TRUST POWERHOLDERS AND THEIR CREDITORS

Asset Protection Committee

ACTEC Annual Meeting – San Antonio TX

Les Raatz

March 7, 2018

v3-13-18

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(with borrowings from ACTEC's Daniel Rubin's 2016 Heckerling presentation and materials from ACTEC's Ed Morrow)

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A. AUTHORITIVE SOURCES:

Uniform Trust Code
Uniform Powers of Attorney Act
Uniform Nonprobate Transfers on Death Act
Uniform Probate Code
Restatement Second of Property (Donative Transfers)
Restatement Third of Property (Wills and Other Donative Transfers)
Restatement Second of Trusts
Restatement Third of Trusts
Bankruptcy Code
State statutes

B. POWERS OF APPOINTMENT:

A power of appointment empowers the holder of the power to vest rights or powers or both in or over property to another. A person who grants another such a power has to hold sufficient interest in the subject property. The interest is either ownership of the subject property or the power to appoint to property to another. Typically, the vehicle to permit the granting of a power of appointment is a trust, and the power is to appoint either property held in trust or a beneficial interest in the trust. The person who grants another the power is the "donor." The person who is granted the power is the "donee" of the power. It is the donee, commonly called the "powerholder," who, through "exercise" of the power, can give another rights or powers or both in the property or interest.

Depending on the type of power, the existence or exercise of a power may create estate and gift transfers for transfer tax purposes. (The exercise of a fiduciary special power of appointment will not spring the Delaware Tax Trap. S. Rep't 382, 82d Cong., 1st Sess., 1951 U.S. Code Cong. & Ad. Serv., Vol. 2 Legislative History, 1535). The type of power may affect exposure of assets subject to the power to creditors of the powerholder.

C. TYPES OF POWERS:

There are two types of powers of appointment:

1. General power of appointment ("GPA") and special power of appointment, a/k/a limited power of appointment ("SPA").

2. A GPA permits the donee to appoint the property to the donee, the donee's estate, or one or more of the creditors of either. An exercisable power of withdrawal is a treated as a general power under the Uniform Trust Code (last paragraph of the Comment to UTC Section 505, discussed below). An SPA does not permit such appointees.

   The scope of what is considered a GPA differs among states. For example in California:

   > "A power to consume, invade, or appropriate property for the benefit of a person in discharge of the donee's [powerholder's] obligation of support that is limited by an ascertainable standard relating to the person's health, education, support, or maintenance is not a general power of appointment."
   >
   > - Cal. Prob. Code Section 611(b).

Authoritive Definitions of a "Power of Appointment:"

i. **As defined by Black's Law Dictionary, a power of appointment is "[a] power created or reserved by a person having property subject to disposition, enabling the donee of the power to designate transferees of the property or shares in which it will be received..." Black's Law Dictionary (10th ed. 2014).**

ii. **In general, there are two classes of powers of appointment, "general" powers of appointment and "non-general" (also sometimes called "special" or "limited") powers of appointment.**

   1. **A general power of appointment is "[a] power of appointment by which the donee can appoint — that is, dispose of the donor's property — in favor of anyone at all, including oneself or one's own estate." Black's Law Dictionary (10th ed. 2014).**

   2. **In contrast, a limited power of appointment is "[a] power of appointment that either does not allow the**

entire estate to be conveyed or restricts to whom the estate may be conveyed; esp., a power by which the donee can appoint to only the person or class specified in the instrument creating the power, but cannot appoint to oneself or one's own estate." Black's Law Dictionary (10th ed. 2014).

D. TYPES OF GPAs:

There are two types of GPAs:

- One is a presently exercisable GPA ("PEG") and the other is a GPA exercisable at a future date (i.e., not presently exercisable). The most common type of GPA not presently exercisable is one exercisable upon the death of the powerholder (a "testamentary GPA"). Testamentary GPAs include powers exercisable at death by Will and other than by a Will.

- Interests subject to a GPA cannot be reached by creditors of the powerholder before the time that it is exercisable by the powerholder (with the exception when the power was created by the powerholder).

E. CONTRACT TO APPOINT PRESENT GPA:

A donee (a powerholder) of a PEG can contract to make an appointment. Restatement Third of Property (Wills and Other Donative Transfers), §21.1(a).

However, the Restatements of Property provide that a contract to exercise a power not presently exercisable (e.g., a testamentary power) is invalid under the common law:

> "A donee of a power of appointment not presently exercisable cannot contract to make an appointment in the future that is enforceable by the promisee." Restatement Second of Property (Donative Transfers), § 16.2 (1986). *See also* Restatement Third of Property (Wills and Other Donative Transfers), §§21.1- 21.2.

See "CONTRACT TO APPOINT PRESENT SPA" below.

F. PEG REACHABLE:

A PEG is generally presently reachable by creditors of the powerholder, whether or not exercised. Restatement Third of Property (Wills and Other Donative Transfers), §22.3(a). This is a change from the common law.

Also, a number of states and the Bankruptcy Code empower creditors of a powerholder to reach the property that is subject to an unexercised presently exercisable general power of appointment.

(i) For example, New York's Estates, Powers and Trusts Law § 10-7.2 provides that "[p]roperty covered by a general power of appointment…which is presently exercisable, or of a postponed power which has become exercisable, is subject to the payment of the claims of creditors of the donee, his estate and the expenses of administering his estate. It is immaterial whether the power was created in the donee by himself or some other person, or whether the donee has or has not purported to exercise the power."

(ii) Similarly, Tennessee Code § 66-1-106 provides that "[w]hen the unlimited power of disposition, qualified or unqualified, not accompanied by any trust, is given expressly, in any written instrument, to the owner of any particular estate for life or years, legal or equitable, such estate is changed into a fee absolute as to right of disposition, and rights of creditors and purchasers."

(iii) Similarly, since Bankruptcy Code § 541(a)(1) provides that the bankruptcy estate consists of "all legal or equitable interests of the debtor in property as of the commencement of the case," a donee's general power of appointment makes the property subject to the power available to the donee's creditors in bankruptcy. *See, e.g., In re Shurley*, 171 B.R. 769 (Bankr. W.D. Tex. 1994) (because a general power of appointment can be exercised for the benefit of the donee herself, it is included in the donee's bankruptcy estate), rev'd on other grounds, 115 F.3d 333 (5th Cir. 1997).

But formerly, there had to be acceptance by exercise to permit creditors to reach appointive property: *Gilman v. Bell*, 99 Ill. 144, at 149-150 (1881).

Under Alaska law the creditors of a holder of a GPA cannot reach the property the subject of the power, even if the powerholder appoints the property, so long as she does not appoint the property to herself or her estate.

G. CONSENT OF NONADVERSE PARTY HAS NO EFFECT ON GPA:

A power to appoint to oneself, even if the consent of a nonadverse party is necessary, is a general power of appointment. If the consent of an adverse party is necessary, then the power is not a general power. Restatement Third of Property (Wills and Other Donative Transfers), §17.3, Comment e and Illustration 6. Restatement Second of Property (Donative Transfers), § 11.4, Illustration 4, and *see* Comment a (1986). See Cal. Prob. Code Section 611(c).

Comment e (to Third Restatement §17.3 above) describes an adverse and nonadverse party:

"An adverse party is a person who has a substantial beneficial interest in the trust or other property arrangement that would be adversely affect by the exercise or nonexercise of

the power in favor of the donee [the holder of the power], or estate of the donee, or the creditors of either; a nonadverse party is a person who does not have such interest."

Illustration 6 provides an example:

"6. Donor transferred property in trust, directing the trustee to pay the income 'to Donee for life, remainder in principal to such person or persons as Donee, with the joinder of Y, shall appoint; in default of appointment, remainder to X.' Donee's power is a general power because Y is a nonadverse party."

However, under the Uniform Trust Code, discussed below, a trust is not revocable (and therefore not reachable by creditors of the settlor) if consent of the trustee is necessary for the settlor to revoke the trust. (In Arizona, the trust is not deemed revocable by the settlor if consent of any person is necessary. A.R.S. Section 14-10103(15).)

The power of the trustee or trust protector to change a power into a general power does not make a power a general power except to the extent and when it is then a general power. Restatement Third of Property (Wills and Other Donative Transfers), §17.3, Comment d.

In theory, all whose consent is required could be considered as a donee of the power, with the potential to be found holding a general power of appointment.

Observations. Even though a present power to appoint to trust property to the powerholder with the consent of a nonadverse party may be a general power under the restatements, there are two observations:

1. Rule against perpetuities. Under the Second Restatement of Property, the requirement that another party, even nonadverse party, must consent to exercise of a PEG does not change the creation date of the interest in for purposes of the rule against perpetuities ("RAP"). Therefore, the determination of the vesting period relates back to the creation of the interest in the property (the date of the irrevocability of the trust) since no person, *acting alone*, can vest the interest. Restatement Second of Property (Donative Transfers), § 1.2 and § 11.4, Illustration 4 (last sentence). However, for purposes of the RAP, the Third Restatement of Property no longer addresses the situation in which a nonadverse party must consent to exercise of a PEG. Restatement Third of Property (Wills and Other Donative Transfers), §27.1, Comment j(1) and (2); §17.4, Comment f(1)(last sentence). If it is a PEG, there is no relation back to the date of the creation of the creation of the power creating the PEG, and the RAP period for the property subject to the PEG begins on the date the PEG ends.

2. No case authority. No case has been discovered by the author that determines one way or the others whether a creditor of a powerholder who must act with a nonadverse party to appoint to himself could reach the appointive property.

H. TESTAMENTARY GPA REACHABLE UNDER RESTATEMENTS:

The latest Restatements now permit creditors of powerholders possessing a GPA exercisable under a Will or otherwise upon death to reach appointable interests. Restatement Third of Property (Wills and Other Donative Transfers), §22.3; Restatement Third of Trusts, §56. This reflects a change of the American Law Institute from its prior position enunciated in Restatement of Property §337 and Restatement Second of Property (Donative Transfers), §13.2, which required exercise of a general power to permit creditors to reach the subject property, unless a statute required otherwise. The holder of a presently exercisable power is treated as the owner of the subject assets for such purposes. Restatement Third of Property (Wills and Other Donative Transfers), §22.3(a). A creditor of the estate of a decedent who possessed the power exercisable in his Will may reach the assets upon the death of the powerholder. Restatement Third of Property (Wills and Other Donative Transfers), §22.3(b).

Attached to this outline as EXHIBIT "A" is a deeply researched excerpt from Ed Morrow's 270 page tome: "*The Optimal Basis Increase and Income Tax Efficiency Trust*," (v.2017) regarding Testamentary GPAs.

I. ORDER OF SATISFACTION OF CLAIMS OF GPA PROPERTY:

The creditor's claim against donee of a GPA must first be satisfied from property owned by the donee, whether during life or from the estate after death. Restatement Third of Property (Wills and Other Donative Transfers), §22.3.

If the powerholder has created the GPA, then the ordering rule does not apply. Restatement Third of Property (Wills and Other Donative Transfers), §22.2; Restatement Second of Property (Donative Transfers), §13.3.

When a person creates a general power of appointment in himself, however, the property can be reached by such person's creditors whether or not the power is exercised or even presently exercisable:

> For example, New York's Estates, Powers & Trusts Law § 10-7.4 provides that "[p]roperty covered by a general power of appointment which, when created, is not presently exercisable is subject to the payment of the claims of creditors of the donee, his estate and the expenses of administering his estate…[i]f the power was created by the donee in favor of himself..."

Two exceptions to self-appointed GPA:

Uniform Powers of Appointment Act (UPAA), § 501, applies the ordering rule even if a Testamentary GPA was created by the powerholder.

If the retained GPA is exercisable if a condition occurs, does the rule apply? (For example, if a GRAT agreement permits the settlor the power to appoint the trust estate if the settlor dies before a date certain.) The rule, logically, should not apply.

J. OLD SCHOOL LAW:

Collateral Power v. Power in Gross. A Collateral Power is a power of appointment held by someone who holds no other interest in the trust or property subject to the power. A Power in Gross is a power held by one who also holds other rights in the trust or property. Is there a difference if the powerholder has no other interest in the trust other than the power of appointment? Not any more:

> "The terms collateral power and power in gross are descriptive only, and carry no legal consequences." - Restatement Third of Property (Wills and Other Donative Transfers), § 17.3, Comment f. In accord, *Mettoy Pension Trustees Ltd. v. Evans*, [1990] 1 W.L.R. 1587 (Ch.) at 1613. This trend, and the cited authorities, were noted with disapproval by Charles C. Rounds, OLD DOCTRINE MISUNDERSTOOD, NEW DOCTRINE MISCONCEIVED: DECONSTRUCTING THE NEWLY-MINTED RESTATEMENT (THIRD) OF PROPERTY'S POWER OF APPOINTMENT SECTIONS, 26 Quinnipiac Probate Law Journal 240, 262 (2013).

K. UNIFORM TRUST CODE:

Revocable trust assets are reachable by the creditors of the settlor (but not so easily after the settlor's death in states adopting the UNIFORM NONPROBATE TRANSFERS ON DEATH ACT, Section 102 – see below). A trust is "revocable" when revocable by the settlor "without the consent of the trustee or a person holding an adverse interest." Uniform Trust Code (UTC) Section 103(13). The comment to that section provides:

> "The definition of "revocable" (paragraph (13)) clarifies that revocable trusts include only trusts whose revocation is substantially within the settlor's control."

The Arizona Trust Code provides that a trust is not revocable if the consent of *any person* is required. A.R.S. Section 14-10103(15).

The UTC codifies many rules:

UTC 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].

It appears that the ULC commentators consider a holder of a **withdrawal power** as holding a PEG. The last paragraph of the Comment to UTC Section 505 provides:

> 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 Second of Property (Donative Transfers), §§13.1-13.7.

See also UPAA §503.

Attached to this outline as EXHIBIT "B" is a state by state survey from Ed Morrow's "IRC §678(a)(1) and the 'Beneficiary Deemed Owner Trust' (BDOT)," regarding withdrawal powers and powers of appointment and their lapses.

L. SPECIAL POWERS OF APPOINTMENT:

Creditors of a holder of an SPA cannot reach appointive property or interests. Restatement Second of Property (Donative Transfers) §§13.1; Restatement Third of Property (Wills and Other Donative Transfers), §22.1. See also: Restatement Second of Property (Donative Transfers) §§ 13.1-13.7; Restatement Third of Property (Wills and Other Donative Transfers) §§ 22.1-22.3. *See also* UPAA §405.

An SPA is presumptively a personal power and not a fiduciary power, unless held by a fiduciary who hold no other interest in the property that is the subject of the power.

M. CONTRACT TO APPOINT PRESENT SPA:

A donee of a presently exercisable SPA can contract to appoint the power unless the contract or appointment confers a benefit upon an impermissible appointee. Restatement Third of Property (Wills and Other Donative Transfers), §21.1(b).

However, the Restatements of Property provide that a contract to exercise a testamentary power is invalid under the common law:

> "A donee of a power of appointment not presently exercisable cannot contract to make an appointment in the future that is enforceable by the promisee." Restatement Second of Property (Donative Transfers), § 16.2 (1986). *See also* Restatement Third of Property (Wills and Other Donative Transfers), §§21.1- 21.2. *See also* UPAA §406.

See "CONTRACT TO APPOINT PRESENT GPA" above.

N. EXERCISE OF SPA TO REVOCABLE TRUST INVALID:

Creditors of the estate of a settlor can reach her revocable trust after her death under the UTC and virtually all other jurisdictions. Therefore, a purported exercise of a special power of appointment held by the settlor to the trust by the settlor, regardless of whether the beneficiaries of the trust were the permissible beneficiaries under the SPA would be invalid. This is because the powerholder would be attempting to exercise the power in favor of her and her estate's creditors. Two recent cases have so held. *BMO Harris Bank N.A. v. Towers*, 2015 IL App (1st) 133351 (2015), and a Nebraska Supreme Court case, *In re Robert McDowell Trust*, 894 NW2d 810 (Neb. 2017).

N. FRAUD ON A POWER:

An appointment under a power with the purpose to confer a benefit on an impermissible beneficiary is a fraud on the power and invalid to the extent of the fraud. Restatement Third of Property (Wills and Other Donative Transfers), §§ 19.15-19.16. *See also* UPAA §307(a).

Example: X has an SPA over Trust A. Y has an SPA over Trust B. After agreement, X appoints Trust A to Y, and Y appoints Trust B to X. The appointments are ineffective.

Fraud on a power is discussed in an estate tax case, *Hauptfuhrer's Estate v. Comm'r.,* 195 F.2d 548 (5th Cir. 1952).

O. UNIFORM NONPROBATE TRANSFERS ON DEATH ACT (UNTDA):

See Map below of the 10 current adopting jurisdictions UNTDA: Arizona, District of Colombia, Colorado, Massachusetts, Montana, Nebraska, New Mexico, North Dakota, South Dakota, Virgin Islands. For example, Michigan had adopted Section 101 of UNTDA, but not the meat of the act, which is Section 102. The Uniform Probate Code incorporates the UNDTA as Sections 6-101 and 6-102 in Article VI, comprising Part 1 thereof.

Section 102(g) imposes a substantial procedural hurdle in order for a creditor of a decedent to reach property appointable by the decedent pursuant to a Testamentary GPA. The creditor must first make demand on the estate personal representative, and if the personal representative does not act then the creditor may proceed to commence a proceeding in the name of the estate ***at its expense***. "Any recovery of costs should be used to reimburse the claimant who bore the risk of loss for the proceeding." – Paragraph 12 of Comment to UNTDA Section 102 (and in Comment to UPC Section 6-102). The personal representative has no liability for declining in good faith to prosecute the claim. (Obviously, if there is no probate estate opened, the creditor may do so.)

UNTDA SECTION 102:

LIABILITY OF NONPROBATE TRANSFEREES FOR CREDITOR CLAIMS AND STATUTORY ALLOWANCES.

(a) In this section, "nonprobate transfer" means a valid transfer effective at death, other than a transfer of a survivorship interest in a joint tenancy of real estate, by a transferor whose last domicile was in this state to the extent that the transferor immediately before death had power, acting alone, to prevent the transfer by revocation or withdrawal and instead to use the property for the benefit of the transferor or apply it to discharge claims against the transferor's probate estate.

(b) Except as otherwise provided by statute, a transferee of a nonprobate transfer is subject to liability to any probate estate of the decedent for allowed claims against decedent's probate estate and statutory allowances to the decedent's spouse and children to the extent the estate is insufficient to satisfy those claims and allowances. The liability of a nonprobate transferee

may not exceed the value of nonprobate transfers received or controlled by that transferee.

(c) Nonprobate transferees are liable for the insufficiency described in subsection (b) in the following order of priority:

(1) a transferee designated in the decedent's will or any other governing instrument, as provided in the instrument;

(2) the trustee of a trust serving as the principal nonprobate instrument in the decedent's estate plan as shown by its designation as devisee of the decedent's residuary estate or by other facts or circumstances, to the extent of the value of the nonprobate transfer received or controlled;

(3) other nonprobate transferees, in proportion to the values received.

(d) Unless otherwise provided by the trust instrument, interests of beneficiaries in all trusts incurring liabilities under this section abate as necessary to satisfy the liability, as if all of the trust instruments were a single will and the interests were devises under it.

(e) A provision made in one instrument may direct the apportionment of the liability among the nonprobate transferees taking under that or any other governing instrument. If a provision in one instrument conflicts with a provision in another, the later one prevails.

(f) Upon due notice to a nonprobate transferee, the liability imposed by this section is enforceable in proceedings in this state, whether or not the transferee is located in this state.

(g) **A proceeding under this section may not be commenced unless the personal representative of the decedent's estate has received a written demand for the proceeding from the surviving spouse or a child, to the extent that statutory allowances are affected, or a creditor. If the personal representative declines or fails to commence a proceeding after demand, a person making demand may commence the proceeding in the name of the decedent's estate, at the expense of the person making the demand and not of the estate. A personal representative who declines in good faith to commence a requested proceeding incurs no personal liability for declining.**

(h) A proceeding under this section must be commenced within one year after the decedent's death, but a proceeding on behalf of a creditor whose claim was allowed after proceedings challenging disallowance of the claim may be commenced within 60 days after final allowance of the claim.

(i) Unless a written notice asserting that a decedent's probate estate is nonexistent or insufficient to pay allowed claims and statutory allowances has been received from the decedent's personal representative, the following rules apply:

(1) Payment or delivery of assets by a financial institution, registrar, or other obligor, to a nonprobate transferee in accordance with the terms of the governing instrument controlling the transfer releases the obligor from all claims for amounts paid or assets delivered.

(2) A trustee receiving or controlling a nonprobate transfer is released from liability under this section with respect to any assets distributed to the trust's beneficiaries. Each beneficiary to the extent of the distribution received becomes liable for the amount of the trustee's liability attributable to assets received by the beneficiary.

P. TESTAMENTARY GPAS ARE COVERED BY UNTDA?

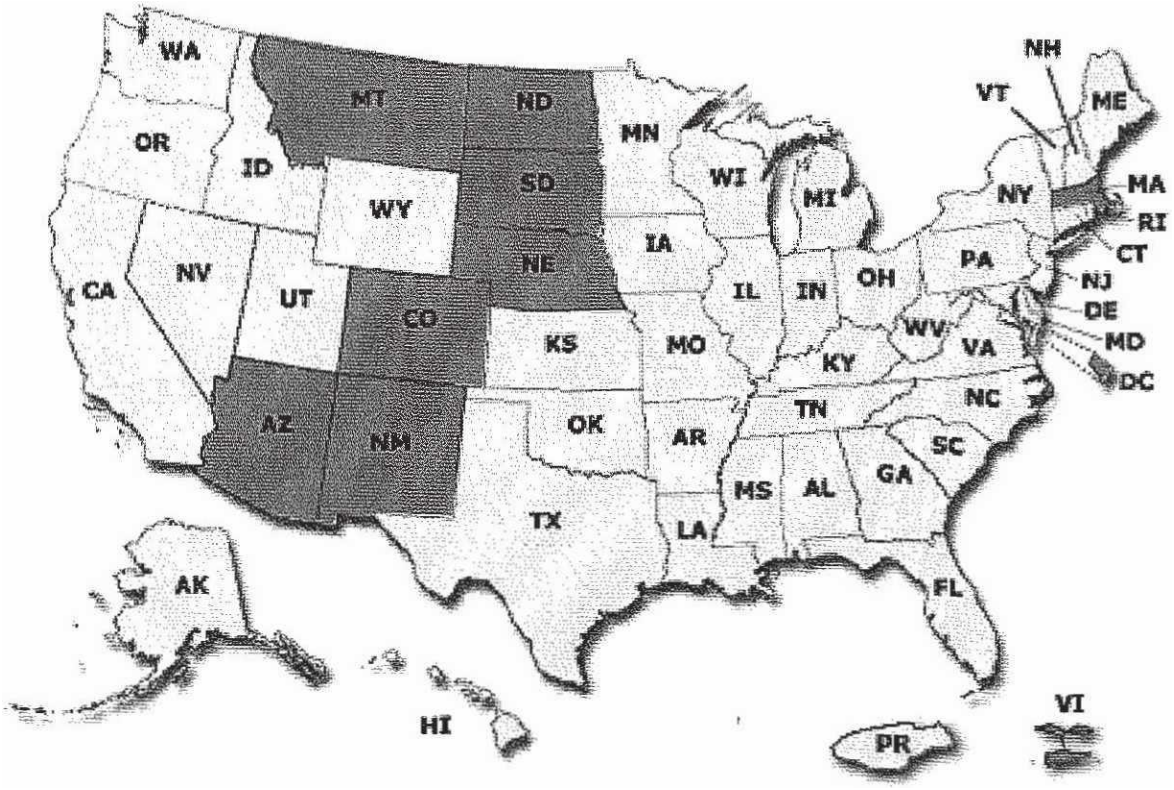
It appears that a testamentary GPA is covered by the Uniform Nonprobate Transfers on Death Act because a PEG was specifically excepted. See Section 102 comments, including Comment Paragraph 3:

3. The definition of "nonprobate transfer" in Section 1-102 reaches revocable transfers by a decedent; **it does not apply to a transfer at death incident to a decedent's exercise or non-exercise of a presently exercisable general power of appointment created by another person.** The drafters decided against creating a remedy for exemption beneficiaries and decedents' creditors based on the idea that a presently exercisable general power of appointment is the equivalent of ownership even though that concept is accepted in the Code's [Uniform Probate Code's] augmented estate provisions dealing with intentional disinheritance of a surviving spouse. Spousal protection against disinheritance by the other spouse supports the institution of marriage; creditors are better able to fend for themselves than financially disadvantaged mates of person inclined to disinherit their spouse. In addition, a presently exercisable general power of appointment created by another person is commonly viewed as a provision in the trust creator's instrument designed to provide flexibility in the estate plan rather than as a gift to the donee. Also, creditors of a deceased donee of such a power are likely to confront spendthrift trust provisions protecting trust benefits from creditors of beneficiaries, meaning that they may be without recourse whether or not a general power is viewed as ownership for purposes of creditors' rights.

Uniform Law Commission

The National Conference of Commissioners on Uniform State Laws

Legislative Enactment Status Nonprobate Transfers on Death Act (10-17)



Uniform Law Commission

The National Conference of Commissioners on Uniform State Laws

Legislative Enactment Status Powers of Appointment Act (10-17)