug. 2004), and Merric and Oshins, "UTC May Reduce the Asset Protection of Non-Self-Settled Trusts, 31 ETPL 411 (Sept. 2004).

18 Restatement Third, section 60, comment a.

19 However, due to the incredibly confusing language in Article 5 of the UTC, some estate planners claim that the discretionary analysis may have been abolished only for the exception creditor for child support or alimony. First, section 503 provides that all exception creditors may pierce a spendthrift provision. No distinction is made between a discretionary trust and a support trust. The second paragraph of the comments under UTC section 503 references section 59(a) of the Restatement Third. The fifth paragraph of the comments under UTC section 503 references section 59(b) of the Restatement Third. General comment (a) of the Restatement Third specifically states that "certain categories of creditors [i.e., the exception creditors] can reach beneficial interests in spendthrift trusts..., including discretionary interests in those trusts." Second, section 60 provides as to discretionary trusts that a spouse, former spouse, or a spouse acting on behalf of a child may reach the trust assets for child support or alimony. So at first blush, it appears that the UTC may be eliminating the discretionary/support distinction for only this purpose. Nevertheless, the first paragraph of the comments under section 60 provides that "[t]his section, similar to the Restatement Third, eliminates the distinction between discretionary and support trusts, unifying the rules for all trusts fitting within either of the former categories." If the rules have been unified (i.e., the discretionary property analysis has been eliminated), then the argument that alimony and spousal support are the only exception to a discretionary trust has little merit. Third, adding more confusion to an already confusing Article 5, UTC section 503(c) provides no limit to any state or federal claim to the extent the statute provides. By the literal terms of this section, this means that all of these types of federal claimants may directly attach the trust assets, regardless of whether it is a federal or state claim. This also appears to support the argument that the discretionary/support distinction has been completely eliminated. Fourth, again adding more confusion to Article 5, there is no definition of a discretionary trust or a support trust in the UTC. Both UTC section 504 and section 60 of the Restatement Third say that they apply to discretionary interests. But unlike the Restatement Second, there is no definition.

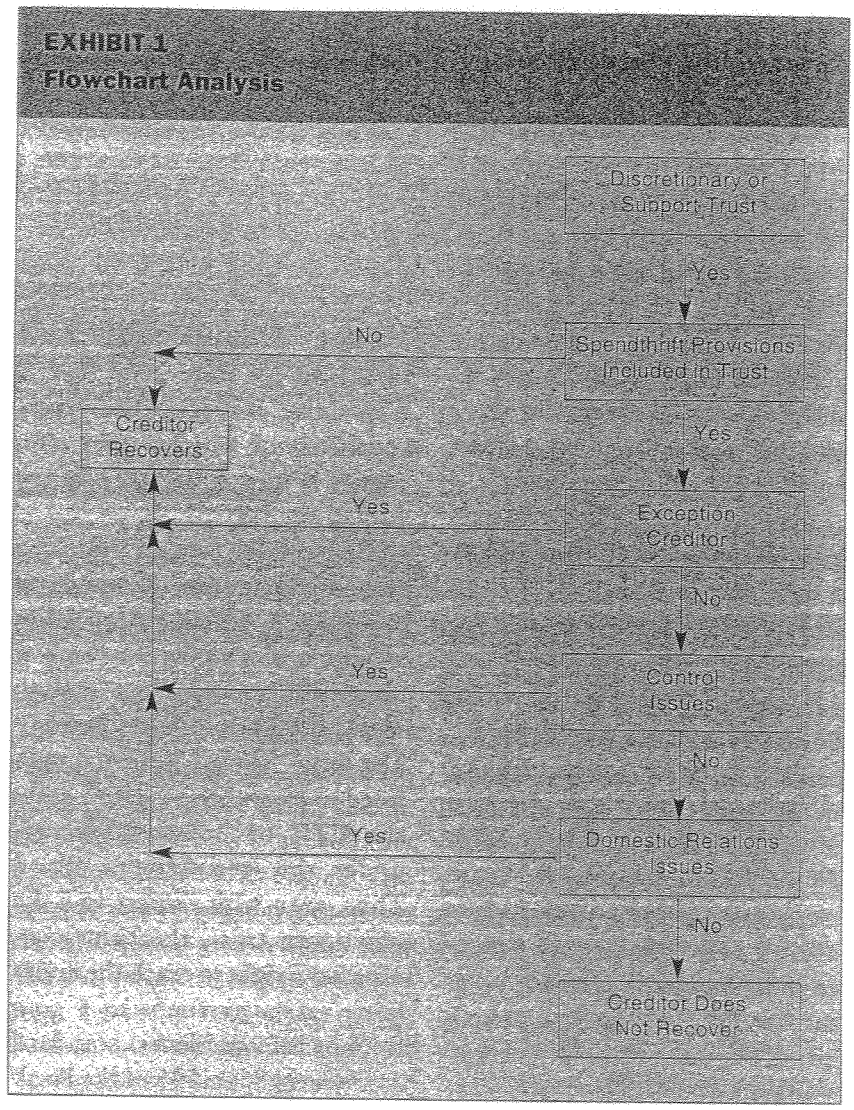
20 756 N.E.2d 17 (Mass. Ct. of App., 2001).

21 Restatement Third, section 60, comment a goes to some length to explain a continuum of discretion under a reasonableness standard. Unfortunately, when courts are given a factor test, a balancing test, or a continuum to choose from, it is usually nothing more than a blank check for a court to decide the case almost any way it chooses. For an example, in a divorce case apparently using a Restatement Third analysis with a discretionary trust, see Dwight v. Dwight, 756 N.E.2d 17 (Mass. Ct. of App., 2001).

trust. The issue is whether the beneficiary has an enforceable right if the beneficiary can force a distribution. Unfortunately, the case law from Ohio proves this to be the case. Once the beneficiary has an enforceable right (i.e., a property interest), the following are issues:

- What remedies are available to exception creditors?
- What remedies are available to ordinary creditors?
- Will governmental aid be denied because the trust is considered an available resource?
- Will the beneficiary's interest be considered either marital property or a factor for equitable division in the divorce context?
- Will income will be imputed to a beneficiary for purposes of computing child support or alimony?

EXHIBIT 1
Flowchart Analysis



Expansion of exception creditors?

Similar to the Restatement Second, both the UTC and the Restatement Third set forth a list of exception creditors. Some practitioners have argued that, at least in the short term, because the UTC list of exception creditors is smaller than that of the Restatement Second, the UTC is more protective for support trusts (but not for discretionary trusts). In the short term, this may be the case. Nevertheless, since the Restatement Second was promulgated almost 50 years ago, only three of the four exception creditors have been generally adopted by state courts. On the other hand, when legislators have been given the ability to determine exception creditors, the magnitude of the exception creditors appears to be much more expansive than the judicial exception creditors. Accordingly, this greater asset protection for a support trust may last for only a relatively short time.

Restatement Second. The Restatement Second lists the following four exception creditors:

1. Alimony and child support;
2. Reasonable needs of a beneficiary;
3. Expenses to preserve a beneficial interest; or
4. Any federal or state claim.

The exception for expenses to preserve a beneficial interest (i.e., attorney's fees for a beneficiary, or an exception creditor standing in the shoes of the beneficiary suing the trust) never gained much acceptance in the state courts. For this reason, in the 50-year period since the promulgation of the Restatement Second, only three of the four exception creditors have gained acceptance by the state courts.

Uniform Trust Code. From an asset protection perspective, at first glance the UTC appears to be an improvement over the Restatement Second because it reduces the number of exception creditors to three, as listed below. (The exception creditor for "necessary expenses of the beneficiary" appears to have been deleted.)

1. "...a beneficiary's child, spouse, or former spouse who

has a judgment or court order against the beneficiary for support or maintenance, or
2. 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."[22]
3. "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."

For the most part, though, this is not really the case. The UTC has actually combined most of the necessary-expenses-of-a-creditor cases (i.e., Medicaid and special needs trust cases) with the third exception for claims by the federal or state government. While exception creditors had no claim against a discretionary trust under common law, all exception creditors would be allowed to directly attach the assets of a discretionary trust under the UTC or the Restatement Third. Furthermore, future exception creditors may now be added both judicially and legislatively.

At first glance, the UTC appears to be an improvement for Medicaid and special needs trusts over the common law of most states. The reason is that a state or federal government must now enact a statute to recover from a Medicaid or special needs trust. Governmental agencies that provide benefits are no longer automatically considered an exception creditor (i.e., the necessary expenses of a beneficiary under the Restatement Second).

Once the state governmental agencies realize that they no longer may recover from this type of trust, it may be only a matter of time before the state or federal government is able to convince the state legislators to add them as an exception creditor. At this time, a state or federal governmental agency would be able to recover from all trusts in a UTC state, including third-party discretionary Medicaid or special needs trusts. In almost all states, the UTC is retroactive. It applies to all trusts, regardless of whether they were created before or after the effective date of the UTC.

Under UTC section 504(d), 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." The term "abuse" has been redefined to mean "good faith" under the UTC or "reasonableness" under the Restatement Third. Thus, even with respect to a discretionary trust, the beneficiary now has a right to reach the underlying assets pursuant to a good faith or reasonableness standard.

Under section 541 of the Bankruptcy Code,[23] upon the filing of a bankruptcy, the bankruptcy estate receives all the assets of the debtor. Due to the decrease in the review standard to good faith, all beneficiaries of a discretionary trust have an enforceable right that is also most likely considered a property interest under state law. Hence, this discretionary beneficial interest is now part of the bankruptcy estate.

Further under Bankruptcy Code section 541, the bankruptcy trustee stands in the shoes of the bankrupt for all purposes. Does this mean that the bankruptcy trustee may now exercise the beneficiary's rights to force a distribution pursuant to UTC section 504(d)? Under Bankruptcy Code section 541(c)(1), any contract clause or other arrangement calling for the termination of rights upon the filing of a bankruptcy may be voided by the Bankruptcy Court. Prior to the UTC and the Restatement Third, this was not an issue with a discretionary trust because the beneficiary of a discretionary trust did not have a right to force a distribution.

Moreover, the list of exception creditors may easily be expanded under the UTC. For example, for many years, the trial bar has attempted to create an exception for tort creditors. The Mississippi Supreme Court actually adopted this view in *Sligh v. First Nat'l Bank of Holmes County*.[24] Within a year after the supreme court rendered this landmark decision, the Mississippi legislature specifically overturned it by statute due to the anticipated loss of trust business that would migrate to other states with more favorable trust legislation.[25] Under the UTC, the state legislature may easily do this statutorily by simply appending an unnoticed exception as part of any other bill that passes through the legislature.

In addition to the tort creditor exception, what if the federal Bankruptcy Code one day references the UTC exception creditor list? UTC 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." The federal Bankruptcy Code could take advantage of this loophole by enacting a statute such as, "[t]he Federal Bankruptcy Trustee is an exception creditor

22 UTC section 503.

23 11 U.S.C. § 541.

24 704 So. 2d 1020 (Miss., 1997).

25 Miss. Code Ann. § 91-9-503 (Family Trust Preservation Act of 1998).

pursuant to section 503(c) of any State that has adopted this provision of the Uniform Trust Code."

All a creditor need do is 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 and tort creditors—but anyone who had a debt greater than $11,625.[26] Should federal bankruptcy law ever allow recovery against a trust in a UTC state, *there is virtually no asset protection provided by a spendthrift provision.* In other words, all credit card companies as well as any other creditors could easily recover from any spendthrift trust through this possible bankruptcy end-run approach.

Many asset protection attorneys have indicated that, with a spendthrift trust, all the trustee need do to avoid attachment and still support the beneficiary is to pay the debtor/beneficiary's expenses directly rather than making a distribution to the beneficiary.[27] Both the UTC and Restatement Third end this possibility. UTC section 501 provides that a creditor may attach "present or future distributions to *or for the benefit of the beneficiary.*"(Emphasis added.) Section 60, comment c and Illustration 4 of the Restatement Third provide 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.

The inability of the trustee to pay the expenses of a beneficiary is much more expansive than one might think. This is how most special needs trusts pay beneficiaries' expenses so that a distribution is not considered an available resource. Also, the interpretation of UTC section 501 may lead to the unfortunate conclusion that all creditors may attach present or future distributions. The reason is that UTC section 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. . . ."

Pursuant to the Restatement Second,[28] any distributions received by a beneficiary are not protected by spendthrift provisions.[29] The result is that spendthrift provisions protect assets only while held in trust. Therefore, if spendthrift provisions protect only assets that are held in trust, does UTC section 501 allow attachment by *any* creditor? If UTC section 501 is interpreted this way, *it for the most part almost completely defeats the asset protection benefits of using a trust* because any creditor could attach the interest in the trust and merely wait for satisfaction of his or her claim.

The UTC does not limit the courts from adding judicially created exception creditors. Further, the Restatement Third encourages the expansion of exception creditors. Comment a(2) specifically provides that "[s]pecial circumstances or evolving policy may justify recognition of other exceptions, allowing the beneficiary's interest to be reached by certain creditors in appropriate proceedings....[p]ossible exceptions in this case require case-by-case weighing of the relevant considerations and evolving policies."

In essence, this part of the Restatement Third gives the courts a blank check to create an exception at 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. Furthermore, this portion of the Restatement Third continues, "[i]n 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." (Emphasis added.) Since it is inconceivable that a client would ever ask the scrivener to draft the trust so that creditors of the beneficiaries can recover from the trust, it is unlikely that this could ever be a "purpose" of the trust.

Under the Restatement Second, when attorneys sued the trust for fees to protect a beneficial interest, the courts have seldom adopted this exception. The UTC takes the opposite position of common law by codifying this exception for attorney's fees.[30] The comment under UTC section 503 provides that "[t]his exception allows a beneficiary of modest means to overcome an obstacle preventing the beneficiary obtaining services essential to the protection or enforcement of the beneficiary's

[26] If there are 12 or fewer creditors, any one creditor with a claim greater than $11,625 may file an involuntary bankruptcy. If there are more than 12 creditors, any three with claims aggregating greater than $11,625 may file an involuntary bankruptcy. 11 U.S.C. § 303(b).

[27] Duncan v. Elkins, 45 A.2d 297 (N.H., 1946).

[28] Restatement Second, section 152, comment j.

[29] See also Lundgren v. Hoglund, 711 P.2d. 809 (Mont., 1985); Guidry v. Sheet Metal Workers, Int'l Ass'n, 10 F.3d 700 (CA-10, 1993).

[30] UTC section 503.

rights under the trust." However, almost all discretionary trusts are created with the purpose that the beneficiaries have virtually no right to challenge the trust. Hence, the terms "sole," "absolute," "unfettered," and "uncontrolled" discretion were used to mean exactly what they say.

Under the UTC and the Restatement Third, a reasonableness standard (or good faith standard) is now imposed on the trustee. Does the attorney fee exception under the UTC now mean that the trust is obligated to pay for a challenge by the beneficiary where most likely such challenge is against the settlor's wishes? Does this mean that an exception creditor may challenge a discretionary trust when suing under the distribution standard, and that the trust is obligated to pay for it? Unfortunately, in the first situation, this may easily be the case and, in the second situation, neither the statutory language of the UTC nor its comments clearly establish whether this is in fact the case.

The Restatement Third. The Restatement Third adopts a substantially similar approach to that of the UTC by imposing a reasonableness standard of review for a discretionary trust. In this respect, the Restatement Third is in no sense a restatement of the current law of trusts. As related to the common law of almost all states, the Restatement Third is a complete rewrite of history in this area.

At first blush, the Restatement Third appears to have narrowed the exception creditors to three:

1. Support of a child, spouse, or former spouse;
2. Services or supplies provided for the necessities; or
3. For the protection of the beneficiary's interest in the trust.[31]

However, comment a(1) specifically provides that governmental claimants, and other claimants as well, may reach the interest of a beneficiary of a spendthrift trust to the extent provided by federal law or an applicable state statute.

Additional considerations

Special needs trusts. With respect to Medicaid or special needs trusts, the UTC and Restatement Third create two major concerns. First, will a federal or state government be able to attach the beneficial interest? Second, will the Medicaid or special needs trust be considered an available resource of the beneficiary?

For states that adopt the UTC, it may be only a short time before third-party[32] Medicaid trust or special needs trust planning is greatly curtailed and eventually eliminated. If the discretionary trust and support trust distinction no longer exists, the federal government or state legislature can pierce any trust by enacting a statute saying that the government may attach the beneficiary's interest and reach some or all of the trust assets.

In states that do not follow the UTC or Restatement Third, an interest in a discretionary trust is not a property interest (i.e., an enforceable right). Both Medicaid trust and special needs trust planning depend on the dichotomy between discretionary and support trusts related to this property issue. Regarding the second issue, if a beneficiary has an enforceable right to a distribution, the federal or state government need not necessarily attach a beneficiary's interest. The federal or state government may merely consider the trust as an "available resource" and deny benefits.[33]

Beneficiary as sole trustee. Attorneys often draft trusts in which one of the beneficiaries is the sole trustee. For estate tax purposes, such a trust—if drafted correctly with an ascertainable standard—is not included in the trustee-beneficiary's taxable estate.[34] Unfortunately, under the Restatement Third, section 60, when a trustee-beneficiary is the sole trustee, any creditor—not just an exception creditor—may reach the maximum amount that the trustee may properly take.[35] The Restatement Third departs from common law. Originally, the UTC was silent about this issue. However, after opponents to the UTC expressed their concern over this issue, the UTC was amended in August 2004 so that a sole trustee-beneficiary's interest would not be subject to creditor attachment if such interest was limited by an ascertainable standard.

Domestic relations case and imputed income. In *Dwight v. Dwight*, upon dad's death, 60% of the estate went to his two daughters outright, and the other 40% of the estate went to his son in a discretionary trust.[36] The trust was created approximately two years after the son was divorced.

The trust was discretionary, and provided that the trustee may

[31] Restatement Third, section 59.

[32] A third-party Medicaid or special needs trust is a trust that the parents or grandparents have created for the benefit of a child. It is *not* the self-settled trust under 42 U.S.C. § 1396p(d)(4)(A) (many times commonly referred to as a "d4A trust").

[33] Metz v. Ohio Dept. of Human Services, 762 N.E.2d 1032 (Ohio App., 2001).

[34] IRC Section 2041.

[35] Restatement Third, section 60, comment g.

[36] For an excellent analysis of *Dwight v Dwight*, see Bove Jr. and Langa, "Another Look at 'Dwight' and Spendthrift Trusts," Massachusetts Lawyers Weekly (12/10/01).

make distributions of income and principal as the trustee deems to be necessary or desirable for the support, comfort, maintenance or education of the beneficiaries. The court concluded that this was a discretionary standard. The trust beneficiaries were the son and the son's issue. During the nine years prior to the Massachusetts Appeals Court decision, the trust made one discretionary distribution of $7,000 to the son. During this period of time, the trust corpus grew from $435,000 to $937,508.

The trial court judge stated that it was highly likely that the primary reason the son received his inheritance in trust rather than outright was in order to defeat a claim for alimony. The trial court also found that the son had access to additional funds anytime he desired based on two facts:

1. The broad purposes for which the trustee may make payments to the son; and
2. A statement the son made to the trustee that he did not need any additional money.

The trial court found that earnings should be imputed to the son from the discretionary trust for purposes of alimony. The Massachusetts Court of Appeals agreed with the trial court.

Without any discussion, the appellate court dismissed the son's contention that he had no enforceable right to a distribution. Rather, the opinion cited the Restatement Third, section 59 (Ten. Draft No. 2, 1999) as authority for dismissing the son's claim. Under the Restatement Third as well as the UTC,[37] a spouse can reach the assets of a discretionary trust for alimony and child support. Further, a judge may determine what amount the trustee should "reasonably" distribute or what amount should be distributed in "good faith."[38]

The broad standards for the purpose of the distributions must be analyzed to determine whether distributions should have been made (and therefore be part of the alimony computation). Here, the court determined that defeating an alimony claim was not an acceptable purpose. Therefore, under both the UTC and the Restatement Third, the court was within its authority to impute income to the husband for the basis of alimony, even though he received only a token of what was imputed to him.

Although *Dwight v. Dwight* relied on the Restatement Third in reaching its conclusion, the case was decided before the Restatement Third was even finalized. Further, Massachusetts has not yet adopted the UTC. However, if Massachusetts had adopted the UTC, to add insult to injury, it appears that the former spouse would also be able to recover legal fees from the trust.

End run to force a distribution for all creditors. All creditors may attach an "overdue" or "mandatory" distribution under UTC section 506. Unfortunately, the terms "overdue" and "mandatory" are both undefined. More 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."[39] The reason is that a judge must now interpret the distribution language of the trust to determine where the trust should be classified on this new undefined continuum of discretionary trusts.

Once this determination has been made, the judge would then decide when and how much should be periodically distributed to the beneficiary. This is the amount that would become an overdue distribution if it was not timely paid. For example, 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 in which the judge concludes that the trustee should periodically make distributions to the beneficiary. If this is the result, then these deemed overdue distributions would be subject to attachment by any creditor.

Planning ramifications

Planning around the Restatement Third and UTC. Both the UTC and the Restatement Third seem to have gone to great lengths to significantly reduce the asset protection provided by creating a reasonableness or good faith standard, even if the terms of the trust provide for the opposite. Therefore, the trust scrivener should consider providing absolutely no standard when drafting a discretionary trust. For example, the trust could be drafted to state that "the trustee may make distributions in his sole and absolute discretion to any beneficiary."

37 UTC section 504.

38 Restatement Third, section 50, comment b.; UTC section 814(a).

39 Restatement Third, section 60, comment e and e(1).

While this will provide some help to mitigate the asset protection problems posed by the Restatement Third, it may not solve the problem. The reason is that, under section 50, comment d, when no standard is provided, the Restatement Third indicates that "even then a general standard of reasonableness, or at least a good-faith judgment, will apply to the trustee, based on the extent of the trustee's discretion, the various beneficial interests created, the beneficiaries' circumstances and relationships to the settlor, and the general purposes of the trust." Nevertheless, not including a standard of distribution in a trust will make it more difficult for a judge to conclude that the settlor's intent was to create an enforceable right in the beneficiary for a distribution.

While all exception creditors may generally attach a remainder interest, it appears that a remainder interest in a dynasty trust could not be attached because it is an interest that does not vest with anyone. In this respect, drafting trusts with dynasty interests should still avoid many creditor issues and should be a matter of course for most clients, not just a technique for the ultra-wealthy.

Forum shopping. From an asset protection perspective, the defects in both the UTC and the Restatement Third may be so great that high-net-worth clients domiciled in a UTC state should strongly consider forum shopping and using the laws of another state. From a domestic perspective, there are two options: (1) a non-UTC state, or (2) a domestic asset protection trust ("APT") state.

A domestic APT state may prove to be a better choice. First, if 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 would 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 (that have not enacted the UTC), estate planners should consider Alaska, Delaware, Nevada, and Rhode Island.

Unfortunately, the conflict of law clause in both the UTC and the Restatement Third allows 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.[40] It is questionable whether the U.S. Supreme Court would uphold this conflict of law provision. However, a factor test, including the residence of the trustee, the location of assets, the place 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. Furthermore, two of the factors—the residence of the trustee and the location of the assets—may be weighed to a greater extent than the other factors. For this reason, if an estate planner has decided that forum shopping is the best alternative, it may be wise to move all liquid assets out of UTC states to non-UTC jurisdictions.

Conclusion

Although the UTC has not yet been adopted by many states, nor are the authors aware of a reported case interpreting the asset protection results decided under the Restatement Third (with the exception of *Dwight v. Dwight*), both of these promulgations would change over 125 years of common law regarding the distinction between support trusts and discretionary trusts. Unfortunately, the changes would significantly reduce the asset protection of discretionary trusts and special needs trusts from all exception creditors, including an estranged spouse.

Moreover, the possible expansion of exception creditors in this area of spendthrift trusts is quite troublesome, particularly in the bankruptcy context. The possible classification of current as well as remainder interests as marital property, a factor to be used to determine the equitable division of marital property, and the imputation of income from the trust for purposes of child support and alimony, also create problems.

The ability of all creditors to force a distribution based on the undefined distribution terms "mandatory" and "overdue" adds further complications. Finally, in the event a court determines that all creditors may attach an interest in a trust and wait for any future distributions, then asset protection through spendthrift protection may be substantially impaired, if not virtually eliminated. The same is true if the bankruptcy trustee is allowed to stand in the shoes of the debtor and force a distribution based on the standard included in the spendthrift trust. In this respect, to retain the traditional asset protection afforded by discretionary trusts and spendthrift trusts, many estate planners may want to forum shop by moving both the trust and the underlying assets out of a UTC state. ■

[40] UTC section 107.