

Understanding Spendthrift Trusts, Basic Probate Provisions, and Application of the King Case in Bankruptcy Cases

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Presentation Overview

- Spendthrift Trusts and examples
 - Arizona law applies
 - Assume no fraudulent transfers
- Basic Probate Provisions
- Beneficiary Designation of Insurance Policy to Revocable Trust
 - How to review trust to determine if King case applies

What are the Elements of a Trust?

- Arizona Trust Code Section 14-10402(A): A valid trust includes the following essential elements:
 - A competent settlor
 - The settlor indicates an intention to create trust
 - A definite beneficiary (or qualifies as a charitable trust, pet trust or purpose trust)
 - The Trustee has duties to perform
 - The same person is not the sole trustee and sole beneficiary.

What is a spendthrift trust?

- A trust that contains a spendthrift provision

What is a spendthrift provision?

- A term of a trust that restrains either voluntary or involuntary transfer of a beneficiary's interest. §14-10103(18)
- Difficult to have a defective provision. A term of a trust providing that the interest of a beneficiary is held subject to a spendthrift trust. §14-10502(B)
- The magic words are (on next page)...

Best Spendthrift Provision

- The interest of a beneficiary in the principal or income of any trust created hereunder shall not be subject to claims of his or her creditors, or others, or liable to attachment, execution, voluntary or involuntary assignment or transfer, or other process of law, and no beneficiary shall have any right to assign, transfer, encumber or hypothecate his or her interest in the principal or income of the trusts created under this instrument in any manner, except to the extent otherwise expressly provided in this instrument.

Rules for Creditors of Settlers – Rule No. 1

1. A creditor can reach assets held in a revocable trust created by the Settlor. §14-10505(A)(1)
 - What is a revocable trust? Any trust unless the terms of the trust provide that it is irrevocable. But see 14-10103(15) “Revocable” as applied to a trust means revocable by a settlor without the consent of any person.
 - A revocable trust is also referred to as a “living trust.”
 - Upon the death of a settlor, the trust becomes irrevocable.

Rules for Creditors of Settlers – Rule No. 2

2. Creditors can reach a decedent's estate and revocable trust after the death of the settlor. §14-10505(A)(3).
 - Creditors must file a claim in the probate estate within four months after the date of first publication. Sections 14 -3801 and 3804.
 - If there is no estate because all assets are held in trust, creditors may file a claim against the trust in same manner as probate. Section 14-6103.
 - If no probate action is opened within 45 days after death, a creditor may open a probate estate. 14-3203(A)(7).

Rules for Creditors of Settlers – Rule No. 2

- If the estate is insolvent, there is a statute governing priority of creditors (§14-3805):
 - Costs and expenses of administration
 - Allowances (§14-2401 et seq.)
 - Reasonable funeral expenses
 - Debts and taxes with preference under federal law
 - Reasonable and necessary medical and hospital expenses of the last illness of decedent, including compensation of persons attending him
 - Debts and taxes with preference under the laws of this state
 - All other claims

Rules for Creditors of Settlers – Rule No. 2

- Creditors may reach nonprobate assets other than a transfer of a survivorship interest in a joint tenancy of real estate to the extent that the probate estate is insufficient. §14-6102
 - Joint accounts
 - Beneficiary deeds
 - Vehicle transferred by ADOT beneficiary designation
 - Does not include life insurance or inherited IRAs.

Rules for Creditors of Settlers – Rule No. 3

- A person is not a settlor of a trust in excess of the person's share of contributions to the trust. §14-10505(A)(1).
 - This section does not abrogate applicable laws relating to community property.
 - If a settlor contributed property to a trust and a third party also contributed property, then the creditor may only reach the property contributed by settlor-debtor.

Rules for Creditors of Settlers – Rule No. 4

- Creditors of the settlor can reach the maximum amount the trustee of an irrevocable trust can pay to or for his benefit.
§14-10505(A)(2).
 - A self-settled trust is not prohibited under Arizona law, but creditors can reach any amount that may be paid to the settlor.
 - For example, a settlor may receive income from his own irrevocable trust. Creditors can reach.
 - For example, a settlor creates a grantor retained annuity trust to receive an annual annuity payment and remainder to children or charity. Creditors can reach annuity amount.

Rules for Creditors of Settlers – Rule No. 4

- Many irrevocable trusts allow a trustee to reimburse a settlor for the income taxes payable by the settlor for income taxes due from income of the trust (intentionally defective grantor trusts cause the settlor to be taxed on the income as a continuous gifting program without using gift exemption)

Rules for Creditors of Settlers – Rules No. 5 & 6

As a result of more complicated trusts such as spousal access trusts:

- A settlor of a trust for his spouse is not a settlor if he reacquires rights in the trust after the spouse dies.
§14-10505(E)
- A person is not the settlor of a trust created by his spouse as a result of creating a trust for the spouse.
§14-10505(E)

Rules for creditors of beneficiaries – No. 1

- A Trust is invalid if beneficiary may withdraw principal. (See Mitchell, supra)
 - For example, if the beneficiary may withdraw the balance of the trust property at age 40, and the beneficiary is over the age of 40, creditors of the beneficiary may reach the property.

Rules for creditors of beneficiaries – No. 2

- The Trust is invalid if the beneficiary is the sole beneficiary and trustee.
 - If there is a residual beneficiary, then the trust is not invalid because the beneficiary is not the sole beneficiary. See In Re Coumbe, 304 B.R. 378 (9th Cir. 2003).

Rules for creditors of beneficiaries – No. 3 and 4

- A creditor may not compel a distribution subject to Trustee's discretion. A.R.S. 14-10504(A).
 - For example, if the Trustee may distribute amounts:
 - for the beneficiary's health, education, support and maintenance;
or
 - amounts in the sole discretion of the Trusteethe creditor may not compel a trustee to make any distributions.
- Even if the beneficiary is the Trustee, the creditor may not compel a distribution subject to Trustee's discretion. A.R.S. 14-10504(E).

How to Analyze Arizona Law Re: Trusts

- Review Arizona Trust Code. Applicable to all trusts now.
- Sections 14-10501 et seq. apply to creditor issues.
- Section 14-10506 amended (see next slide)
- Compare the ATC provision to the UTC provision. Review comments to UTC provision (usually instructive).
- Review Restatement (Second) of Trusts for interpretation of common law related to the rights and powers of creditors of beneficiaries. See 14-10106(B).
- Review Arizona case law (not California case law unless interp. Az law).

Recent Amendment to 14-10506(B)

- Section 14-10506 describes creditors' remedies if a Trustee fails to make a mandated distribution within a reasonable time. The definition of a mandatory distribution was amended (in S.B. 1204) and now includes:
 - Distribution of income or principal that Trustee is required to make to beneficiary (e.g. all income quarterly);
 - (new) Distribution at a stated age (e.g. 1/3 at age 30, ½ at age 35, balance at age 40);
 - (new) Distribution pursuant to exercise of power of withdrawal (e.g. 5% at end of year); and
 - Distribution at termination of trust.

Arizona Case Law (spendthrift provision invalid)

- In Re Pugh, 274 B.R. 883 (D. Ariz. 2002)
 - Statute at time was 14-7706 – spendthrift provision is valid “even if the beneficiary was one of the multiple trustees of the trust,” but “is invalid if the sole beneficiary of the trust is also the sole trustee of the trust.”
 - Trust provided that no beneficiary acting as trustee may exercise discretion without a co-trustee. Co-Trustee did not know of acts of beneficiary/trustee.
 - The court found that the beneficiary acted as the sole trustee.
 - Would new ATC provisions change decision? Probably not because there does not appear to be another beneficiary. GPOA. Arguments could use for validity: ATC 14-10504(A)(2) or ATC 14-10504(E)

Arizona Case Law (spendthrift provision invalid)

- In Re Rhonda K. Mitchell, 423 B.R. 758 (E.D. Wisc. 2009)
 - Is spendthrift clause technically valid?
 - ATC applies. ATC is inconsistent. Definition in 10103 states “both voluntary and involuntary transfers.” 10502(A) states “either.” Subsequently, amended to state “either.”
 - Spendthrift provision in Trust provided “may not be voluntarily or involuntarily alienated or encumbered.”
 - It does not matter what the spendthrift clause states. The beneficiary could withdraw the entire principal immediately. 14-10106 provides Restatement (Second) of Trusts applies (specifically Section 153(2)).

Arizona Case Law

(spendthrift provision invalid)

- In Re Kent, 396 B.R. 46 (Bankr. D. Ariz. 2008); see also In Re Messer, BAP No. AZ-11-1505-JuPaD, Bk No. 11-03007 (9th Cir. Not for publication) (re: “annuities”)
 - The annuities were not “trusts” under Arizona common law (14-10402 did not apply yet but is similar)
 - Cannot argue spendthrift trust provision applies since contracts were not trusts.
 - Debtors are not owners – life insurance companies are owners; Debtors are not settlors; Debtors are not beneficiaries – the Estate of Kimberly Kent was the beneficiary; No trustee.
 - Debtors argued Patterson v. Shumate, 504 U.S. 753 (1992) applied to create a new exclusion (ERISA plan excluded). Patterson was distinguishable: pension plan set up as a trust with trustee acting as a fiduciary and beneficiaries under the plan with an anti-alienation provision.
 - A.R.S. 33-1125 (A)(7) does not apply because it applies to annuities owned by Debtor.

Arizona Case Law (spendthrift provision valid)

- In Re Coumbe, 304 B.R. 378 (9th Cir. BAP 2003) (interpreting AZ law)
 - Settlor creates testamentary trust (w/ spendthrift provision) naming children as primary beneficiaries. If children predeceased settlor, grandchildren were secondary beneficiaries.
 - Bankruptcy Court found that Debtor was the only beneficiary receiving distributions from Trust but that it was a valid spendthrift trust.
 - Under 541(a)(5), debtor’s acquisition of a “bequest, devise or inheritance” within 180 days after filing of petition is property of estate.
 - The Court determined that a distribution from a testamentary trust (within 180 days) turns on whether the distribution is from corpus or income. A distribution of corpus (principal) is excluded if distributed from a testamentary trust within 180 days of filing. A distribution of income from testamentary trust is included in property of estate because it is a bequest.
 - Distributions from a revocable trust are not included in the definition of “bequest, devise or inheritance.”

Case Study

- Attorney drafts trust that after death of settlor, the beneficiary is to receive income and amounts in the discretion of the trustee. The beneficiary is the trustee. After death of beneficiary, the trust shall terminate and the trustee shall distribute remainder pursuant to Article X to beneficiaries listed.
- Settlor dies. Trust created for beneficiary.
- Beneficiary declares bankruptcy.
- Bankr. Court holds that trust is property of bankruptcy estate because the sole beneficiary is the sole trustee. 14-10402(A)(5).
- Is this an accurate holding?
- See In Re Coumbe, supra and 14-10504(E).

Planning to Avoid Invalid Spendthrift Clause

- Retain beneficiary's interest in trust (no staged distributions);
- Use clause to retain beneficiary's interest in trust if creditor issues arise (14-10506(A) allows terms of trust to delay distribution to protect it);
- Use Trust Protector to amend distribution provisions if creditor issues arise;

Basic Probate Provisions You Need to Know

- A creditor of an estate must file a claim against the estate within four months after notice to creditors has been published. Sections 14-3801, 14-3804.
- If a Trustee of a Trust has not published notice to creditors, a creditor may have up to two years to file a claim. 14-3803.

Basic Probate Provisions You Need to Know

- If an estate is insolvent, the creditors are paid pro rata in order of priority. 14-3805.
 - a. Costs and expenses of administration
 - b. Allowances (§14-2401 et seq.) Very minimal - Homestead (\$18k), Family (\$12k), Personal Property (\$7k)
 - c. Reasonable funeral expenses
 - d. Debts and taxes with preference under federal law
 - e. Reasonable and necessary medical and hospital expenses of the last illness of decedent, including compensation of persons attending him
 - f. Debts and taxes with preference under the laws of this state
 - g. All other claims.

Basic Probate Provisions You Need to Know

- Nonprobate transfers may be subject to creditor claims. 14-6101. There are exceptions (life insurance, IRAs, etc.)
 - A nonprobate transfer does not include real property held as JTWROS. 14-6102(I).
 - In Re Chernushin, 2018 BL 27539 (D. Colo. 2018). Husband files Ch. 13 bankruptcy. Converted to Ch 7. Husband dies. Wife receives real property held as JTWROS. Trustee's interest in property terminated.
 - A nonprobate transfer includes a transfer by beneficiary deed.
- If no probate is filed, a creditor may open a probate 45 days after decedent's death. 14-3203

Basic Probate Provisions You Need to Know

- Debtor has a claim against estate. Filing a petition in the bankruptcy action is sufficient to provide notice to the personal representative of the estate. 14-3804(2).
- Debtor inherited property from deceased mother on her date of death, not on the date that the probate was filed. Four days before he filed his petition, his mother passed away. The inherited property became property of the bankruptcy estate.

Beneficiary Designation of Life Insurance Policy to Revocable Trust

- Insurance proceeds are exempt from creditor claims whether paid to a beneficiary or to a revocable trust. 14-10504(D)(2); 20-1131(A).
- In re Estate of King, 228 Ariz. 565, 269 P.3d 1189 (2012). The court expanded the protection for beneficiaries by stating that the waiver of statutory protection must be specific. The trust language that authorized trustee to pay debts of trust assets was not sufficient to waive statutory protection. Waiver must be specific (e.g. “The settlor authorizes the Trustee to pay estate taxes, expenses and settlor’s debts from any life insurance proceeds received by this Trust.”)

Arizona Case Law

- Midfirst Bank v. Barness, 2014 WL 6456046 (Ariz. App. 2014).
 - H owned term life insurance policy with W as beneficiary.
 - In Jan 2011, H established trust with W as beneficiary and sister as Trustee. H transferred policy to Trust as owner but failed to change beneficiary to Trust. W remained beneficiary of policy.
 - In Feb 2012, creditors obtained a default judgment against H&W.
 - In Sep 2012, sister as Trustee identified Trust as beneficiary.
 - In Oct 2012, H died.
 - Proceeds were exempt from garnishment to satisfy either H or W's debts. It was not a fraudulent transfer because the Trustee made the change in beneficiary designation. The proceeds were not H's because they did not come into existence until he died. Transfer to the Trust did not affect the creditors because the wife was also a beneficiary of the Trust.

Estate Planning Provisions

- Specifically provide that no clause in a revocable trust waives any rights under Section 20-1131.
- Specifically include a clause that the settlor intends for the trust assets to be protected from creditors. When create trust, need to be able to complete an Affidavit of Solvency.

Need more information?

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**UNDERSTANDING SPENDTHRIFT TRUSTS, BASIC PROBATE PROVISIONS AND
APPLICATION OF THE KING CASE IN BANKRUPTCY CASES**

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- I. Arizona law regarding Spendthrift Trusts
 - A. What is a Spendthrift Trust
 - B. What is a Trust
 - C. What is a Spendthrift Provision
 - D. What is a Voluntary Transfer
 - E. What is an Involuntary Transfer
 - F. Exceptions
 - G. Rules Applicable to Creditors of Settlers
 - H. Rules Applicable to Creditors of Beneficiaries
 - I. How to Analyze Arizona law concerning Trusts
 - J. Cases Interpreting AZ law concluding that spendthrift clause is invalid
 - a. In Re Pugh
 - b. In Re Rhonda K. Mitchell
 - c. In Re Kent
 - d. In Re Messer
 - K. Cases Interpreting AZ law concluding that spendthrift clause is valid
 - a. In Re Coumbe
 - L. Cases Other than AZ law concluding that spendthrift clause is valid
 - a. Patterson v. Shumate (pension plan)
 - M. Planning to avoid an invalid spendthrift provision
- II. Probate Provisions that may be useful upon the death of a Person for the benefit of creditors
 - A. File a Claim Against Estate
 - B. File a Claim Against Trust
 - C. Priority of Creditors
 - D. Allowances
 - E. Nonprobate Transfers may be subject to Creditor Claims
 - F. Debtor has a Claim against Estate
 - G. Miscellaneous Case - Chappel v. Proctor
- III. Beneficiary Designation of Insurance Policy to Revocable Trust
 - A. §14-10504(D)
 - B. §20-1131
 - C. Estate of King
 - D. In Re Garcia
 - E. Midfirst Bank v. Barness
 - F. Planning provisions to assist in achieving result in King

Documents Attached

ATC Sections 14-10501 et seq. and notes comparing to UTC

UTC Sections 501 et seq. and related comments concerning intention of sections

Property of a debtor becomes property of the bankruptcy estate, subject to a debtor's right to reclaim certain property as exempt. Bankruptcy Code §541(c)(1). Bankruptcy Code Section 541(c)(2) provides: "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title." A restriction on the transfer of a beneficial interest is a spendthrift provision. The Bankruptcy Code recognizes spendthrift trusts to the extent they are enforceable under state law and assets in a valid spendthrift trust do not become property of the estate.

This summary does not consider fraudulent transfers.

- I. Arizona law regarding Spendthrift Trusts. See Arizona Trust Code Sections 14-10501 et seq.
 - A. What is a spendthrift trust? A trust that contains a spendthrift provision.
 - B. What is a trust? The essential elements of a valid trust include (1) a competent settlor; (2) an intention to create a trust; (3) a definite beneficiary (subject to exceptions); (4) the trustee has duties to perform; and (5) the same person is not the sole trustee and sole beneficiary. A.R.S. Section 14-10402(A).
 - C. What is a spendthrift provision?
 - (1) §14-10103(18) – Definition of spendthrift provision “means a term of a trust that restrains either voluntary or involuntary transfer of a beneficiary’s interest.”
 - (2) §14-10502(B) – Spendthrift provision – A term of a trust providing that the interest of a beneficiary is held subject to a spendthrift trust, or words of similar import, is sufficient to restrain both voluntary and involuntary transfer of the beneficiary’s interest.
 - (3) Example of a Spendthrift Clause in a Revocable Trust. The interest of a beneficiary in the principal or income of any trust created hereunder shall not be subject to claims of his or her creditors, or others, or liable to attachment, execution, voluntary or involuntary assignment or transfer, or other process of law, and no beneficiary shall have any right to assign, transfer, encumber or hypothecate his or her interest in the principal or income of the trusts created under this instrument in any manner, except to the extent otherwise expressly provided in this instrument.
 - (4) It would be difficult to have a defective spendthrift clause. According to statute, set forth above, the trust can just state that the interest of a beneficiary is held subject to a spendthrift trust. For planning purposes, however, I would recommend stating (at a bare minimum) that a beneficiary’s interest is not subject to claims of creditors, or subject to voluntary or involuntary assignment.
 - D. A beneficiary may not transfer an interest in a trust in violation of a spendthrift provision (voluntary transfer). §14-10502(C).
 - E. Except as otherwise provided in this Article, a creditor may not reach an interest or a distribution by the trustee before its receipt by the beneficiary (involuntary transfer). §14-10502(C).
 - F. Exceptions to validity of spendthrift provision:

(1) A beneficiary's child with a judgment or court order may collect against the beneficiary for support or maintenance, unless it is a special needs trust. §14-10503(A)

(2) A claim of the state or the United States (e.g. IRS) has priority. §14-10503(B).

G. Rules applicable to creditors of settlors (see §14-10505) (a settlor is the person that created the trust):

(1) A creditor can reach assets held in a revocable trust created by the Settlor. §14-10505(A)(1).

(2) A Trust becomes irrevocable upon the death of the settlor. Creditors of decedent can reach decedent's estate and revocable trust. §14-10505(A)(3). Creditors can reach nonprobate assets to the extent that the probate estate is insufficient. See §14-6101 et seq.

(3) A person is not a settlor of a trust in excess of the person's share of contributions to the trust. §14-10505(A)(1).

(4) Creditors of the settlor can reach the maximum amount the trustee of an irrevocable trust can pay to or for his benefit. §14-10505(A)(2). A creditor shall not reach any power of trustee to reimburse the settlor for any income tax that is payable by the settlor.

(5) A settlor of a trust for his spouse is not a settlor if he reacquires rights in the trust after the spouse dies. §14-10505(E)

(6) A person is not the settlor of a trust created by his spouse as a result of creating a trust for the spouse. §14-10505(E)

H. Rules applicable to creditors of beneficiaries (see §14-10504):

(1) A Trust is invalid if beneficiary may withdraw principal. (Mitchell, supra) For example, if the beneficiary may withdraw the balance of the trust property at age 40, and the beneficiary is over the age of 40, creditors of the beneficiary may reach the property.

(2) Trust is invalid if beneficiary is sole beneficiary and trustee. (Pugh, supra (beneficiary acted as sole Trustee; Coumbe, supra (beneficiary was not sole beneficiary))

(3) A creditor may not compel distribution subject to Trustee's discretion such as to distribute for beneficiary's health, education, maintenance and support. §14-10504(A).

(4) A beneficiary may be the Trustee and distribute amounts in the Trustee's sole discretion or limited to an ascertainable standard (e.g. for the beneficiary's health, education, maintenance and support) to himself or herself, and the creditor may not reach the beneficiary's interest. §14-10504(E)

I. How to Analyze Arizona law concerning Trusts.

- a. Review Arizona Trust Code (specifically Sections 14-10501 et seq.). Arizona Trust Code will most likely apply to all situations now. (Sec.18 of Laws 2008, Ch. 247 of ATC); In Re Mitchell, 423 B.R. 758 (2009).

Sec. 18. Application to existing relationships.

“A. Except as otherwise provided in this act, beginning on January 1, 2009;

1. This act applies to all trusts created before, on or after January 1, 2009;
2. This act applies to all judicial proceedings concerning trusts commenced on or after January 1, 2009.
3. This act applies to judicial proceedings concerning trusts commenced before January 1, 2009.
4. Any rule of construction or presumption provided in this act applies to trust instruments executed before January 1, 2009, unless there is a clear indication of a contrary intent in the terms of the trust.
5. An act done before January 1, 2009 is not affected by this act.”

(1) Section 14-10501 – describes law if trust does not contain spendthrift provision.

(2) Section 14-10502 – describes the effect of a spendthrift provision.

(3) Section 14-10503 – describes exceptions to spendthrift provisions.

(4) Section 14-10504 – describes discretionary trusts or trust with standard of care.

(5) Section 14-10505 – describes creditor claims against settlor

(6) Section 14-10506 – describes creditors’ remedies if Trustee fails to make mandated distribution within reasonable time. This section was amended this last legislative session (Spring 2018), effective 90 days after sine die as follows:

B. For the purposes of this section, "mandatory distribution" means a distribution of income or principal that the trustee is required to make to a beneficiary under the terms of the trust, including A DISTRIBUTION AMOUNT FOR A STATED AGE, A DISTRIBUTION TO BE MADE PURSUANT TO THE EXERCISE OF A POWER OF WITHDRAWAL AND a distribution on termination of the trust. Mandatory distribution does not include a distribution that is subject to the exercise of the trustee's discretion even if:

1. The discretion is expressed in the form of a standard of distribution.

2. The terms of the trust authorizing a distribution couple language of discretion with language of direction.

(7) Section 14-10507 – although trustee holds property, property is not subject to trustee’s personal debts.

- b. Compare the ATC provision to the UTC provision because there is more authority and cases for UTC provisions. Review comments in UTC for reasoning behind statutes.

c. Review Restatement (Second) of Trusts for interpretation of the common law, and not to subsequent restatements of trust to determine:

- **the rights and powers of creditors of beneficiaries;**
- the duties of trustees to distribute to those to whom a beneficiary owes any duties;
- whether public policy may affect enforceability and effectiveness of the terms of the trust; and
- effectuate the settlor's intent.

§14-10106(B). Otherwise you may look to the Restatement (Third) of Trusts to assist in interpretation of the common law.

d. Review case law, specifically Arizona case law. Please note that California has not adopted the UPC or the UTC when attempting to analyze California case law for interpretation of state law.

J. Cases (interpreting Arizona law) where a court has concluded that a spendthrift provision is invalid.

e. In Re Pugh, 274 B.R. 883 (Bankr. D. Ariz. 2002). Debtor's mother died leaving an irrevocable trust with a spendthrift provision for the benefit of each of her children. Each beneficiary was to be both trustee and beneficiary of their own trusts. Before any money is withdrawn, the beneficiary must name a person to serve as co-trustee, but no beneficiary acting as Trustee may exercise Trustee's discretion to make distributions of principal to a beneficiary without the agreement of the co-trustee. The son/debtor distributed money without co-trustee's knowledge, signature or consent. At that time, Arizona statutes provided that a spendthrift provision is valid even if the beneficiary is also one of the trustees. 14-7706. The concept was that "[i]f a trust instrument allows the trustee to exercise discretion in the use of income or principal, a transferee or creditor of the beneficiary may not compel the trustee to pay an amount that may be paid only in the exercise of his discretion." In this case, a trustee who does not know she is a trustee cannot possibly exercise such discretion. Basically, the beneficiary is in reality the sole trustee so the spendthrift trust provision is invalidated. Query: Would this case be decided in the same manner after ATC was enacted? See Section 14-10504(A)(2) – a creditor of a beneficiary may not compel a distribution that is subject to the trustee's discretion even if the trustee has abused the discretion regarding distributions. In addition, pursuant to Section 14-10504(E) a creditor may not reach the beneficiary's beneficial interest even if the beneficiary is the Trustee if the trustee's discretion is purely discretionary or limited to a standard. Nonetheless, the case appears to be stating that the beneficiary had a power of withdrawal and a power of withdrawal is a general power of appointment which includes the assets in the beneficiary's estate for creditor purposes.

f. In Re Rhonda K. Mitchell, 423 B.R. 758 (E.D. Wisc. 2009). Mother of the debtor created the Lois L. Mitchell Trust and under the terms of her will all of her property would pass to the Trust (pourover Will). The Trust provided that as soon as the trust was divided into shares each child may withdraw the balance from the principal of his

or her share at any time or times. The Court found that the Arizona Trust Code applied. At the time of the case, the two provisions in the ATC were inconsistent (§14-10103 and §14-10502(A)).¹ Those two provisions have been amended to be consistent. The court will look to the Restatement (Second) of Trusts for the interpretation of common law (in some situations). §14-10106(B). Whereas beneficiary is entitled to immediate payment of the principal, the restraint on alienation of his interest is invalid. Such is the case here and the spendthrift provision is invalid.

- g. In Re Kent, 396 B.R. 46 (Bankr. D. Ariz. 2008) (contrary to Patterson v. Shumate, referred to below. In Patterson, the pension plan was held not to be property of the estate because it was a trust with a spendthrift provision). **The annuities discussed in Kent and Messer, below, are not the typical annuity described as insurance products that provide long-term income through a stream of future payments.** The “annuities” discussed in these two cases are contracts with the insurance company as the owner. Accordingly, the court holds that the “annuities” are property of the estate and are not excluded from the estate under Bankruptcy Code §541(c)(2). These “annuities” are not trusts. These “annuities” were contracts with a nonassignment provision. Even though the annuities included an anti-alienation clause, they do not qualify as trusts. The debtors are not owners and are not settlors. The beneficiary is the Estate of Debtor, not the Debtor. The Debtor is the payee. The annuity is a contract with an anti-alienation provision in it. There is not the necessary third party Trustee acting independently. The case reports that the “annuities” did not qualify as exempt assets under Arizona law under §33-1126 because the “annuities” were not owned by debtor.
- h. In Re Messer, BAP No. AZ-11-1505-JuPaD, Bk.No. 11-03007 (9th Circuit not for publication). The “annuity” arose from a settlement for the wrongful death of debtor’s husband. The insurer owned the “annuity” and it was not assignable. Because the “annuity” was never owned by debtor, debtor could not claim it as exempt under A.R.S. Section 33-1126(A)(7). The “annuity” did not qualify as a spendthrift trust citing Kent.
- K. Cases (interpreting Arizona law) where a court concluded that a spendthrift provision is valid.
- a. In Re Coumbe, 304 B.R. 378 (9th Circuit BAP 2003).
- Principal of a spendthrift trust distributed within 180 days after filing petition is not reachable.
- Income of a spendthrift testamentary trust distributed within 180 days after filing petition is reachable because it is a “bequest”.
- Debtor’s mother created a testamentary trust naming her children as the primary beneficiaries and her grandchildren as secondary beneficiaries. Trustee filed a motion

¹ At the time of the case, Section 14-10103(17) stated that such a term of a trust must restrain both voluntary and involuntary transfers of a beneficiary’s interest. However, Section 14-10502(A) of ATC declared that such a spendthrift provision is valid “only if it restrains either voluntary or involuntary transfers of a beneficiary’s interest.” Section 14-10103(18) was subsequently amended to define a spendthrift provision as “a term of a trust that restrains *either* voluntary or involuntary transfer of a beneficiary’s interest.”

arguing that because Debtor was the sole Trustee and sole beneficiary, the Trust was not a valid spendthrift trust. Debtor had also distributed \$20,000 from the Trust to himself within 180 days of filing of petition. Creditor alleged the \$20,000 was estate property. Debtor argued that he was not the sole beneficiary and that the \$20,000 was not acquired by "bequest, devise or inheritance within 180 days of filing." The Trust is a valid spendthrift trust because there are multiple beneficiaries. The main issue is whether a distribution from the Trust is a "bequest, devise or inheritance" under Section 541(c)(2). A bankruptcy trustee can assert no claim to the corpus of a spendthrift trust within 180 days of filing petition because it is not property of estate. Therefore, it flows logically that a corpus distribution within 180 days after filing petition from a spendthrift trust should also be excluded from property of the estate. However, income distributed within 180 days of filing petition constitutes a "bequest" and is property of the estate.

L. Cases (other than Arizona law) where a court concluded that a spendthrift provision is valid.

- a. Patterson v. Shumate, 504 U.S. 753 (1992). Debtor's interest in an ERISA qualified pension plan may be excluded from the property of the bankruptcy estate pursuant to Section 541(c)(2) because the restriction on transfer was enforceable under "applicable nonbankruptcy law." Section 541(c)(2) provides that "a restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title." The Court determined that applicable nonbankruptcy law was not limited to state law. Then the Court determined that the antialienation provision contained in the ERISA Qualified Plan at issue satisfied the terms of Section 541(c)(2). The Court found that the spendthrift clause imposed a "restriction on the transfer" of a debtor's "beneficial interest" in the trust. The important fact is that the court found the pension plan to be a trust.

M. Planning to avoid invalid spendthrift provisions.

- a. Retain beneficiary's interest in trust with spendthrift clause and term of trust delaying distribution to protect beneficiary's interest and/or have trust protector ability to amend trust to change distribution provisions to prevent distributions to beneficiary when they will be distributed to creditor. For example, a beneficiary may receive amounts for health, education, maintenance and support plus a 5% withdrawal power once per year at the end of the year, plus a special power to appoint the property, with a special provision to delay distributions to protect beneficiary's interest from creditors and the ability of a trust protector to amend the trust to prevent distributions in the event beneficiary has creditor issues.
- b. A.R.S. Section 14-10506(A) provides that a creditor can reach a mandatory distribution of income or principal, whether or not the trust contains a spendthrift provision if the trustee has not made the distribution to the beneficiary within a reasonable time after the mandated distribution date unless the terms of the trust expressly authorize the trustee to delay the distribution to protect the beneficiary's interest in the distribution. The underlined clause is not in the Uniform Trust Code. Arizona has added this clause.
- c. Our trusts include clauses that are intended to avoid distributions to beneficiaries that have creditor issues.

- d. Example of clause to prevent distributions: No person, including, without limitation, a spouse of Distributee, is a beneficiary or claimant of a Distributee Trust. If any person, estate, or trustee shall stand in the stead of, or substitution of, Distributee, through legal entitlement or compulsion or otherwise, with respect to rights, interests or powers of Distributee in a Distributee Trust, who is not the actual human being who is Distributee, then the Trustee shall not make any distribution to or for the benefit of Distributee or act on any direction, election, exercise of power of or by Distributee, for so long as such stand or substitution shall continue. No distribution shall be made to for a bankruptcy trustee of Distributee, or to or for beneficiaries or creditors of the bankruptcy trustee.
- e. Another method (or can be used as additional protection) of creditor protection for beneficiaries is appointing a Trust Protector to have the power to amend a trust to prevent distributions to a beneficiary when creditors can reach distribution.

II. Probate Provisions that may be useful upon the death of a Person for the benefit of creditors

- A. File a Claim Against Estate. Creditors must file a claim in the probate estate within four months after the date of first publication or if notice is provided to an actual creditor, within four months or sixty days after actual notice, whichever is later. Sections 14 -3801 and 3804.
- B. File a Claim Against Trust. Trustees of Trusts must publish notice if they want to bar creditors after the death of settlor. §14-6103. If notice is not published, then a creditor has two years after death of decedent to file a claim. §14-3803.
- C. Priority of Claims. If the estate is insolvent, the creditors are paid pro rata in order of priority. See §14-3805.
 - a. Costs and expenses of administration.
 - b. Allowances (§14-2401 et seq.)
 - c. Reasonable funeral expenses
 - d. Debts and taxes with preference under federal law
 - e. Reasonable and necessary medical and hospital expenses of the last illness of decedent, including compensation of persons attending him
 - f. Debts and taxes with preference under the laws of this state
 - g. **All other claims.**
- D. Allowances. Allowances are very minimal in estates (the maximum amount is \$37,000) §14-2401 et seq.
 - a. Homestead – surviving spouse is entitled to \$18,000 or no SS then \$18,000 divided by number of minor and dependent children. (§14-2402)
 - b. Family – up to \$12,000 (\$1,000 for up to 12 months) for SS and minor children (§14-2404)
 - c. Personal Property - \$7,000 to SS or dependent children in excess of security interest in the following: household furniture, automobiles, furnishings, appliances, personal effects. (§14-2403)

- E. Nonprobate transfers may be subject to creditor claims. §14-6101 et seq. A nonprobate transfer does not include real property held as JTWROS. §14-6102(I). It would include a transfer by beneficiary deed. Id.
- F. Debtor has a Claim. If a debtor has a claim against a deceased person, they may file a petition in the bankruptcy action naming the estate as a defendant within the time limit for submitting a claim against the estate (4 months after first publication of notice). The filing of the petition naming the estate as a defendant serves as sufficient notice of the claim against the estate, if the filing is timely without filing a claim against the estate in the probate action. §14-3804(2).
- G. Miscellaneous Case.
 - a. The relevant date for determining when property passes to debtor is the date of death, not the date of filing probate. Chappel v. Proctor, 189 B.R. 489 (9th Cir. BAP 1995). Four days before the debtor filed his petition, his mother passes away. The mother's will was entered into probate more than 180 days after filing of the debtor's bankruptcy. Debtor argued his interest was not part of estate. Decedent's property passes to the beneficiary at the time of death. Therefore, the property passed to the debtor before the filing and became property of the estate. There was no trust involved here.

III. Beneficiary Designation of Insurance Policy to Revocable Trust.

- A. Whether or not trust has a spendthrift provision, a creditor may not compel a distribution from insurance proceeds payable to the trustee as beneficiary to the extent state law exempts the insurance proceeds from creditors' claims if it had been paid directly to the trust beneficiary. §14-10504(D)(2). Effective January 1, 2008. This statute is duplicative of §20-1131(A).
- B. Section 20-1131(A) protects life insurance proceeds paid to a third-party trust beneficiary (even if it was paid to a revocable trust that becomes irrevocable upon the settlor's death). It provides:

“If a policy of life insurance is effected by any person on the person's own life or on another life in favor of another person having an insurable interest in the policy, or made payable by assignment, change of beneficiary or other means to a third person the lawful beneficiary or such third person, other than the person effecting the insurance or the person's legal representatives, is entitled to its proceeds against the creditors and representatives of the person effecting the insurance.”

- C. In re Estate of King, 228 Ariz. 565, 269 P.3d 1189 (2012). The court added another protection for beneficiaries by stating that the waiver of statutory protection must be specific.

State law exempts the insurance proceeds from creditor claims under Section 20-1131(A).

The Arizona Court of Appeals has held that insurance proceeds paid to a revocable trust that became irrevocable as a result of the settlor's death are not subject to creditors' claims.

The creditor argued that the settlor waived protection because the trust language generically directing debts of trustor be paid from trust assets, but the court held that such clause was not sufficient to waive statutory protection. The waiver must be in clear effective language. Neither the Will nor the Trust specifically lists the insurance proceeds as a source in the directive to pay King's debts.

The clause in the Will provided:

"My Personal Representative shall pay out of the residue of my estate my funeral expenses, the expenses of administering my estate wherever incurred, estate and inheritance taxes,... and other proper charges against my estate... If, however, the cash and readily marketable assets in my residuary estate are insufficient to make the foregoing payments in full, the Personal Representative shall notify the Trustee of the trust ... of the amount of the insufficiency and request payment thereof."

The clause in the Trust provided:

"After payment from the Trustor's probate estate, the Trustee shall pay from the principal of the trust estate all remaining inheritance, estate or other death taxes ... that by reason of the Trustor's death are attributable to the trust estate and attributable to the Trustor's probate estate ... In addition to the extent such items have not been paid out of the residue of Trustor's probate estate, the Trustee shall pay first from income and then principal the expenses of Trustor's funeral, including gravestone, burial, and last illness, debts (except real estate mortgages) and expenses of administration of the Trustor's estate."

- D. In Re Garcia, 567 B.R. 168 (Bankr. D. Ariz. 2017). In this case the court held that the proceeds of a group policy are exempt from Debtor's creditors. Joint debtors filed for Chapter 7. Shortly after, Debtor-husband passes away and Debtor-wife is entitled to insurance proceeds of group life insurance policy. Debtor claims proceeds are exempt under A.R.S. §20-1132. Bankruptcy court held that proceeds were not exempt and Debtor appealed. Reversed.

20-1132 provides that "proceeds ...payable to... the beneficiary thereunder shall not be liable ... to be applied by any legal or equitable process to pay any liability of any person having a right under the policy." The court reads §20-1132 as providing an expanded protection for group life insurance policies as a sub-category of life insurance policies more generally (20-1131).

- E. Midfirst Bank v. Barness, 2014 WL 6456046 (Ariz. App. 2014). Based on the facts of this case, there is a surprising result.

- Mr. B owned a term life insurance policy, applied for in 1997, beneficiary is wife.
- January 2011, Mr. B established Trust with wife as the beneficiary of the trust and sister as the Trustee. Transferred policy to Trust as owner. Wife remained beneficiary of policy.
- In February 2012, creditors obtained a default judgment against Mr. and Mrs. B.
- On September 2012, sister, as trustee signed a document revoking the prior beneficiary designation for death proceeds and identified the Trust as the designated beneficiary of the Policy.
- Mr. B died in October 2012.

- Proceeds were exempt from garnishment to satisfy either Mr. B's debt or his wife's.

It was not a fraudulent transfer because Trustee made the change in beneficiary. Same facts as King in that proceeds were paid to a trust in which the beneficiary was a third party. The proceeds were never the decedent's as they did not exist until the insured's death. The Trust was the beneficiary of the proceeds. Transfer to the Trust did not affect the creditors because wife was also the beneficiary under the Trust.

F. Planning provisions that assist in achieving the result in King.

- a. Specifically provide that no clause in a revocable Trust waives any rights under §20-1131 etc.

- (1) Example:

The Settlers specifically do not waive the protections of A.R.S Sections 20-1131 and 33-1126 and similar legislative and regulatory protections.

- (2) Also include a general clause that the settlor intends for the trust assets to be protected from creditors.

A material purpose of the trusts created under this instrument is to protect the assets of the trusts created hereunder from claims of creditors of the beneficiaries thereof consistent with the provisions of this Trust Agreement.

14-10501. Rights of beneficiary's creditor or assignee; exception

A. 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 or by other means. The court may limit the award to such relief as is appropriate under the circumstances.

B. This section does not apply and a trustee has no liability to any creditor of a beneficiary for any distributions made to or for the benefit of the beneficiary to the extent a beneficiary's interest is protected by a spendthrift provision or is a discretionary trust interest referred to in section 14-10504.

} Not
in
UTC

14-10502. Spendthrift provision

A. A spendthrift provision is valid only if it restrains either voluntary or involuntary transfer of a beneficiary's interest.

B. A term of a trust providing that the interest of a beneficiary is held subject to a spendthrift trust, or words of similar import, is sufficient to restrain both voluntary and involuntary transfer of the beneficiary's interest.

C. A beneficiary may not transfer an interest in a trust in violation of a valid spendthrift provision and, except as otherwise provided in this article, a creditor or assignee of the beneficiary may not attach, garnish, execute on or otherwise reach the interest or a distribution by the trustee before its receipt by the beneficiary.

14-10503. Exceptions to spendthrift provision: definition

A. Even if a trust contains a spendthrift provision, a beneficiary's child who has a judgment or court order against the beneficiary for support or maintenance, or a judgment creditor who has provided services relating to 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 only for these matters.

UTC
includes
a
benef's
spouse
or
former
spouse

B. The exception prescribed in subsection A is unenforceable against a special needs trust.

C. A spendthrift provision is unenforceable against a claim of this state or the United States only to the extent a statute of this state or federal law so provides.

D. For the purposes of this section, "child" includes any person for whom an order or judgment for child support has been validly entered in this or another state.

14-10504. Discretionary trusts; effect of standard; definition

A. Except as provided in subsection B of this section, whether or not a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution that is subject to the trustee's discretion, even if either:

- 1. The discretion is expressed in the form of a standard of distribution.
- 2. The trustee has not complied with the applicable standard of distribution or has abused the discretion regarding distributions.

B. To the extent a trustee has not complied with the applicable standard of distribution or has abused the discretion regarding distributions:

- 1. Except as provided in section 14-10503, a distribution may be ordered by the court to satisfy a judgment or court order against the beneficiary for support or maintenance of the beneficiary's child.
- 2. The court shall direct the trustee to pay to the child an amount as is equitable under the circumstances but not more than the amount the trustee would have been required to distribute to or for the benefit of the beneficiary had the trustee complied with the standard or not abused the discretion.

} UTC includes a benef's spouse or former spouse

C. This section does not limit the right of a beneficiary to maintain a judicial proceeding against a trustee for an abuse of discretion or failure to comply with a standard for distribution, provided that this right may not be exercised by a creditor of the beneficiary or to the extent that any creditor of the beneficiary takes through the name or rights of the beneficiary.

D. Whether or not a trust contains a spendthrift provision:

- 1. A creditor of a trust beneficiary may not compel a distribution from insurance proceeds payable to the trustee as beneficiary to the extent state law exempts the insurance proceeds from creditors' claims if it had been paid directly to the trust beneficiary.
- 2. To the extent that under Arizona law life insurance proceeds, policy cash surrender values or other distributions or payments are exempt from attachment or garnishment by, execution on or otherwise the reach of creditors, if the death benefit is payable to an individual beneficiary, the life insurance proceeds, policy cash surrender values or other distributions or payments are also exempt from attachment or garnishment by, execution on or otherwise the reach of creditors if payable to a trust of which a beneficiary is that individual.

} Not in UTC

E. A creditor of a beneficiary, whether or not the beneficiary is also a trustee or cotrustee, may not reach the beneficiary's beneficial interest or otherwise compel a distribution if either the trustee's discretion to make distributions for the trustee's or beneficiary's own benefit is purely discretionary or is limited by an ascertainable standard, including a standard relating to the beneficiary's health, education, support or maintenance or similar language within the meaning of section 2041(b)(1)(a) of the internal revenue code.

F. For the purposes of this section, "child" includes any person for whom an order or judgment for child support has been entered in this or another state.

14-10505. Creditor's claim against settlor

A. Whether or not the terms of a trust contain a spendthrift provision, the following rules apply:

1. During the lifetime of the settlor, the property of a revocable trust is subject to claims of the settlor's creditors. If a trust has more than one settlor or contributor, the amount the creditor or assignee of a particular settlor may reach may not exceed the settlor's interest in the portion of the trust attributable to that settlor's contribution. This paragraph does not abrogate otherwise applicable laws relating to community property.

2. Subject to the requirements of this section, with respect to an irrevocable trust, a creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit. If a trust has more than one settlor, the amount the creditor or assignee of a particular settlor may reach may not exceed the settlor's interest in the portion of the trust attributable to that settlor's contribution. This paragraph does not apply to any trust from which any distribution to the settlor can be made pursuant to the exercise of a power of appointment held by a third party or abrogate otherwise applicable laws relating to community property. A creditor of a settlor:

(a) Shall not reach any trust property based on a trustee's, trust protector's or third party's power, whether or not discretionary, to pay or reimburse the settlor for any income tax on trust income or trust principal that is payable by the settlor under the law imposing the tax or to pay the tax directly to any taxing authority.

(b) Is not entitled to any payment or reimbursement that is to be made directly to any taxing authority.

(c) Shall not reach or compel distributions to or for the benefit of the beneficiary of a special needs trust.

Not in UTC

3. After the death of a settlor, and subject to the settlor's right to direct the source from which liabilities will be paid, the property of a trust that was revocable at the settlor's death is subject to claims of the settlor's creditors, costs of administration of the settlor's estate, the expenses of the settlor's funeral and disposal of remains and statutory allowances to a surviving spouse and children to the extent the settlor's probate estate is inadequate to satisfy those claims, costs, expenses and allowances, except to the extent that state or federal law exempts any property of the trust from these claims, costs, expenses or allowances. If a trust has more than one settlor or contributor, the amount the creditor or assignee of a particular settlor may reach may not exceed the settlor's interest in the portion of the trust attributable to that settlor's contribution. This paragraph does not abrogate otherwise applicable laws relating to community property.

B. For the purposes of this section:

1. During the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power.

2. On the lapse, release or waiver of a power of withdrawal, the holder is not, by reason of any such power of withdrawal, treated as the settlor of the trust.

C. For the purposes of this section, a trust settled or established by a corporation, professional corporation, partnership, limited liability company, governmental entity, trust, foundation or other

Remaining provisions not in UTC

entity is not deemed to be settled or established by its directors, officers, shareholders, partners, members, managers, employees, beneficiaries or agents.

D. For the purposes of this section, amounts contributed to a trust by a corporation, professional corporation, partnership, limited liability company, governmental entity, trust, foundation or other entity are not deemed to have been contributed by its directors, officers, shareholders, partners, employees, beneficiaries or agents. Powers, duties or responsibilities granted to or reserved by the settlor pursuant to the trust and any actions or omissions taken pursuant to the trust are deemed to be the powers, responsibilities, duties, actions or omissions of the settlor and not those of its directors, officers, shareholders, partners, members, managers, employees, beneficiaries or agents.

E. For the purposes of this section, amounts and property contributed to the following trusts are not deemed to have been contributed by the settlor, and a person who would otherwise be treated as a settlor or a deemed settlor of the following trusts shall not be treated as a settlor:

1. An irrevocable inter vivos marital trust that is treated as qualified terminable interest property under section 2523(f) of the internal revenue code if the settlor is a beneficiary of the trust after the death of the settlor's spouse.
2. An irrevocable inter vivos marital trust that is treated as a general power of appointment trust under section 2523(e) of the internal revenue code if the settlor is a beneficiary of the trust after the death of the settlor's spouse.
3. An irrevocable inter vivos trust for the settlor's spouse if the settlor is a beneficiary of the trust after the death of the settlor's spouse.
4. An irrevocable trust for the benefit of a person, the settlor of which is the person's spouse, regardless of whether or when the person was the settlor of an irrevocable trust for the benefit of that spouse.
5. An irrevocable trust for the benefit of a person to the extent that the property of the trust was subject to a general power of appointment in another person.

F. For the purposes of subsection E, a person is a beneficiary whether so named under the initial trust instrument or through the exercise by that person's spouse or by another person of a limited or general power of appointment.

G. Subsections C and D do not apply to:

1. A trust that has no valid business purpose and that has as its principal purpose the evasion of the claims of the creditors of the persons or entities listed in those subsections.
2. A trust that would be treated as a grantor trust pursuant to sections 671 through 679 of the internal revenue code. This paragraph does not apply to a qualified subchapter S trust that is treated as a grantor trust solely by application of section 1361(d) of the internal revenue code.

14-10505. Creditor's claim against settlor

A. Whether or not the terms of a trust contain a spendthrift provision, the following rules apply:

1. During the lifetime of the settlor, the property of a revocable trust is subject to claims of the settlor's creditors. If a trust has more than one settlor or contributor, the amount the creditor or assignee of a particular settlor may reach may not exceed the settlor's interest in the portion of the trust attributable to that settlor's contribution. This paragraph does not abrogate otherwise applicable laws relating to community property.

2. Subject to the requirements of this section, with respect to an irrevocable trust, a creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit. If a trust has more than one settlor, the amount the creditor or assignee of a particular settlor may reach may not exceed the settlor's interest in the portion of the trust attributable to that settlor's contribution. This paragraph does not apply to any trust from which any distribution to the settlor can be made pursuant to the exercise of a power of appointment held by a third party or abrogate otherwise applicable laws relating to community property. A creditor of a settlor:

(a) Shall not reach any trust property based on a trustee's, trust protector's or third party's power, whether or not discretionary, to pay or reimburse the settlor for any income tax on trust income or trust principal that is payable by the settlor under the law imposing the tax or to pay the tax directly to any taxing authority.

(b) Is not entitled to any payment or reimbursement that is to be made directly to any taxing authority.

(c) Shall not reach or compel distributions to or for the benefit of the beneficiary of a special needs trust.

3. After the death of a settlor, and subject to the settlor's right to direct the source from which liabilities will be paid, the property of a trust that was revocable at the settlor's death is subject to claims of the settlor's creditors, costs of administration of the settlor's estate, the expenses of the settlor's funeral and disposal of remains and statutory allowances to a surviving spouse and children to the extent the settlor's probate estate is inadequate to satisfy those claims, costs, expenses and allowances, except to the extent that state or federal law exempts any property of the trust from these claims, costs, expenses or allowances. If a trust has more than one settlor or contributor, the amount the creditor or assignee of a particular settlor may reach may not exceed the settlor's interest in the portion of the trust attributable to that settlor's contribution. This paragraph does not abrogate otherwise applicable laws relating to community property.

B. For the purposes of this section:

1. During the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power.

2. On the lapse, release or waiver of a power of withdrawal, the holder is not, by reason of any such power of withdrawal, treated as the settlor of the trust.

C. For the purposes of this section, a trust settled or established by a corporation, professional corporation, partnership, limited liability company, governmental entity, trust, foundation or other

entity is not deemed to be settled or established by its directors, officers, shareholders, partners, members, managers, employees, beneficiaries or agents.

D. For the purposes of this section, amounts contributed to a trust by a corporation, professional corporation, partnership, limited liability company, governmental entity, trust, foundation or other entity are not deemed to have been contributed by its directors, officers, shareholders, partners, employees, beneficiaries or agents. Powers, duties or responsibilities granted to or reserved by the settlor pursuant to the trust and any actions or omissions taken pursuant to the trust are deemed to be the powers, responsibilities, duties, actions or omissions of the settlor and not those of its directors, officers, shareholders, partners, members, managers, employees, beneficiaries or agents.

E. For the purposes of this section, amounts and property contributed to the following trusts are not deemed to have been contributed by the settlor, and a person who would otherwise be treated as a settlor or a deemed settlor of the following trusts shall not be treated as a settlor:

1. An irrevocable inter vivos marital trust that is treated as qualified terminable interest property under section 2523(f) of the internal revenue code if the settlor is a beneficiary of the trust after the death of the settlor's spouse.
2. An irrevocable inter vivos marital trust that is treated as a general power of appointment trust under section 2523(e) of the internal revenue code if the settlor is a beneficiary of the trust after the death of the settlor's spouse.
3. An irrevocable inter vivos trust for the settlor's spouse if the settlor is a beneficiary of the trust after the death of the settlor's spouse.
4. An irrevocable trust for the benefit of a person, the settlor of which is the person's spouse, regardless of whether or when the person was the settlor of an irrevocable trust for the benefit of that spouse.
5. An irrevocable trust for the benefit of a person to the extent that the property of the trust was subject to a general power of appointment in another person.

F. For the purposes of subsection E, a person is a beneficiary whether so named under the initial trust instrument or through the exercise by that person's spouse or by another person of a limited or general power of appointment.

G. Subsections C and D do not apply to:

1. A trust that has no valid business purpose and that has as its principal purpose the evasion of the claims of the creditors of the persons or entities listed in those subsections.
2. A trust that would be treated as a grantor trust pursuant to sections 671 through 679 of the internal revenue code. This paragraph does not apply to a qualified subchapter S trust that is treated as a grantor trust solely by application of section 1361(d) of the internal revenue code.

14-10506. Overdue distribution; definition

A. Whether or not a trust contains a spendthrift provision, a creditor or assignee of a beneficiary may reach a mandatory distribution of income or principal, including a distribution on termination of the trust, if the trustee has not made the distribution to the beneficiary within a reasonable period after the mandated distribution date unless the terms of the trust expressly authorize the trustee to delay the distribution to protect the beneficiary's interest in the distribution.

B. For the purposes of this section, "mandatory distribution" means a distribution of income or principal that the trustee is required to make to a beneficiary under the terms of the trust, including a distribution on termination of the trust. Mandatory distribution does not include a distribution that is subject to the exercise of the trustee's discretion even if:

1. The discretion is expressed in the form of a standard of distribution.
2. The terms of the trust authorizing a distribution couple language of discretion with language of direction.

14-10507. Personal obligations of trustee

Trust property is not subject to personal obligations of the trustee, even if the trustee becomes insolvent or bankrupt.

ARTICLE 5
CREDITOR'S CLAIMS; SPENDTHRIFT AND
DISCRETIONARY TRUSTS

General Comment

This article addresses the validity of a spendthrift provision and the rights of creditors, both of the settlor and beneficiaries, to reach a trust to collect a debt. Sections 501 and 502 state the general rules. Section 501 applies if the trust does not contain a spendthrift provision or the spendthrift provision, if any, does not apply to the beneficiary's interest. Section 502 states the effect of a spendthrift provision. Unless a claim is being made by an exception creditor, a spendthrift provision bars a beneficiary's creditor from reaching the beneficiary's interest until distribution is made by the trustee. An exception creditor, however, can reach the beneficiary's interest subject to the court's power to limit the relief. Section 503 lists the categories of exception creditors whose claims are not subject to a spendthrift restriction. Sections 504 through 507 address special categories in which the rights of a beneficiary's creditors are the same whether or not the trust contains a spendthrift provision. Section 504 deals with discretionary trusts and trusts for which distributions are subject to a standard. Section 505 covers creditor claims against a settlor, whether the trust

is revocable or irrevocable, and if revocable, whether the claim is made during the settlor's lifetime or incident to the settlor's death. Section 506 provides a creditor with a remedy if a trustee fails to make a mandated distribution within a reasonable time. Section 507 clarifies that although the trustee holds legal title to trust property, that property is not subject to the trustee's personal debts.

The provisions of this article relating to the validity and effect of a spendthrift provision and the rights of certain creditors and assignees to reach the trust may not be modified by the terms of the trust. See Section 105(b)(5).

This article does not supersede state exemption statutes nor an enacting jurisdiction's Uniform Fraudulent Transfers Act which, when applicable, invalidates any type of gratuitous transfer, including transfers into trust.

Comment Amended in 2004

SECTION 501. RIGHTS OF BENEFICIARY'S CREDITOR OR ASSIGNEE. To the extent a beneficiary's interest is not subject to a spendthrift provision, the court may authorize a creditor or assignee of the beneficiary to reach the beneficiary's interest by attachment of present or future distributions to or for the benefit of the beneficiary or other means. The court may limit the award to such relief as is appropriate under the circumstances.

Comment

This section applies only if the trust does not contain a spendthrift provision or the spendthrift provision does not apply to a particular beneficiary's interest. A settlor may subject to spendthrift protection the interests of certain beneficiaries but not others. A settlor may also subject only a portion of the trust to spendthrift protection such as an interest in the income but not principal. For the effect of a spendthrift provision on creditor claims, see Section 503.

Absent a valid spendthrift provision, a creditor may ordinarily reach the interest of a beneficiary the same as any other of the beneficiary's assets. This does not necessarily mean that the creditor can collect all distributions made to the beneficiary. The interest may be too indefinite or contingent for the creditor to reach or the interest may qualify for an exemption under the state's general creditor exemption statutes. See (Third) of Trusts §56 (2003); Restatement (Second) of Trusts §§147-149, 162 (1959). Other creditor law of the State

may limit the creditor to a specified percentage of a distribution. See, e.g., Cal. Prob. Code Section 15306.5. This section does not prescribe the procedures ("other means") for reaching a beneficiary's interest or of priority among claimants, leaving those issues to the enacting State's laws on creditor rights. The section does clarify, however, that an order obtained against the trustee, whatever state procedure may have been used, may extend to future distributions whether made directly to the beneficiary or to others for the beneficiary's benefit. By allowing an order to extend to future payments, the need for the creditor periodically to return to court will be reduced.

Because proceedings to satisfy a claim are equitable in nature, the second sentence of this section ratifies the court's discretion to limit the award as appropriate under the circumstances. In exercising its discretion to limit relief, the court may appropriately consider the circumstances of a beneficiary and the beneficiary's

family. See Restatement (Third) of Trusts Section 56 cmt. e (Tentative Draft No. 2, approved 1999).

2005 Amendment. A 2005 amendment changes “protected by” to “subject to” in the first sentence of the section. No substantive change is intended. The amendment was made to negate an implication that this

section allowed an exception creditor to reach a beneficiary’s interest even though the trust contained a spendthrift provision. The list of exception creditors and their remedies are contained in Section 503. Clarifying changes are also made in the comments and unnecessary language on creditor remedies omitted.

SECTION 502. SPENDTHRIFT PROVISION.

(a) A spendthrift provision is valid only if it restrains both voluntary and involuntary transfer of a beneficiary’s interest.

(b) A term of a trust providing that the interest of a beneficiary is held subject to a “spendthrift trust,” or words of similar import, is sufficient to restrain both voluntary and involuntary transfer of the beneficiary’s interest.

(c) A beneficiary may not transfer an interest in a trust in violation of a valid spendthrift provision and, except as otherwise provided in this [article], a creditor or assignee of the beneficiary may not reach the interest or a distribution by the trustee before its receipt by the beneficiary.

Comment

Under this section, a settlor has the power to restrain the transfer of a beneficiary’s interest, regardless of whether the beneficiary has an interest in income, in principal, or in both. Unless one of the exceptions under this article applies, a creditor of the beneficiary is prohibited from attaching a protected interest and may only attempt to collect directly from the beneficiary after payment is made. This section is similar to Restatement (Third) of Trusts § 58 (Tentative Draft No. 2, approved 1999), and Restatement (Second) of Trusts §§ 152-153 (1959). For the definition of spendthrift provision, see Section 103(15).

For a spendthrift provision to be effective under this Code, it must prohibit both the voluntary and involuntary transfer of the beneficiary’s interest, that is, a settlor may not allow a beneficiary to assign while prohibiting a beneficiary’s creditor from collecting, and vice versa. See Restatement (Third) of Trusts § 58 cmt. b (Tentative Draft No. 2, approved 1999). See also Restatement (Second) of Trusts § 152(2) (1959). A spendthrift provision valid under this Code will also be recognized as valid in a federal bankruptcy proceeding. See 11 U.S.C. § 541(c)(2).

Subsection (b), which is derived from Texas Property Code § 112.035(b), allows a settlor to provide maximum spendthrift protection simply by stating in the instrument that all interests are held subject to a “spendthrift trust” or words of similar effect.

A disclaimer, because it is a refusal to accept ownership of an interest and not a transfer of an interest already owned, is not affected by the presence or absence of a spendthrift provision. Most disclaimer statutes expressly provide that the validity of a disclaimer is not affected by a spendthrift protection. See, e.g., Uniform Probate Code § 2-801(a). Releases and exercises of powers of appointment are also not affected because they are not transfers of property. See Restatement (Third) of Trusts § 58 cmt. c (Tentative Draft No. 2, approved 1999).

A spendthrift provision is ineffective against a beneficial interest retained by the settlor. See Restatement (Third) of Trusts § 58(2), approved 1999. This is a necessary corollary to Section 505(a)(2), which allows a creditor or assignee of the settlor to reach the maximum amount that can be distributed to or for the settlor’s benefit. This right to reach the trust applies whether or not the trust contains a spendthrift provision.

A valid spendthrift provision makes it impossible for a beneficiary to make a legally binding transfer, but the trustee may choose to honor the beneficiary’s purported assignment. The trustee may recommence distributions to the beneficiary at anytime. The beneficiary, not having made a binding transfer, can withdraw the beneficiary’s direction but only as to future payments. See Restatement (Third) of Trusts § 58 cmt. d (Tentative Draft No. 2, approved 1999); Restatement (Second) of Trusts § 152 cmt. i (1959).

SECTION 503. EXCEPTIONS TO SPENDTHRIFT PROVISION.

(a) In this section, “child” includes any person for whom an order or judgment for child support has been entered in this or another State.

(b) A spendthrift provision is unenforceable against:

(1) a beneficiary’s child, spouse, or former spouse who has a judgment or court order against the beneficiary for support or maintenance;

(2) a judgment creditor who has provided services for the protection of a beneficiary's interest in the trust;
and

(3) a claim of this State or the United States to the extent a statute of this State or federal law so provides.

(c) A claimant against which a spendthrift provision cannot be enforced may obtain from a court an order attaching present or future distributions to or for the benefit of the beneficiary. The court may limit the award to such relief as is appropriate under the circumstances.

Comment

This section exempts the claims of certain categories of creditors from the effects of a spendthrift restriction and specifies the remedies such exemption creditors may take to satisfy their claims.

The exception in subsection (b)(1) for judgments or orders to support a beneficiary's child or current or former spouse is in accord with Restatement (Third) of Trusts Section 59(a) (Tentative Draft No. 2, approved 1999), Restatement (Second) of Trusts Section 157(a) (1959), and numerous state statutes. It is also consistent with federal bankruptcy law, which exempts such support orders from discharge. The effect of this exception is to permit the claimant for unpaid support to attach present or future distributions that would otherwise be made to the beneficiary. Distributions subject to attachment include distributions required by the express terms of the trust, such as mandatory payments of income, and distributions the trustee has otherwise decided to make, such as through the exercise of discretion. Subsection (b)(1), unlike Section 504, does not authorize the spousal or child claimant to compel a distribution from the trust. Section 504 authorizes a spouse or child claimant to compel a distribution to the extent the trustee has abused a discretion or failed to comply with a standard for distribution.

Subsection (b)(1) refers both to "support" and "maintenance" in order to accommodate differences among the States in terminology employed. No difference in meaning between the two terms is intended.

The definition of "child" in subsection (a) accommodates the differing approaches States take to defining the class of individuals eligible for child support, including such issues as whether support can be awarded to stepchildren. However the State making the award chooses to define "child" will be recognized under this Code, whether the order sought to be enforced was entered in the same or different State. For the definition of "state," which includes Puerto Rico and other American possessions, see Section 103(17).

The definition of "child" in subsection (a) is not exclusive. The definition clarifies that a "child"

includes an individual awarded child support in any state. The definition does not expressly include but neither does it exclude persons awarded child support in some other country or political subdivision, such as a Canadian province.

The exception in subsection (b)(2) for a judgment creditor who has provided services for the protection of a beneficiary's interest in the trust is in accord with Restatement (Third) of Trusts Section 59(b) (Tentative Draft No. 2, approved 1999), and Restatement (Second) of Trusts Section 157(c) (1959). This exception allows a beneficiary of modest means to overcome an obstacle preventing the beneficiary's obtaining services essential to the protection or enforcement of the beneficiary's rights under the trust. See Restatement (Third) of Trusts Section 59 cmt. d (Tentative Draft No. 2, approved 1999).

Subsection (b)(3), which is similar to Restatement (Third) of Trusts Section 59 cmt. a (Tentative Draft No. 2, approved 1999), exempts certain governmental claims from a spendthrift restriction. Federal preemption guarantees that certain federal claims, such as claims by the Internal Revenue Service, may bypass a spendthrift provision no matter what this Code might say. The case law and relevant Internal Revenue Code provisions on the exception for federal tax claims are collected in George G. Bogert & George T. Bogert, *The Law of Trusts and Trustees* Section 224 (Rev. 2d ed. 1992); and 2A Austin W. Scott & William F. Fratcher, *The Law of Trusts* Section 157.4 (4th ed. 1987). Regarding claims by state governments, this subsection recognizes that States take a variety of approaches with respect to collection, depending on whether the claim is for unpaid taxes, for care provided at an institution, or for other charges. Acknowledging this diversity, subsection (c) does not prescribe a rule, but refers to other statutes of the State on whether particular claims are subject to or exempted from spendthrift provisions.

Unlike Restatement (Third) of Trusts Section 59(2) (Tentative Draft No. 2, approved 1999), and Restatement (Second) of Trusts Section 157(b) (1959), this Code does not create an exception to the spendthrift restriction for creditors who have furnished necessary services or supplies to the beneficiary. Most of these cases involve claims by governmental entities, which

the drafters concluded are better handled by the enactment of special legislation as authorized by subsection (b)(3). The drafters also declined to create an exception for tort claimants. For a discussion of the exception for tort claims, which has not generally been recognized, see Restatement (Third) of Trusts Section 59 Reporter's Notes to cmt. a (Tentative Draft No. 2, approved 1999). For a discussion of other exceptions to a spendthrift restriction, recognized in some States, see George G. Bogert & George T. Bogert, *The Law of Trusts and Trustees* Section 224 (Rev. 2d ed. 1992); and 2A Austin W. Scott & William F. Fratcher, *The Law of Trusts* Sections 157-157.5 (4th ed. 1987).

Subsection (c) provides that the only remedy available to an exception creditor is attachment of present or future distributions of present or future distributions. Depending on other creditor law of the state, additional remedies may be available should a beneficiary's interest not be subject to a spendthrift provision. Section 501, which applies in such situations, provides that the creditor may reach the beneficiary's interest under that section by attachment or "other means." Subsection (c), similar to Section 501,

clarifies that the court has the authority to limit the creditor's relief as appropriate under the circumstances.

2005 Amendment. The amendment rewrote this section. The section previously provided:

SECTION 503. EXCEPTIONS TO SPENDTHRIFT PROVISION.

(a) In this section, "child" includes any person for whom an order or judgment for child support has been entered in this or another State.

(b) Even if a trust contains a spendthrift provision, a beneficiary's child, spouse, or former spouse who has a judgment or court order against the beneficiary for support or maintenance, or 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.

(c) A spendthrift provision is unenforceable against a claim of this State or the United States to the extent a statute of this State or federal law so provides.

SECTION 504. DISCRETIONARY TRUSTS; EFFECT OF STANDARD.

(a) In this section, "child" includes any person for whom an order or judgment for child support has been entered in this or another State.

(b) Except as otherwise provided in subsection (c), whether or not a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution that is subject to the trustee's discretion, even if:

- (1) the discretion is expressed in the form of a standard of distribution; or
- (2) the trustee has abused the discretion.

(c) To the extent a trustee has not complied with a standard of distribution or has abused a discretion:

- (1) a distribution may be ordered by the court to satisfy a judgment or court order against the beneficiary for support or maintenance of the beneficiary's child, spouse, or former spouse; and
- (2) the court shall direct the trustee to pay to the child, spouse, or former spouse such amount as is equitable under the circumstances but not more than the amount the trustee would have been required to distribute to or for the benefit of the beneficiary had the trustee complied with the standard or not abused the discretion.

(d) This section does not limit the right of a beneficiary to maintain a judicial proceeding against a trustee for an abuse of discretion or failure to comply with a standard for distribution.

(e) If the trustee's or cotrustee's discretion to make distributions for the trustee's or cotrustee's own benefit is limited by an ascertainable standard, a creditor may not reach or compel distribution of the beneficial interest except to the extent the interest would be subject to the creditor's claim were the beneficiary not acting as trustee or cotrustee.

Comment

This section addresses the ability of a beneficiary's creditor to reach the beneficiary's discretionary trust interest, whether or not the exercise of the trustee's discretion is subject to a standard. This section, similar to the Restatement, eliminates the distinction between discretionary and support trusts, unifying the rules for all trusts fitting within either of the former categories. See Restatement (Third) of Trusts Section 60 Reporter's Notes to cmt. a (Tentative Draft No. 2, approved 1999).

By eliminating this distinction, the rights of a creditor are the same whether the distribution standard is discretionary, subject to a standard, or both. Other than for a claim by a child, spouse or former spouse, a beneficiary's creditor may not reach the beneficiary's interest. Eliminating this distinction affects only the rights of creditors. The affect of this change is limited to the rights of creditors. It does not affect the rights of a beneficiary to compel a distribution. Whether the

trustee has a duty in a given situation to make a distribution depends on factors such as the breadth of the discretion granted and whether the terms of the trust include a support or other standard. See Section 814 comment.

For a discussion of the definition of "child" in subsection (a), see Section 503 Comment.

Subsection (b), which establishes the general rule, forbids a creditor from compelling a distribution from the trust, even if the trustee has failed to comply with the standard of distribution or has abused a discretion. Under subsection (d), the power to force a distribution due to an abuse of discretion or failure to comply with a standard belongs solely to the beneficiary. Under Section 814(a), a trustee must always exercise a discretionary power in good faith and with regard to the purposes of the trust and the interests of the beneficiaries.

Subsection (c) creates an exception for support claims of a child, spouse, or former spouse who has a judgment or order against a beneficiary for support or maintenance. While a creditor of a beneficiary generally may not assert that a trustee has abused a discretion or failed to comply with a standard of distribution, such a claim may be asserted by the beneficiary's child, spouse, or former spouse enforcing a judgment or court order against the beneficiary for unpaid support or maintenance. The court must direct the trustee to pay the child, spouse or former spouse such amount as is equitable under the circumstances but not in excess of the amount the trustee was otherwise required to distribute to or for the benefit of the beneficiary. Before fixing this amount, the court having jurisdiction over the trust should consider that in setting the respective support award, the family court has already considered the respective needs and assets of the family. The Uniform Trust Code does not prescribe a particular procedural method for enforcing a judgment or order against the trust, leaving that matter to local collection law.

Subsection (e), which was added by a 2004 amendment, is discussed below.

2004 Amendment

Section 504(e), 103(11)

Trusts are frequently drafted in which a trustee is also a beneficiary. A common example is what is often referred to as a bypass trust, under which the settlor's spouse will frequently be named as both trustee and beneficiary. An amount equal to the exemption from

federal estate tax will be placed in the bypass trust, and the trustee, who will often be the settlor's spouse, will be given discretion to make distributions to the beneficiaries, a class which will usually include the spouse/trustee. To prevent the inclusion of the trust in the spouse-trustee's gross estate, the spouse's discretion to make distributions for the spouse's own benefit will be limited by an ascertainable standard relating to health, education, maintenance, or support.

The UTC, as previously drafted, did not specifically address the issue of whether a creditor of a beneficiary may reach the beneficial interest of a beneficiary who is also a trustee. However, Restatement (Third) of Trusts §60, comment g, which was approved by the American Law Institute in 1999, provides that the beneficial interest of a beneficiary/trustee may be reached by the beneficiary/trustee's creditors. Because the UTC is supplemented by the common law (see UTC Section 106), this Restatement rule might also apply in states enacting the UTC. The drafting committee has concluded that adoption of the Restatement rule would unduly disrupt standard estate planning and should be limited. Consequently, Section 504 is amended to provide that the provisions of this section, which generally prohibit a creditor of a beneficiary from reaching a beneficiary's discretionary interest, apply even if the beneficiary is also a trustee or cotrustee. The beneficiary-trustee is protected from creditor claims to the extent the beneficiary-trustee's discretion is protected by an ascertainable standard as defined in the relevant Internal Revenue Code sections. The result is that the beneficiary's trustee's interest is protected to the extent it is also exempt from federal estate tax. The amendment thereby achieves its main purpose, which is to protect the trustee-beneficiary of a bypass trust from creditor claims.

The protection conferred by this subsection, however, is no greater than if the beneficiary had not been named trustee. If an exception creditor can reach the beneficiary's interest under some other provision, the interest is not insulated from creditor claims by the fact the beneficiary is or becomes a trustee.

In addition, the definition of "power of withdrawal" in Section 103 is amended to clarify that a power of withdrawal does not include a power exercisable by the trustee that is limited by an ascertainable standard. The purpose of this amendment is to preclude a claim that the power of a trustee-beneficiary to make discretionary distributions for the trustee-beneficiary's own benefit results in an enforceable claim of the trustee-beneficiary's creditors to reach the trustee-beneficiary's interest as provided in Section 505(b). Similar to the amendment to Section 504, the amendment to "power of

withdrawal" is being made because of concerns that Restatement (Third) of Trusts Section 60, comment g, otherwise might allow a beneficiary-trustee's creditors to reach the trustee's beneficial interest.

The Code does not specifically address the extent to which a creditor of a trustee/beneficiary may reach a

beneficial interest of a beneficiary/trustee that is not limited by an ascertainable standard.

For the definition of "ascertainable standard," see Section 103(2).

SECTION 505. CREDITOR'S CLAIM AGAINST SETTLOR.

(a) Whether or not the terms of a trust contain a spendthrift provision, the following rules apply:

(1) During the lifetime of the settlor, the property of a revocable trust is subject to claims of the settlor's creditors.

(2) With respect to an irrevocable trust, a creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit. If a trust has more than one settlor, the amount the creditor or assignee of a particular settlor may reach may not exceed the settlor's interest in the portion of the trust attributable to that settlor's contribution.

(3) After the death of a settlor, and subject to the settlor's right to direct the source from which liabilities will be paid, the property of a trust that was revocable at the settlor's death is subject to claims of the settlor's creditors, costs of administration of the settlor's estate, the expenses of the settlor's funeral and disposal of remains, and [statutory allowances] to a surviving spouse and children to the extent the settlor's probate estate is inadequate to satisfy those claims, costs, expenses, and [allowances].

(b) For purposes of this section:

(1) during the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power; and

(2) upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in Section 2041(b)(2) or 2514(e) of the Internal Revenue Code of 1986, or Section 2503(b) of the Internal Revenue Code of 1986, in each case as in effect on [the effective date of this [Code]] [, or as later amended].

Comment

Subsection (a)(1) states what is now a well accepted conclusion, that a revocable trust is subject to the claims of the settlor's creditors while the settlor is living. See Restatement (Third) of Trusts Section 25 cmt. e (Tentative Draft No. 1, approved 1996). Such claims were not allowed at common law, however. See Restatement (Second) of Trusts Section 330 cmt. o (1959). Because a settlor usually also retains a beneficial interest that a creditor may reach under subsection (a)(2), the common law rule, were it retained in this Code, would be of little significance. See Restatement (Second) of Trusts Section 156(2) (1959).

Subsection (a)(2), which is based on Restatement (Third) of Trusts Section 58(2) and cmt. e (Tentative Draft No. 2, approved 1999), and Restatement (Second) of Trusts Section 156 (1959), follows traditional doctrine in providing that a settlor who is also a beneficiary may not use the trust as a shield against the settlor's creditors. The drafters of the Uniform Trust Code concluded that traditional doctrine reflects sound policy. Consequently, the drafters rejected the approach taken in States like Alaska and Delaware, both of which allow a settlor to retain a beneficial interest immune from creditor claims. See Henry J. Lischer, Jr., Domestic Asset Protection Trusts: Pallbearers to

Liability, 35 Real Prop. Prob. & Tr. J. 479 (2000); John E. Sullivan, III, Gutting the Rule Against Self-Settled Trusts: How the Delaware Trust Law Competes with Offshore Trusts, 23 Del. J. Corp. L. 423 (1998). Under the Code, whether the trust contains a spendthrift provision or not, a creditor of the settlor may reach the maximum amount that the trustee could have paid to the settlor-beneficiary. If the trustee has discretion to distribute the entire income and principal to the settlor, the effect of this subsection is to place the settlor's creditors in the same position as if the trust had not been created. For the definition of "settlor," see Section 103(15).

This section does not address possible rights against a settlor who was insolvent at the time of the trust's creation or was rendered insolvent by the transfer of property to the trust. This subject is instead left to the State's law on fraudulent transfers. A transfer to the trust by an insolvent settlor might also constitute a voidable preference under federal bankruptcy law.

Subsection (a)(3) recognizes that a revocable trust is usually employed as a will substitute. As such, the trust assets, following the death of the settlor, should be subject to the settlor's debts and other charges.

However, in accordance with traditional doctrine, the assets of the settlor's probate estate must normally first be exhausted before the assets of the revocable trust can be reached. This section does not attempt to address the procedural issues raised by the need first to exhaust the decedent's probate estate before reaching the assets of the revocable trust. Nor does this section address the priority of creditor claims or liability of the decedent's other nonprobate assets for the decedent's debts and other charges. Subsection (a)(3), however, does ratify the typical pourover will, revocable trust plan. As long as the rights of the creditor or family member claiming a statutory allowance are not impaired, the settlor is free to shift liability from the probate estate to the revocable trust. Regarding other issues associated with potential liability of nonprobate assets for unpaid claims, see Section 6-102 of the Uniform Probate Code, which was added to that Code in 1998.

Subsection (b)(1) treats a power of withdrawal as the equivalent of a power of revocation because the two powers are functionally identical. This is also the approach taken in Restatement (Third) of Trusts Section 56 cmt. b (Tentative Draft No. 2, approved 1999). If the power is unlimited, the property subject to the power will be fully subject to the claims of the power holder's creditors, the same as the power holder's other assets. If the power holder retains the power until death, the property subject to the power may be liable for claims and statutory allowances to the extent the power holder's probate estate is insufficient to satisfy those claims and allowances. For powers limited either in time or amount, such as a right to withdraw a \$10,000 annual exclusion contribution within 30 days, this

SECTION 506. OVERDUE DISTRIBUTION.

(a) In this section, "mandatory distribution" means a distribution of income or principal which the trustee is required to make to a beneficiary under the terms of the trust, including a distribution upon termination of the trust. The term does not include a distribution subject to the exercise of the trustee's discretion even if (1) the discretion is expressed in the form of a standard of distribution, or (2) the terms of the trust authorizing a distribution couple language of discretion with language of direction.

(b) Whether or not a trust contains a spendthrift provision, a creditor or assignee of a beneficiary may reach a mandatory distribution of income or principal, including a distribution upon termination of the trust, if the trustee has not made the distribution to the beneficiary within a reasonable time after the designated distribution date.

Comment

The effect of a spendthrift provision is generally to insulate totally a beneficiary's interest until a distribution is made and received by the beneficiary. See Section 502. But this section, along with several other sections in this article, recognizes exceptions to this general rule. Whether a trust contains a spendthrift provision or not, a trustee should not be able to avoid creditor claims against a beneficiary by refusing to make a distribution required to be made by the express terms of the trust. On the other hand, a spendthrift

subsection would limit the creditor to the \$10,000 contribution and require the creditor to take action prior to the expiration of the 30-day period.

Upon the lapse, release, or waiver of a power of withdrawal, the property formerly subject to the power will normally be subject to the claims of the power holder's creditors and assignees the same as if the power holder were the settlor of a now irrevocable trust. Pursuant to subsection (a)(2), a creditor or assignee of the power holder generally may reach the power holder's entire beneficial interest in the trust, whether or not distribution is subject to the trustee's discretion. However, following the lead of Arizona Revised Statutes Section 14-7705(g) and Texas Property Code Section 112.035(e), subsection (b)(2) creates an exception for trust property which was subject to a Crummey or five and five power. Upon the lapse, release, or waiver of a power of withdrawal, the holder is treated as the settlor of the trust only to the extent the value of the property subject to the power at the time of the lapse, release, or waiver exceeded the greater of the amounts specified in IRC Sections 2041(b)(2) or 2514(e) [greater of 5% or \$5,000], or IRC Section 2503(b) [\$10,000 in 2001].

The Uniform Trust Code does not address creditor issues with respect to property subject to a special power of appointment or a testamentary general power of appointment. For creditor rights against such interests, see Restatement (Property) Second: Donative Transfers Sections 13.1-13.7 (1986).

provision would become largely a nullity were a beneficiary's creditors able to attach all required payments as soon as they became due. This section reflects a compromise between these two competing principles. A creditor can reach a mandatory distribution, including a distribution upon termination, if the trustee has failed to make the payment within a reasonable time after the designated distribution date. Following this reasonable period, payments mandated by the express terms of the trust are in effect being held

by the trustee as agent for the beneficiary and should be treated as part of the beneficiary's personal assets.

This section is similar to Restatement (Third) of Trusts Section 58 cmt. d (Tentative Draft No. 2, approved 1999).

2001 Amendment. By amendment in 2001, "designated distribution date" was substituted for "required distribution date" in subsection (b). The amendment conforms the language of this section to terminology used elsewhere in the Code.

2005 Amendment. The amendment adds a clarifying definition of "mandatory distribution" in subsection (a), which is based on an Ohio proposal. The amendment:

tracks the traditional understanding that a mandatory distribution includes a provision requiring that a beneficiary be paid the income of a trust or receive principal upon termination;

correlates the definition of "mandatory distribution" in this section to the broad definition of

SECTION 507. PERSONAL OBLIGATIONS OF TRUSTEE. Trust property is not subject to personal obligations of the trustee, even if the trustee becomes insolvent or bankrupt.

Comment

Because the beneficiaries of the trust hold the beneficial interest in the trust property and the trustee holds only legal title without the benefits of ownership, the creditors of the trustee have only a personal claim against the trustee. See Restatement (Third) § 5 cmt. k (Tentative Draft No.1, approved 1996); Restatement (Second) of Trusts § 12 cmt. a (1959). Similarly, a personal creditor of the trustee who attaches trust property to satisfy the debt does not acquire title as a bona fide purchaser even if the creditor is unaware of the trust. See Restatement (Second) of Trusts § 308 (1959). The protection afforded by this section is consistent with that provided by the Bankruptcy Code. Property in which the trustee holds legal title as trustee is not part of the trustee's bankruptcy estate. 11 U.S.C. § 541(d).

The exemption of the trust property from the personal obligations of the trustee is the most significant feature of Anglo-American trust law by comparison with the devices available in civil law countries. A principal objective of the Hague Convention on the Law Applicable to Trusts and on their Recognition is to protect the Anglo-American trust with respect to transactions in civil law countries. See Hague Convention art. 11. See also Henry Hansmann & Ugo

discretionary trust used in Section 504. Under both Sections 504 and 506, a trust is discretionary even if the discretion is expressed in the form of a standard, such as a provision directing a trustee to pay for a beneficiary's support;

addresses the situation where the terms of the trust couple language of discretion with language of direction. An example of such a provision is "my trustees shall, in their absolute discretion, distribute such amounts as are necessary for the beneficiary's support." Despite the presence of the imperative "shall," the provision is discretionary, not mandatory. For a more elaborate example of such a discretionary "shall" provision, see Marsman. Nasca, 573 N.E. 2d 1025 (Mass. Ct. App. 1991).

is clarifying. No change of substance is intended by this amendment. This amendment merely clarifies that a mandatory distribution is to be understood in its traditional sense such as a provision requiring that the beneficiary receive an income or receive principal upon termination of the trust.

Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 N.Y.U. L. Rev. 434 (1998); John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 Yale L.J. 165, 179-80 (1997).