

# Scheffel v. Krueger: The Effectiveness of Statutory Spendthrift Trust Protection<sup>1</sup>

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Since creditor and divorce protection are significant concerns for most clients, the lessons learned from cases remain important for estate planners.

In *Scheffel v. Krueger*,<sup>2</sup> decided by the New Hampshire Supreme Court on July 26, 2001, the mother of a minor boy who was sexually assaulted by a trust's beneficiary sought to attach the beneficiary's interest in the trust to satisfy a tort judgment. The lower court dismissed the action. On appeal, the New Hampshire Supreme Court held that: 1) the trust's spendthrift provision barred a claim to satisfy a tort creditor, and 2) the trust qualified as a spendthrift trust even

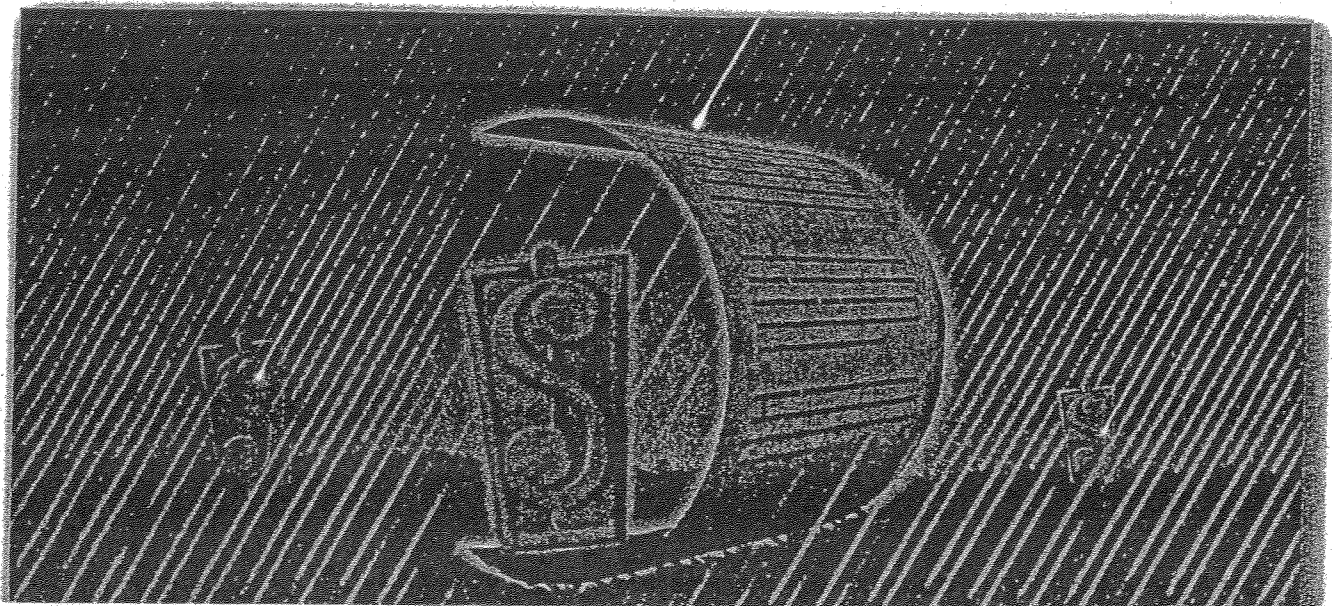
though the beneficiary exerted significant control over it.

Ironically, it is the uncomfortable and unfortunate result of the holding in this case that best illustrates the effectiveness of estate planning that addresses asset protection considerations. Since creditor and divorce protection are significant concerns for most clients, the lessons learned from cases like this remain important for estate planners regardless of the future of the transfer tax system.

## Facts

In 1998, the plaintiff filed suit in superior court asserting tort claims against the defendant, Kyle Krueger. In her suit, the plaintiff alleged that the defendant sexually assaulted her minor child. The same conduct that the plaintiff alleged in the tort claims also formed the basis for criminal charges against the defendant.<sup>3</sup> The court entered a default judgment against the defendant and ordered him to pay \$551,286.25 in damages. To satisfy the judgment against the defendant, the plaintiff sought an attachment of the defendant's beneficial interest in the Kyle Krueger Irrevocable Trust, a trust with a bank serving as trustee.

Krueger's grandmother estab-



lished the trust in 1985 for his benefit. Its terms direct the trustee to pay all of the net income from the trust to Krueger, at least quarterly, or more frequently if he requests. The trustee is further authorized to pay any of the principal to Krueger if, in the trustee's sole discretion, the funds are necessary for his maintenance, support and education. Krueger, currently 35, may not invade the principal until he reaches the age of 50.

Krueger is prohibited from making any voluntary or involuntary transfers of his interest in the trust. The trust instrument specifically provides:

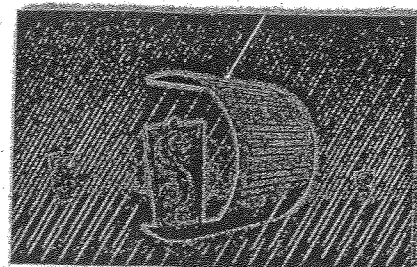
No principal or income payable or to become payable under any of the trusts created by this instrument shall be subject to anticipation or assignment by any beneficiary thereof or to the interference or control of any creditors of such beneficiary or to be taken or reached by any legal or equitable process in satisfaction of any debt or liability of such beneficiary prior to its receipt by the beneficiary.

The trial court ruled that under New Hampshire's spendthrift trust statute, the trust's spendthrift provision bars the plaintiff's attempt to reach Krueger's interest in the trust. The relevant New Hampshire statute<sup>4</sup> provides:

In the event the governing instrument so provides, a beneficiary of a trust shall not be able to transfer his or her right to future payments of income and principal and a creditor of a beneficiary shall not be able to subject the beneficiary's interest to the payment of its claim.

The only exceptions to this rule against attachment by creditors are for self-settled spendthrift trusts or where assets were fraudulently transferred to the trust.

The plaintiff argued that the legislature did not intend for the statute to shield the trust assets from tort creditors. However, the statute plainly states that "a creditor of a beneficiary shall not be able to subject the beneficiary's interest to the payment of its claim." The New Hampshire Supreme Court held that the New Hampshire legislature has enacted a statute repudiating the public policy excep-



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tion sought by the plaintiff, and that it must interpret legislative intent from the statute as written. Therefore, the Court would not create an exception for tort creditors.

The plaintiff further argued that the trust does not qualify as a spendthrift trust because the trust instrument allows the beneficiary too much control over the trust assets for the trust to be recognized as a trust. Specifically, the plaintiff noted that the trust allows him to determine the frequency of income payments, to demand principal and interest after his fiftieth birthday, and to dispose of the trust assets by Will. The court rejected this argument with little discussion, simply concluding that, because the settlor of this trust is not the beneficiary, the spendthrift provision is enforceable.

### Analysis

Generally, a beneficiary's interest in a trust is an asset of the beneficiary and is subject to attachment unless:

- The beneficiary's interest is contingent and the contingency has not yet occurred;
- The beneficiary's receipt of benefits is determined

completely in the discretion of the trustee; or

- The trust contains a provision making it a "spendthrift trust" under common law or under the statutory law of the jurisdiction the law of which governs the trust, such as New Hampshire RSA Sec. 564.23 (unless the beneficiary is also the settlor of the trust, although the laws of Alaska,<sup>5</sup> Delaware,<sup>6</sup> Nevada,<sup>7</sup> and Rhode Island<sup>8</sup> allow for the creation of self-settled spendthrift trusts).

In the *Scheffel* case, we see the strict application of the third of these exceptions. The New Hampshire legislature specifically allowed the creation of spendthrift trusts for third-party beneficiaries. It is perhaps unfortunate that the plaintiff in this case cannot recover what seem to be clearly deserved damages from the defendant. However, the trust was created within the bounds of statutory law, and it is not a court's place to make judicial exceptions to unequivocal statutory law.

### Other Notable Cases

In *Sligh v. First National Bank of Holmes County*,<sup>9</sup> the Mississippi Supreme Court created a "public policy exception" to spendthrift trust protection involving judicially-created spendthrift trust law, not statutory law. The plaintiff judgment creditors sought to attach the debtor-defendant's beneficial interest in two spendthrift trusts in order to partially satisfy a tort judgment for damages resulting from injuries sustained in an automobile accident with the debtor-defendant. The Court relied on scholarly arguments in the *Restatement (Second) of Trusts*, *Bogert on Trusts and Trustees*, and *Scott on Trusts* to conclude that one of the main reasons for enforcing spendthrift trust provisions — the responsibility of creditors to be aware of the law and of the substance of such provisions — does not apply in the case of tort judgment creditors. Accordingly, the Court ruled as a matter of public policy that the assets of spend-

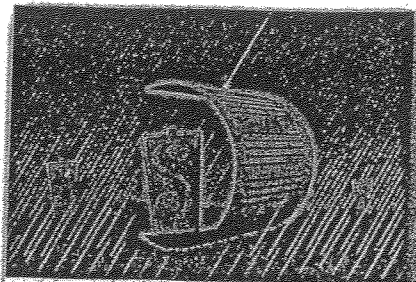
thrift trusts may be attached to satisfy the claims of tort judgment creditors. The *Sligh* case has since been "overturned" by the Mississippi legislature, which enacted a specific spendthrift trust statute soon after the decision was handed down.

Another example of the protection that can be obtained using a discretionary spendthrift trust settled by a third party was illustrated in *Doksansky v. Norwest Bank, N.A.*<sup>10</sup> In *Doksansky*, the former spouse of a trust beneficiary brought a claim for past due child support against the debtor's interest in a trust set up by the debtor's father. The trust authorized the trustees to make distributions to the debtor and his issue as the trustees determined to be in the best interest of the beneficiaries. The court held that, because the debtor could not require the trustees to make distributions to satisfy his debt, his interest could not be reached by his former spouse.

### Enhancing The Plan

Although the result in *Scheffel* was perhaps morally unfortunate, it does emphasize the asset protection planning opportunities available through the use of a spendthrift trust. The fact that the beneficiary's interest in the trust was protected in a fact pattern as egregious as this one illustrates the nearly absolute protection of a properly structured and timely created spendthrift trust.

According to the facts as presented in *Scheffel*, the beneficiary will have a general power of appointment over trust principal upon reaching age 50. In some states, such as Texas,<sup>11</sup> property subject to a general power of appointment is subject to the claims of the powerholder's creditors. In other states, such as Colorado,<sup>12</sup> such property is protected from the claims of the powerholder's creditors. However, because the protection is judicially created in those states, it is subject to judicially created exceptions, perhaps such as an exception for tort creditors. In most other states, the issue has been addressed neither by



The objective of control and use of assets can be accomplished by using a discretionary spendthrift trust that becomes a beneficiary-controlled trust upon the beneficiary reaching a specified age. This technique is clearly superior to making outright gifts or bequests and to making mandatory trust distributions at a specified age.

statute nor at the appellate court level. The position of the most recent *Tentative Draft of the Restatement (Third) of Trusts*<sup>13</sup> follows federal bankruptcy law<sup>14</sup> in treating property subject to a presently exercisable general power of appointment as a property interest subject to the claims of the powerholder's creditors.

Although many of us might have wanted Krueger's interest in the principal of the trust to be subject to attachment in this particular case because of the horrific circumstances leading to the judgment in favor of *Scheffel*, this case gives us some important lessons about the nature of trusts and protecting the assets of our clients and their beneficiaries. As Justice Prather put it in his dissent in *Sligh*:

Spendthrift trusts provide a means for a parent or other concerned party to provide for the basic needs of a beneficiary, and the largely exempt status of the trust benefits has given comfort and support to countless settlers and beneficiaries. The facts of the present case are tragic, but this Court should, in my view, avoid changing longstanding precedent based on the fact pattern of a particular case.

The protection of a spendthrift trust like Krueger's would have been enhanced by continuing it as a discretionary trust for the beneficiary's lifetime. Although clients often prefer to make outright gifts and bequests or to use trusts with mandatory distributions, most clients can be convinced of the wisdom of using a beneficiary-controlled trust to provide the flexibility and control over assets they desire along with the protection of the beneficiary's interest from the claims of creditors and divorcing spouses.

A beneficiary-controlled trust is a discretionary trust settled by a third party where the beneficiary is also the trustee. Many credit shelter trusts and QTIP trusts (with respect to principal), for example, are beneficiary-controlled trusts. The present law of most states, whether statutory<sup>15</sup> or judicially created,<sup>16</sup> does not allow a creditor of a beneficiary who is also a trustee to force a distribution which would then be attachable by the creditor.

The *Restatement (Third) of the Law of Trusts, Tentative Draft No. 2, supra*, however, takes the position in Sec. 60, cmt. g, that a creditor of a trustee-beneficiary can reach as much as the trustee-beneficiary could properly distribute to himself under the terms of the trust instrument. Thus, an even more effective asset and divorce protection strategy is to design the beneficiary-controlled trust with two trustees — the primary beneficiary as the investment trustee, and an independent trustee (e.g., the primary beneficiary's best friend) as the distribution trustee. The primary beneficiary can be given the power to remove and replace the independent trustee,<sup>17</sup> thereby maintaining the beneficiary-controlled feature of this trust design.

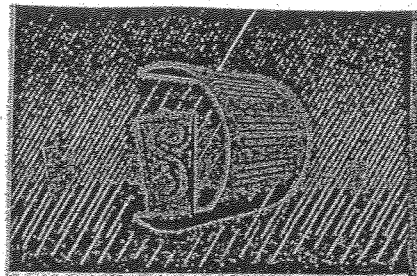
When a client tells her advisor that she wants trust property distributed to a beneficiary upon reaching a specified age, in most cases, the client has selected this age because she believes that the beneficiary will be mature enough to prudently

administer and use the assets, not necessarily because she wants the beneficiary to hold legal title to the assets at that time. The objective of control and use of assets can be accomplished by using a discretionary spendthrift trust that becomes a beneficiary-controlled trust upon the beneficiary reaching a specified age. This technique is clearly superior to making outright gifts or bequests and to making mandatory trust distributions at a specified age. In states where property subject to a general power of appointment is subject to the claim of the powerholder's creditors, the beneficiary-controlled discretionary spendthrift trust will also be a superior tool. Because this strategy creates a nearly insurmountable asset and divorce protection shield, the trust should be designed to continue for multiple generations so that the secondary and more remote beneficiaries also enjoy the benefit of a third-party created spendthrift trust.

Estate and asset protection planners should help their clients take advantage of this incredibly powerful protection by drafting spendthrift and discretionary trusts that continue for multiple generations, thereby providing asset and divorce protection benefits for their clients' families. ♦

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### Conclusion

*Scheffel v. Krueger* illustrates that, even when faced with an egregious and morally repugnant factual situation, courts will respect the anticipated asset protection bene-

Charities should take the approach that an ounce of prevention is worth it and engage competent legal counsel to advise on their pledge agreements generally and on specific agreements when the margin of error is small. ♦

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### ENDNOTES

1. For application of the doctrine of promissory estoppel to pledges, see Farnsworth, *Contracts* (2d ed.), p. 94; *Allegheny Col-*

1. Parts of this article were incorporated from the Monday, August 20, 2001 issue of Leimberg Information Services, Inc. (LISD), available at [www.leimbergservices.com](http://www.leimbergservices.com). That issue was authored by Chris Riser and edited by Steve Leimberg.
2. 2001 WL 839850, (N.H. 2001)
3. See *State v. Krueger*, 146 N.H. —, — (decided June 22, 2001).
4. N.H. Rev. Stat. Ann. Sec. 564.23.
5. Alaska Stat., Secs. 13.12.205(2), 13.27.050(a), 13.36.035, 13.36.310, 13.36.390, 34.40.010, 34.40.110(a), 34.40.110.
6. 12 Del. Code Ann. Secs. 3570-3576 (1997) (The Qualified Dispositions in Trust Act).
7. N.R.S. Sec. 166.040.
8. *R.I. Gen. Laws, Title 18, Ch. 9.2* (The Qualified Dispositions in Trust Act).
9. *Sligh v. First National Bank of Holmes County*, 704 So.2d 1020, 1024 (Miss. 1997).
10. *Doksansky v. Norwest Bank, N.A.*, 615 N.W.2d 104 (Neb. 2000).
11. *Fewell v. Republic National Bank of Dallas*, 513 S.W.2d 596 (Ct. App. 1974).
12. *University National Bank v. Rboadamer*, 827 P.2d 561 (Ct. App. 1991).
13. Restatement (Third) of the Law of Trusts, Sec. 56, cmt. b (Tentative Draft No. 2, March 10, 1999).
14. Bankruptcy Code Sec. 541(a).
15. Sec., e.g., N.C. Gen. Stat. Sec. 36A-115(b)(1).
16. See, e.g., *Atborne v. Atborne*, 128 A.2d 910 (N.H. 1957).
17. Rev. Rul. 95-58, 1995-36 I.R.B. 16; PLR 9746007.

- 246 N.Y.369, 159 N.E. 173 (1927); Restatement, Second, *Contracts* Sec. 90(1).
2. *Allegheny College, supra*
3. Reg. Sec. 53.4941(d)-2(f)(2)
4. *Mount Sinai Hospital of Greater Miami, Inc. v. Jordan*, 290 So.2d 484 (1974)
5. *Salsbury v. Northwestern Bell Telephone Co.*, 221 N.W.2d 609 (1974)
6. *Papas v. Hauser*, 197 N.W.2d 607 (1972); *Papas v. Bever*, 219 N.W.2d 720 (1974)
7. 33 P.S. Sec. 6
8. *Mount Sinai Hospital of Greater Miami, Inc., supra*.
9. See, e.g., Cal. Civ. Code Sec. 1624(e); N.Y. Gen. Oblig. Law Sec. 5-701(1). But cf. *Allegheny v. Noble*, 101 Conn. 54, 124 A. 717 (1924).
10. See, e.g., Letter Ruling 8230156.
11. Rev. Rul. 64-240; Letter Ruling 8242043
12. Reg. 1.170A-1(a)
13. Rev. Rul. 79-9
14. Reg. Sec. 53.4941(d)-2(f)(1)
15. Letter Ruling 9714010
16. Letter Ruling 9718031
17. Id.
18. Reg. 20.2055-1(a) sets forth the two basic requirements for allowance of the federal estate tax charitable deduction for property passing to charity:
  - 1) the property must be included in the decedent's gross estate, and
  - 2) the property must be transferred by the decedent during life or by Will. The second of these requirements knocks out an estate tax charitable deduction for a voluntary payment to charity by the decedent's executor.

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