ESTATE & SUCCESSION PLANNING CORNER—Spendthrift Trusts: Much Ado About (Almost) Nothing, or Is It?

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Creating Creditor Protection Trusts Must Extend Beyond the Spendthrift Provision

In discussing the creditor protection of trusts, practitioners almost always focus *first* on whether the trust has a spendthrift provision and the protections afforded by the spendthrift provision. In our opinion, this is much like focusing on whether your car has a "Police Up Ahead Alerter" when in fact your car cannot go greater than 30 mph. The Alerter is not really relevant if the car is not going to violate the speed limit. Similarly, for trusts, if not properly structured in terms of distribution provisions, the value of the spendthrift provision will be substantially reduced.

Instead of the spendthrift provision, the primary focus in establishing creditor protection trusts should be on the terms of the discretionary provisions, who to name as trustees, and the absence of certain powers of appointment and withdrawal rights.

The spendthrift provision is relevant, ironically, not for the protection provided, but for its implications when a court holds it to be inapplicable—in that instance, creditors can reach in and often obtain assets then available to a beneficiary. For example, a court might hold that a spendthrift provision is rendered ineffective by an unlimited right of withdrawal, *see, e.g., Frisch*,[1] and then by implication allow a creditor access to the trust property because the creditor can attach (in essence force) the beneficiary's exercise of that right of withdrawal in favor of the creditor.

Typical Spendthrift Provision

A spendthrift trust is typified by the following provision:

> "Spendthrift. No interest under this instrument shall be assignable by any beneficiary, voluntarily or involuntarily, or be subject to the claims of his or her creditors, including claims for alimony or separate maintenance. The preceding sentence shall not be construed as restricting in any way the exercise of any right of withdrawal or power of appointment or the ability of any beneficiary to release his or her interest."

But what does it mean, really? And how is it differentiated from the protection afforded by a discretionary trust?

The Genesis of the Spendthrift Trust

There was a time when mandatory income trusts, with no discretionary principal, were extremely popular. But now, other than functioning in the qualified terminable interest property ("QTIP") context, the mandatory income trust has fallen out of favor.

Instead, modern trusts are established with discretionary income and principal distributions pursuant to a standard, whether that standard is health, support and maintenance (for tax or non-tax purposes), or welfare or best interests, or in the total discretion of the trustee. The practitioner should be prepared to answer the question as to whether there is greater protection afforded in a "spendthrift trust" versus a "purely discretionary trust." While the courts may view this differently, the difference from a protective perspective is marginal. Here is why.

First, we cannot recall the last time we saw a trust drafted without a spendthrift provision. We would venture to say they are always in there, essentially as a boilerplate provision. As a standard provision, they operate as an accompaniment to the protection offered by the discretionary feature.

Second, with a discretionary trust, the creditor protection is sound, provided (1) the trustee does not make any distributions, (2) the trustee does not have to make a distribution (*e.g.*, the trustee "shall" distribute versus "may" in front of a distribution standard), (3) the jurisdiction does not have *Berlinger*[2]—like rules, discussed, *infra*, and (4) the beneficiary (in the eyes of certain state courts) cannot force the trust to make a distribution (*e.g.*, the beneficiary does not have a withdrawal right or serve as trustee of a trust with an unascertainable distribution standard).

Third, the spendthrift provision merely prevents a third-party creditor from attaching the income or other interest by substituting the creditor for the beneficiary of that income or other interest. For example, assume the beneficiary of a $100,000 spendthrift trust is entitled to all the income on a mandatory basis. A third-party creditor of the beneficiary cannot substitute themselves for the beneficiary to satisfy the debt. However, once the trustee makes a distribution to the beneficiary, the funds are in the beneficiary's hands and can then be reached by the creditor.

With a discretionary trust, created by a third party, the general rule is that a creditor cannot force the trustee to make a distribution.[3] Therefore, the creditor cannot effectively substitute in as the beneficiary. Because no mandatory distributions are required to be made, in a purely discretionary trust, a creditor would have no interest absent the trustee making, or being "required to make," a distribution to the beneficiary.

> **Practice Tip.** Focus on the discretionary provisions in a trust in determining creditor protection, rather than relying solely on the spendthrift provision for any great creditor protection. For example, as a rule of thumb, a purely discretionary trust, with no mandatory income interest, has in effect more relevant creditor protection than a mandatory income trust coupled with the typical spendthrift provision.

Using a Spendthrift Trust to Allow a Trustee to Game-Play

If the trust has discretionary distribution language as to income and principal, the spendthrift clause in that discretionary trust will provide a practical layer of additional creditor protection. With that clause added, creditors "may not reach the … distribution … before its receipt by the beneficiary."[4] This has two practical results.

First, courts often allow third-party creditors access to trust funds, ignoring fiduciary constraints on discretionary distributions, whenever they find the spendthrift clause is rendered ineffective. Those same courts may ignore the discretion to the trustee and the trustee's fiduciary obligation in exercising that discretion. For example, where the beneficiary and trustee is the same person, subject to a discretionary standard for distribution, the court may conclude that such a degree of control renders the spendthrift clause ineffective and then imply that a third-party creditor can reach into the trust and obtain the trust property. This condenses what is truly a two-step process into one.

Step two should be: Has the trustee exercised, or must the trustee exercise, its discretionary authority? Focusing on the spendthrift clause often causes a court to conclude that it can override this second step. Therefore, right or wrong, practitioners should try to preserve and argue for the application of the spendthrift clause.

Second, if the spendthrift clause is valid, then trustees may then try to use funds for the beneficiary's benefit by making a distribution to a third party or may make a distribution to a beneficiary that requires the creditor to go after the distribution after it is in the hands of the beneficiary.

If the trustee then makes distribution to a third party for the use of the beneficiary (*e.g.*, to pay down the mortgage on the personal residence that perhaps has already qualified for the homestead exemption), in most jurisdictions the creditor will not be able to pull back that distribution for the creditor's use. However, evolving case law may give creditors greater rights even here, including obtaining a garnishment order under state law.

For example, Florida Trust Code sections 736.0503 and 736.0504 reflect the public policy of most states in indicating that spendthrift protection is not enforceable against a court-ordered child or spousal support determination. In *Berlinger*,[5] according to the court's interpretation of the same statute, the creditor (spouse or child) may not "compel a distribution that is subject to the trustee's discretion or attach or otherwise reach that interest." Instead (somewhat bizarre) a spouse or child can obtain a writ of garnishment against disbursements made by a trustee.

A “writ of garnishment” is an order requiring a third party to withhold some type of property (usually money) of the defendant’s (also called the “garnishee” or “judgment debtor”) for delivery to a creditor to whom they owe an overdue debt. It means that the creditor can tell the trustee, in effect, “any time you want to make a distribution to or for the benefit of my deadbeat husband, your beneficiary, you have to give it to me first.”

> **Practice Tip.** Using the spendthrift provision, if there are creditors, the trustee can undertake two approaches. First, discuss a compromise on the debt with the creditor since the creditor may be waiting a long time for a distribution to the beneficiary; that compromise could be 20 or 30 cents on the dollar. And second, without a compromise, to consider making all distributions “for the benefit of” (to third parties) of the beneficiary.

Consideration of Spendthrift Protection in the Modern World

In crafting creditor protection trusts for children and grandchildren of your clients, and after all, all trusts should be considered for construction in this manner at some level (that is, with some degree of shielding from creditors, even if not 100%), think of the spendthrift provision as umbrella protection. The initial creditor protection should be based on the absence of (1) mandatory income distribution provisions, (2) mandatory withdrawal rights at certain ages, and (3) too much discretion with the beneficiary to force distributions to the beneficiary. The spendthrift clause, coupled with well thought out distribution provisions, can function as a solid base for creditor protection in trusts.

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[1]*Frisch v. Frisch*, U.S. Bankruptcy Court, D.C. Michigan, No. 13-80072. There, the court held that the withdrawal right at age 30 allows creditors access to funds at that age despite spendthrift protection because the beneficiary “has the equivalent of complete ownership.” *Id.*

[2]*Berlinger v. Casselberry*, 133 So3d 961 (2013).

[3]*See*, *e.g.*, section 504 of the Uniform Trust Code (regardless of whether the trust has a spendthrift clause, a trust with a distribution standard prevents a creditor of the beneficiary from reaching the beneficiary’s trust interest). *See also* section 60 of the Restatement of Trusts (Third). (A transferee or creditor of a trust beneficiary cannot compel the trustee to make discretionary distributions if the beneficiary personally could not do so.) While a

creditor could argue “abuse of discretion,” we would posit that a reasoned decision against making the distribution would not be an abuse of discretion if the standard is “may,” not “shall.” The Restatement goes so far as to suggest that the existence of a creditor should create a strong argument supporting fiduciary discretion against making distributions. Section 60, Restatement*, infra*, “a trustee’s refusal to make distributions might not constitute an abuse as against an assignee or creditor” even when it would constitute an abuse if there had been no creditor.

[4] *See, e.g.,* section 502(b) of the Uniform Trust Code.

[5] *See supra* note 2.