Steve Leimberg's Asset Protection Planning Email Newsletter - Archive Message #258
Date: 08-Sep-14
From: Steve Leimberg's Asset Protection Planning Newsletter
Subject: **Jay Adkisson, David Slenn & Philip Martino on In re Castellano: A Wake-Up Call for Self-Settled Trusts and Spendthrift Provisions**

"Castellano is a wake-up call for planners who believe that they can simply include a spendthrift clause in their trust documents, and the trust assets will then never become available to creditors of a beneficiary. The truth is that protecting a surviving beneficiary's interest is much more complicated than one would think, and it requires several different provisions to work closely in tune with the others so that the beneficiary's interest never quite vests, the beneficiary doesn't have any access to the trust assets, and the trust doesn't terminate so long as a debtor-beneficiary has creditor difficulties. Castellano is also a wake-up call as to the possibly amazing breadth of Bankruptcy Code 548(e) as it applies to self-settled trusts and similar devices."

Jay Adkisson, **David Slenn** and **Philip Martino** provide members with important commentary on In re Castellano.

Jay D. Adkisson is a partner of **Riser Adkisson LLP**, with his offices in Henderson, Nevada, and Newport Beach, California. Jay is a co-author (with Chris Riser) of "Asset Protection: Concepts & Strategies" (McGraw-Hill, 2004). Jay practices in the area of creditor-debtor law, and has been lead collection counsel in several high-profile judgment enforcement cases, as well as acted as court-appointed receiver.

David J. Slenn is a senior associate in the Naples, Florida office of **Quarles & Brady LLP**. Dave is the immediate past-Chair of the American Bar Association's Committee Asset Protection Planning Committee in the Section of Real Property, Trust and Estate Law, and the incoming Chair of the Committee on Captive Insurance in the Business Law Section. Dave practices in the areas of estate and wealth transfer planning, taxation and creditor-debtor law.

Both Jay and Dave were American Bar Association Advisors to the 2014 Amendments to the Uniform Voidable Transaction Act (formerly, the Uniform Fraudulent Transfer Act), which were unanimously adopted by the Uniform Law Commission on July 16, 2014.

Philip Martino is a partner at **Quarles & Brady LLP**, practicing in its Chicago and Tampa offices. He concentrates his practice in Commercial Bankruptcy and Commercial Litigation. He was bankruptcy counsel for the court appointed receiver seeking to locate and liquidate the assets of Paul Bilzerian. He has been a Chapter 11

and Chapter 7 trustee in the Northern District of Illinois for almost 25 years, and as trustee he has been involved in high profile cases ranging from failed land developers, to overburdened franchisors, to cornered Ponzi scheme perpetrators.

Here is their commentary:

EXECUTIVE SUMMARY:

A U.S. Bankruptcy Court has held that a surviving beneficiary's interest in a Living Trust vested at the moment of the Grantor's death, such that the beneficiary's share of the trust assets would be part of the beneficiary's bankruptcy estate and subject to immediate collection by the Chapter 7 Trustee, despite the Living Trust having both an elaborate spendthrift clause and language that the beneficiary's interest would terminate if her share of the trust assets would go to creditors. The Bankruptcy Court also applied a very expansive interpretation of Bankruptcy Code 548(e) to defeat attempts by the Trustee to hold back the debtor-beneficiary's interests away from the Chapter 7 Trustee.

FACTS:

In 1997, Faith Campbell created a revocable living trust ("Living Trust"). Faith's Living Trust was unremarkable -- it was a relatively simple trust as trusts go -- and it had (as most such trusts do) a spendthrift clause. The spendthrift clause contained a cessor clause,[i] which provided the beneficiary's interest would terminate due to insolvency and be held in a discretionary trust for the beneficiary. There is nothing like a uniform spendthrift clause, but rather this language is left to the whim of whatever attorney drafts particular trusts. The spendthrift clause in this case provided:

> If any beneficiary should attempt to alienate, encumber, or dispose of all or any part of the income or principal of this Trust before it has been delivered by the Trustee, or if by reason of bankruptcy or insolvency or any attempted execution, levy, attachment, or seizure of any assets remaining in the hands of the Trustee under claims of creditors or otherwise, all or any part of the income or principal might fail to be enjoyed by any beneficiary or might vest in or be enjoyed by some other person, then the interest of that beneficiary shall immediately terminate. Thereafter, the Trustee shall pay to or for the benefit of that beneficiary only those amounts that the Trustee, in its sole and absolute discretion, deems advisable for the education and support of that beneficiary until the death of the beneficiary or the maximum period permissible under the

> South Carolina rule against perpetuities, whichever first occurs.

Otherwise, Faith's Living Trust left the trust assets to her four children in equal shares.

Faith died in 2011, and later that year her Trust's assets were valued at about $1.8 million, plus a cabin in Wisconsin. By the terms of the Trust, Bank of America was appointed the new Trustee, but refused the appointment. Thus, as per the terms of the Trust, the four children were allowed to, and did, name the husband of one of Faith's grandchildren -- the Debtor's nephew, Mr. J.T. Del Alcazar ("J.T.") -- as the new Trustee.

As to three of Faith's children, everything was fine, and apparently distributions from the Living Trust to them proceeded as normal. But one of the children, Linda Castellano ("Linda"), and her husband were having severe financial problems.

On October 5, 2011, Linda's attorney wrote to the J.T.'s attorney, and advised that Linda was insolvent. Further:

> I am writing to you in relation to section 10.03 of the [Living] [T]trust [the Spendthrift Provision], to advise you that my client [the Debtor] and her husband have experienced insolvency due to the recession. They have closed their business and are filing for bankruptcy protection. [The Debtor] considers that it is the [Spendthrift] [T]rustee's obligation to exercise his authority consistent with the provisions of the [Living] [T]trust identified above [*i.e.*, sec. 10.03].

This letter was later known as the "Insolvency Letter." After receiving the Letter, J.T. set up a new Merrill Lynch account, into which J.T. deposited Linda's 1/4th share of the Trust assets. Although technically not a trust, J.T. and Linda referred to this account quite loosely and unfortunately as the "Spendthrift Trust."

The truth is that things get pretty fuzzy as to whether Faith's trust still existed or not. The terms of the Living Trust provide that, "[u]pon the death of Faith F. Campbell and upon settlement of her estate, this [Living] Trust shall terminate."

Well, Faith had obviously died, but whether Linda's interest vested turns out to be a critical issue.

A little over a month after the Insolvency Letter was written, on November 18, 2011, Linda filed her voluntary petition for Chapter 7 bankruptcy. In her schedules required

to be filed with the petition, Linda identified herself as the “[b]eneficiary of deceased mother's trust protected by spendthrift provision” in the amount of $400,000.

Three days later, on November 21, 2011, Linda executed a document entitled “Receipt, Approval of Accounting, Release and Discharge of Trustee,” which everybody later called the “Receipt.” In the Receipt, Linda stated that her status as a named beneficiary of Faith's Trust had terminated, and that she was now simply a limited beneficiary whose rights to assets were subject to the J.T.'s sole discretion.

Linda further stated in the Receipt:

> I acknowledge that pursuant to the attached Schedule of Assets Distributed I will individually receive no distribution from the Living Trust and that the Spendthrift Trust shall receive my lifetime, limited beneficial interest. This is in *full satisfaction of my rights and interests* under the Living Trust, however reserving my beneficial interests pursuant to the Spendthrift Trust, I approve the Schedule of Assets Distributed. (Emphasis added.)

The Chapter 7 Trustee for Linda's bankruptcy case then sued Linda and J.T. for fraudulent transfers under 11 U.S.C. Section 548(e)(1), and also for a turnover of Linda's share of the Trust's assets under Sections 543 and 550.

Section 548(e)(1) provides in full:

> (e)(1) [T]he trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if—
>
> (A) such transfer was made to a self-settled trust or similar device;
>
> (B) such transfer was by the debtor;
>
> (C) the debtor is a beneficiary of such trust or similar device; and
>
> (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that the transfer was made, indebted.

Before the Bankruptcy Court embarked on its analysis of Section 548(e)(1) against these facts, it made the following general comment about that section:

> Section 548(e) has received little attention in the case law. However, there appears to be no dispute that Congress enacted sec. 548(e) in order to avoid the deleterious results of certain state laws that permitted debtors to shelter their assets from their creditors by placing them into self-settled spendthrift trusts (or similar devices) shortly before filing for bankruptcy. *Quality Meat Prods., LLC. v. Porco, Inc*. (*In re Porco, Inc*.), 447 B.R. 590, 595 (Bankr.S.D.Ill.2011); Alan N. Resnick & Henry J. Sommer, 5 Collier on Bankruptcy para. 548.07 at 548–87–89 (16th ed. rev.2014). By permitting the bankruptcy trustee to seize these assets for the benefit of creditors, sec. 548(e) restored the common-law rule allowing creditors to avoid pre-bankruptcy spendthrift trusts designed to shield assets from creditors of an insolvent debtor. *Id*. (citing H.R.Rep. No. 109–31, 109th Cong., 1st Sess. at 449–50 (2005)), reprinted in 2005 U.S.C.C.A.N. p. 88.

Linda made a very straightforward argument, that she didn't transfer anything to the Living Trust. Moreover, if the spendthrift clause worked, the Living Trust gave the Trustee the complete and sole discretion to make or not make distributions, totally independent of what she wanted or not.

The Bankruptcy Trustee countered that there certainly was a transfer of assets, from the Living Trust's main account to the new Merrill Lynch account, which transferred occurred because of the family relationship between the debtor and her nephew, the Trustee.

The Bankruptcy Court agreed with the Bankruptcy Trustee:

> The Court finds that the Debtor voluntarily effectuated an indirect, conditional parting with an interest in property-her share of the Living Trust assets. Rather than accepting direct receipt of those assets and then transferring them into a self-settled trust or the like, she recruited the Spendthrift Trustee to accomplish the equivalent result, schooling him, in the Insolvency Letter, in his “obligation to exercise his authority consistent with the provisions of the [Living Trust, i.e., sec. 10.03].”

What happened, according to the Bankruptcy Court, was that the Spendthrift Trustee followed Linda's suggestions that he not make any distributions to her directly, but instead set up the new Merrill Lynch account, into which he placed Linda's share. Linda then had the use of the moneys in that account, subject only to the discretion of her nephew, the Spendthrift Trustee.

The Bankruptcy Court then turned back to Section 548(e)(1) and focused on the language "self-settled trust or similar device," and commented:

> A self-settled trust has been defined as "[a] trust in which the settlor is also the person who is to receive the benefits from the trust, usually set up in an attempt to protect the trust assets from creditors." [] In determining the scope of the "similar device" language of the statute, the Court agrees with the court's conclusion in *Porco* that Congress's intent in enacting sec. 548(e) was to have the "similar device" provision interpreted broadly:
>
> Collier on Bankruptcy notes that the congressional decision to leave undefined the terms used in sec. 548(e), such as "similar device," indicates an intent for courts to interpret the statute broadly so as to effectuate its aims, noting that, "even if crafty lawyers draft devices not technically "self-settled trust[s]," court[s] will have the power to scrutinize them under the "similar device" provision.[Citations omitted]

Linda argued that since the "Spendthrift Trust" (a/k/a the Merrill Lynch account) was created by the Spendthrift Trustee, she (Linda) was not the settlor, and thus the trust was not self-settled for purposes of Section 548(e)(1).

The Bankruptcy Court disagreed, finding that Linda effectively caused J.T. to set up the Spendthrift Trust by way of Linda's Insolvency Letter. Moreover:

> Thereafter, the Debtor confirmed in the Receipt that the effect of her coaching of the Spendthrift Trustee in the Insolvency Letter was to ensure that her share of the Living Trust assets would be distributed not to her individually but into the newly-created Spendthrift Trust. Read together, the Insolvency Letter and the Receipt provide strong evidence that the Spendthrift Trustee invoked the Spendthrift Provision and created the Spendthrift Trust in direct response to the Debtor's express wishes. By its own terms, the intent of the Spendthrift Provision is to shield a beneficiary's interest in the Living Trust from his or her creditors, and the Debtor is, by her own written admission in the Receipt, clearly a beneficiary of the Spendthrift Trust created thereunder.

The Bankruptcy Court also couldn't get away from the fact that Linda was related to J.T., who was acting as the Spendthrift Trustee, and that with the Spendthrift Trust being fully discretionary, it was Linda who was really in control:

> Further, the Court cannot ignore the family relationship between the Debtor

> and the Spendthrift Trustee, as well as the total absence of any court supervision or control over the Spendthrift Trustee's decisions concerning disposition of the assets of the Spendthrift Trust. Family ties militate against any trustee exercising completely unfettered, independent discretion in administering a spendthrift trust. Lack of judicial oversight exacerbates the risk that the Spendthrift Trustee's independent judgment will be compromised by family entanglements. The Debtor had reason to assume that despite the creation of the Spendthrift Trust she would have every opportunity to influence, if not simply instruct, the Spendthrift Trustee to disburse funds according to her own discretion. Whether the Spendthrift Trust was a self-settled trust or similar device, the practical effect is the same—the Debtor can justifiably expect to exercise a significant degree of control over its assets.

The Bankruptcy Court's conclusion is an eye-popper: The use of a related trustee essentially creates a presumption that a beneficiary has control over the trust (!?!). In that classic, surprised exclamation of Gomer Pyle: Shazaam! Furthermore, what fiduciary has truly unfettered discretion?[ii]

But then the Bankruptcy Court shifted attention away from whether the Spendthrift Trust was a self-settled trust, and instead focused on whether it was a "similar device" to a self-settled trust. In doing so, the Bankruptcy Court identified four factors that it held brought the Spendthrift Trust into the "similar device" language of 548(e)(1):

> 1. Like a self-settled trust, the Spendthrift Trust was created in part to shield the Debtor's assets from her creditors: The Spendthrift Trustee and the Debtor candidly admitted that the purpose of setting up the Spendthrift Trust was to shield assets from the Debtor's creditors. Indeed, the fact that the Spendthrift Trust was not created until after the Debtor had made a written declaration of insolvency and her written mandate to the Spendthrift Trustee "to exercise his authority consistent with the provisions of [the Spendthrift Provision] of the [Living Trust]" make it impossible to reach any other conclusion about the purpose of the parties in setting up the Spendthrift Trust.
>
> 2. Like a self-settled trust, the Spendthrift Trust was created to preserve the right of the Debtor to receive future distributions from the Living Trust: Both the Debtor and the Spendthrift Trustee also conceded that another important purpose of the Spendthrift Trust was to provide for the Debtor's education and support needs under sec. 10.03 of the Living Trust and that the Debtor's nephew, the Spendthrift Trustee, had complete and unfettered discretion to

> make sure that this occurred.
>
> 3. Although not directly created by the Debtor, the Debtor indirectly caused the creation of the Spendthrift Trust via the instructions she conveyed to the Spendthrift Trustee in the Insolvency Letter: While it is true that the Debtor did not personally set up the Spendthrift Trust, there is no dispute that the Spendthrift Trustee did so in response to her request that he "exercise his authority consistent with the [Spendthrift Provision]" of the Living Trust. The Court concludes that the Debtor satisfied the "self-settled" aspect of sec. 548(e) by using the Spendthrift Trustee as her cat's paw to create the Spendthrift Trust, rather than setting it up directly.
>
> 4. It is irrelevant for purposes of sec. 548(e) whether the formal requirements for establishing a trust under South Carolina law were satisfied: Finally, the Court finds that, under the "similar device" language of sec. 548(e), the Chapter 7 Trustee need not establish that a formal trust was established according to South Carolina law; an account that was directly or indirectly created by the Debtor to shield her assets from her creditors while retaining a right to receive the assets from that account suffices to meet the requirements of the statute. Any more restrictive interpretation than that would have the effect of reading the "or-similar-device" language out of sec. 548(e).

The Bankruptcy Court thus found that a transfer had indeed been made to a "similar device" to a self-settled trust.

Linda next argued that she was not a beneficiary of the Spendthrift Trust. The problem was that Linda was obviously a beneficiary, both before and after the Merrill Lynch account was created. But, regardless of what the documents said, the Bankruptcy Court turned again to the close relationship between Linda as the beneficiary, and her nephew J.T. as the Trustee, and that he supposedly had total discretion to do whatever he wanted:

> At trial, [J.T.] candidly admitted that, because he is not subject to any court oversight, it is within his sole discretion to distribute spendthrift funds for the Debtor's support and maintenance in any way he sees fit. By way of example, he could justify giving the entire amount in the Spendthrift Trust to the Debtor as a "support" distribution designed to alleviate the emotional anxiety she presumably feels as a result of her bankruptcy. This is not an entirely facetious analogy, given the family relationship between the two and the complete lack

> of court supervision over the Spendthrift Trustee's exercise of his discretion.

All this brings us to the whether Linda had the actual intent to transfer assets so as to hinder, delay, or defraud her creditors. Here, the Bankruptcy Court simply looked to the timing of Linda's advising J.T. that she was in financial difficulty, and that the Spendthrift Provision of the Living Trust should apply. The Bankruptcy Court held that Linda intended to use the spendthrift clause to defeat her creditors:

> Along with the Debtor's testimony that the purpose of the Spendthrift Trust was to prevent creditors from reaching her interest, the Court finds that these facts establish that the Debtor and the Spendthrift Trustee at a minimum contemplated using the Spendthrift Trust device as a mechanism to avoid the Debtor's creditors. Indeed, they suggest that the Debtor and the Spendthrift Trustee actively planned and structured the creation of the Spendthrift Trust with the explicit purpose of shielding those assets from creditors—the precise action that sec. 548(e) was created to avoid. Even now, the Spendthrift Trustee continues to maintain that account subject to his sole discretion to distribute funds for the Debtor's support or education.
>
> In summary, the transfer of funds was not timed in accordance with the terms of the Living Trust or even with the onset of the Debtor's financial need. It was delayed until an instrumentality had been created to deny the Debtor's creditors access to these assets while making them available for the Debtor's benefit.
>
> Second, the Debtor testified at trial that her understanding was that the Spendthrift Trust was created to prevent her creditors from reaching her one-quarter share of the assets. The Spendthrift Trustee was equally candid, testifying that the purpose in setting up the Spendthrift Trust was to shield assets from the Debtor's creditors. This testimony, coupled with the timing of the events outlined above, make it impossible to characterize the purpose of the parties in setting up the Spendthrift Trust as anything other than to thwart the Debtor's creditors. Therefore, the Court finds that the Debtor intended to hinder, delay, or defraud her creditors in making the transfer.

Finally, in Footnote 5, we find the Bankruptcy Court's final rationale for its decision that Section 548(e) applies to set aside the transfer in this case -- a very surprising rationale: When Faith set up her Living Trust, that trust was a self-settled trust to her, and thus Section 548(e) applies even though Linda did not settle the trust, *i.e.*, a settlor's self-settled status may be applied to beneficiaries.

> Footnote 5. There is an alternative analysis which leads to the same result. It is undisputed that the Living Trust set up by Ms. Campbell was a "self-settled" trust, since it was directly created by Ms. Campbell. All that sec. 548(e) requires is that the avoidable transfer be made within ten years of the bankruptcy filing by a debtor beneficiary. Even if the Court were to ignore the Spendthrift Trust and look solely at the Living Trust, the Debtor's actions taken in the Insolvency Letter and the Receipt would still have accomplished a "transfer" into a "self-settled trust or similar device," i.e., the Living Trust created by Ms. Campbell, that would be avoidable under sec. 548(e).

To summarize, the Bankruptcy Court held that the Living Trust effectively was terminated immediately upon Faith's death, and at that time Linda became unchangeably vested in her one-fourth interest. Thus, according to the Bankruptcy Court, when J.T. as the Trustee did not make the distribution to Linda of her one-fourth interest, but instead placed those moneys into the Merrill Lynch account, a fraudulent transfer occurred under Section 548. As to the spendthrift clause, the Bankruptcy Court essentially held that because Linda became vested in her interest at the time of Faith's death, and the Trust then immediately terminated, the spendthrift clause was inapplicable.

In the end, the Bankruptcy Court ruled against Linda on every issue, and also found that the turnover order for Linda's share of the Living Trust assets should be issued. This was all embodied in the recommendation made by the Bankruptcy Court to the U.S. District Court for the Northern District of Illinois, which now must decide whether to affirm or reject the Bankruptcy Court's recommendations.

COMMENT:

For this court, the issue turned on whether Linda's interest in the Living Trust vested prior to the creation of the Spendthrift Trust.[iii] If Linda's interest vested, the creation of the Spendthrift Trust amounted to a transfer that would trigger avoidance and recovery under the Bankruptcy Code. If avoidance and recovery under Section 548(e) applies, then whatever Section 541(c)(2) and applicable law provide regarding valid restraints on alienation matters not. If Linda's interest did not vest (*i.e.*, due to her insolvency), however, the outcome is troubling: How can an individual transfer an interest he or she never had (or was subject to a restraint on alienation) in the first place?[iv]

So, let's go right to the money question: did Linda's interest vest such that it became part of her bankruptcy estate? Answering this question reveals several competing

interests; deference to the settlor's intent, a presumption in favor of vesting as soon as possible, and the scope of Federal law (Bankruptcy Code Section 541) reaching all of a debtor's interests in property.

It is worth reviewing the sequence of events. Faith died on February 11, 2011. Linda's attorney indicated that Linda was insolvent via letter dated October 5, 2011, however, Linda claimed she was insolvent as of Faith's date of death. Linda filed for bankruptcy on November 18, 2011.

Creation of the Bankruptcy Estate

Generally, the extent of debtor's bankruptcy estate is determined by a snapshot of the debtor's assets as of the date of filing.[v] However, an exception applies for inheritances, which helps to prevent preemptive filings.[vi]

Determining bankruptcy estate inclusion upon trust termination does not always present a major issue. Such was the case in *Frazier v. Wasserman*, which involved an outright distribution to a beneficiary/debtor.[vii] Although the distributing trust in *Wasserman* had a spendthrift clause, the trustee already distributed the debtor's property outright to the debtor. Thus, the court in *Wasserman* could easily find bankruptcy estate inclusion either due to the fact that the debtor's interest vested upon the trust's termination or upon physical receipt by the debtor within six months of the bankruptcy commencement.

The timing issue becomes more complicated in a trust termination situation where the trustee retains possession of trust property and the trust agreement directs the trustee to refrain from distributing property in certain circumstances (such as beneficiary insolvency). Without clarity in the gift provision, ambiguity can arise as a distribution provision might conflict with a retention provision.

The question then arises as to whether the property held in trust would be protected from a beneficiary's creditors in bankruptcy. "As a general rule, a beneficiary's equitable property interest in a trust with a spendthrift provision that is enforceable under state law is not reachable by the beneficiary's trustee in bankruptcy, unless the trust is self-settled."[viii] However, once a beneficiary has the ability to obtain access to trust funds, the interest can no longer be excluded under Section 541(c)(2) because of the beneficiary's right to payment.[ix]

Whether a restraint on alienation is enforceable in a termination situation will largely depend on how a court frames the issue; does trust termination (and actual receipt by

the beneficiary) or vesting govern?[x] In some cases, restraints on alienation of a beneficiary's right to receive principal immediately were held invalid, but in others, restraints were valid until the principal was received by the beneficiary.[xi]

Alternatively, if the beneficiary is driving the enforcement of the trust provisions, a bankruptcy court could conclude such action amounts to control over a vested interest and results in a constructive transfer, thereby obviating the application of 541(c)(2) and triggering Section 548(e). The problem for a debtor with a vested interest is it is really just a matter of timing for the creditor; if immediate avoidance and recovery is not an option, attachment is most likely an available option.[xii]

Giving Deference to the Settlor's Intent

Linda made several arguments that supported the exclusion of the Living Trust from the bankruptcy estate. Again, Section 8.01 of the Living Trust provides two conditions for the termination; Faith's death and "upon settlement of her estate." The latter condition was conspicuously absent from the Trustee's argument in the Joint Pre-Trial Statement.

Linda argued that even if her interest vested, she became insolvent prior to the settlement of the estate and under the doctrine of cessor, her interest terminated before she had any control (direct or indirect) over the property. The Bankruptcy Court took a very restricted view of the term "settlement," and -- with only the most superficial analysis -- deemed "settlement" in this context to essentially mean that once the Trustee had substantially administered the estate and paid out the rest of its assets, then "settlement" was achieved.

In other words, the Bankruptcy Court did not elaborate on the alternative interpretation of the term, which was that the Living Trust could not be considered to be settled until all of its assets had been paid out; further, because of the spendthrift clause, the Living Trust estate could not in fact be settled because Linda as one of the beneficiaries had financial problems thereby preventing the Trustee from making the final distributions to Linda.

The parties did in fact extensively brief the common law doctrine of cessor in their Joint Pre-Trial Statement. That doctrine posits that if a creditor attempts to subject the interests of a beneficiary in property to collection, the beneficiary's interest immediately ceases to exist and instead vests in another beneficiary. South Carolina law, which applied to the Living Trust, follows the doctrine of cessor. [xiii] But the Bankruptcy Court ignored this too, and instead the Bankruptcy Court gives us an

analysis of 548(e)(1) that has ramifications far beyond what many planners would have suspected. We'll get to these in a second.

Linda cited *In re Eley*, where a bankruptcy court upheld a spendthrift clause substantially similar to the one in the Living Trust. In *Eley*, the court adopted an expansive view of the trust agreement and the settlor's intent.

Similarly, in *Domo v. McCarthy*, the trust agreement provided for outright distribution to children upon the settlor's death and had a similar spendthrift clause.[xiv] In *Domo*, one of the settlor's children experienced creditor issues. In 1988, the creditor obtained a judgment against a child/beneficiary. The mother, whose trust provided for outright distributions yet contained a spendthrift clause similar to the one in the Living Trust, died in 1989.

The creditor in *Domo* emphasized that upon the settlor's death, the entire trust terminated, which necessarily included the spendthrift clause in the trust agreement. Thus, because the spendthrift clause was no longer applicable upon the settlor's death, the creditor argued he was entitled to attach the beneficiary's interest in the trust. The court disagreed, and held the trust agreement must be reviewed in its entirety with deference given to the settlor's intent.[xv] Although not cited in the Joint Pre-Trial Statement, clauses that provide for forfeiture-on-alienation have been respected in other bankruptcy cases. The renunciation of such interest results in the debtor having no interest under Section 541(c)(2).[xvi]

Linda also argued that the provisions of the Living Trust entitled "Distributions to Minors or Incompetents," permitting a trustee to retain a beneficiary's interest in further trust under certain circumstances. This type of clause is sometimes referred to as a "retention of benefits" or "holdback" clause. The problem with this argument (which did not make it into the opinion), is that the retention clause assumes the beneficiary's interest has vested. Indeed, the beginning of Section 10.01 provides, "[i]f any beneficiary entitled to receive income or principal from the Trust Estate…"[xvii]

Immediate Vesting

The Living Trust terminated upon Faith's death and settlement of her estate. Of course, any probate or trust estate will require some degree of administration. Should the period of administration postpone a beneficiary's interest from vesting until administration is finished? Courts have found a presumption in favor of vesting in such circumstances unless the settlor's intent *clearly* provides otherwise.[xviii] Thus,

if Linda survived Faith, her right to receive property would accrue given the long-supported view that the law favors vesting at the earliest possible time.[xix] "While the law favors the vesting of interests, and, where possible, will construe a trust provision as a condition subsequent in preference to a condition precedent, there are not any technical words to distinguish between the two types of conditions; this is a matter of construction and depends on the creator's intention."[xx]

Linda's signed Receipt acknowledged she had an interest:

> I acknowledge that pursuant to the attached Schedule of Assets Distributed I will individually receive no distribution from the Living Trust and that the Spendthrift Trust shall receive my lifetime, limited beneficial interest. This is in *full satisfaction of my rights and interests* under the Living Trust, however reserving my beneficial interests pursuant to the Spendthrift Trust, I approve the Schedule of Assets Distributed. (Emphasis added.)

Had Faith intended to continue spendthrift protection for her beneficiaries beyond her death, she would have either explicitly provided that solvency was a condition precedent for receiving a share of her trust estate or, she would have provided for ongoing trusts instead of an outright distribution.[xxi]

Protecting a Beneficiary's Interest

There are numerous ways to avoid the result in *Castellano* from a drafting perspective.[xxii] Where the settlor intends to define vesting at a point other than death, it should be done in a clear fashion. If insolvency was a bar to receipt, it should have been addressed in the gift itself as a condition precedent.[xxiii] It is understandable why many choose to expand spendthrift clauses to include conditions precedent, given reported successes. But in trust termination situations involving vested interests, the ability to protect a beneficiary's interest is less than certain. It has been noted that "the distinction between vested and contingent interests is not uniformly recognized, defined, or applied."[xxiv]

Furthermore, the fact that solvency wasn't raised until right before bankruptcy seemed "too cute" and gave the Bankruptcy Court an opportunity to sidestep the Section 541(c)(2) analysis. The Bankruptcy Court noted that "the transfer of funds was not timed in accordance with the terms of the Living Trust or even with the onset of [Linda's] financial need. It was delayed until an instrumentality had been created to deny [Linda's] creditors access to these assets while making them available for

[Linda's] benefit."

Obviously, the most effective way to avoid termination and vesting issues is by keeping assets in ongoing trust, with distributions subject to the trustee's discretion.[xxv] If protection from creditors is a concern, the cost of ongoing trusts should be weighed against the added protection and assurance one derives from using ongoing trusts. In situations where a trust terminates, one should not rely on the courts to view a spendthrift and/or cessor clause as self-executing so as to defeat the claims of creditors. Instead, one should be prepared for the same result as in *Castelleno* for the bankrupt beneficiary.[xxvi]

Although there have been reported successes with the use of protective clauses similar to *Castellano*, the use of such clauses may cause confusion, especially from an administrative and property rights perspective. For instance, when should a trustee expect the protective clause to take effect? Even if a trustee is provided with sole and absolute discretion in determining solvency, what steps should a trustee take when serving as trustee under an agreement with solvency provisions? Presumably, it wasn't until the Trustee received a letter from Linda's attorney that the Trustee ascertained insolvency.[xxvii] Does the trust agreement provide guidance as to the determination of solvency if such a calculation is required?

In *Castellano*, Linda claimed she was insolvent prior to Faith's death. Would a single claim of $100 trigger the clause, since it provides for application if someone else could enjoy all or "any part" of the trust property? How would the clause impact the exercise of a beneficiary's attempt to disclaim? If property is diverted to a discretionary trust (as was the case in *Castelleno*), care should be taken to review the trust agreement provision pertaining to the Rule Against Perpetuities. Additionally, the decision should be made as to the appropriate party to initiate the solvency issue; trustees would no doubt prefer to avoid such a task, but a beneficiary would most likely ignore such a provision unless a creditor was present.

Thus, one should seriously consider simply keeping assets in trust or being clear as to any condition precedent to vesting. If one chooses to decant as a result of impending termination, thought should be given to timing, among other issues.[xxviii]

Suffolk University Law Professor Charles Rounds agrees with the Bankruptcy Court's analysis. "A fair reading of the Living Trust instrument is that the Living Trust had terminated upon Faith's death, with the subject property becoming distributable to Linda, that is to say becoming possessory, upon settlement of Faith's probate estate. Linda's equitable remainder interest then would have vested as of the

death of her mother, which means the debtor had constructively received her share of the trust property at that time. There is no indication that vesting itself was subject to the condition precedent of solvency or the settlement of Faith's probate estate."

If there is constructive receipt, it also follows that the creation of the new account reflected an agency agreement, whereby Linda was the principal with a fee simple interest in her property. Under this approach, the argument for bankruptcy inclusion is straightforward and does not require any analysis involving a spendthrift trust.

Yet, for those who have relied upon a terminating trust as being "saved" by the inclusion of a spendthrift, protective and/or cessor clause, the Bankruptcy Court's rationale, if adopted in future cases, means that those clauses might be defective as to the intended operation. While it is true that testamentary construction should give effect to the testator's intent,[xxix] ambiguity should be avoided and a stated contingency affecting the receipt of funds should be included with the gift itself to avoid a result like *Castellano*.

Bankruptcy Exception for Self-Settled Trusts

Now let's turn to the Section 548(e) issues. Fasten your seatbelt, and pull it tight, as this is going to be a wild ride.

In 2005, Congress passed the Bankruptcy Abuse Prevent and Consumer Protection Act ("BAPCPA").[xxx] The BAPCPA gave us a new addition to section 548, which is bankruptcy law's fraudulent transfer provision. That addition is 548(e), which, as set forth above, operates to set aside transfers to "self-settled trusts and similar devices."

According to the Congressional record, and as recognized by the Bankruptcy Court, the stated purpose of Section 548(e) was to eviscerate in bankruptcy the protections afforded by the so-called Domestic Asset Protection Trusts ("DAPTs").[xxxi]

Section 548(e) is the reason why many asset protection planners believe that, whatever else DAPTs do or don't accomplish, they are at best a very weak asset protection device that won't work in bankruptcy, at least within the first 10 years after a transfer was made to such a trust, which 10 years is the Statute of Limitations given in 548(e).

While DAPTs likely will not work in bankruptcy, at least as to the settlor/beneficiary, Congress' inclusion of the language "or similar device" raises substantial questions about just how far Section 548(e) will be interpreted in bringing other, non-DAPT,

trusts within its orbit.[xxxii] Also important is the context in which the issue is raised. Any attack on the trust or "similar device" would be filed by a bankruptcy trustee, who has no stake in the outcome but is acting on behalf of all creditors. The issue is decided by a bankruptcy judge who sees and hears lots of debtor excuses why assets should not be liquidated for the benefit of creditors. Not surprisingly, bankruptcy judges are quite receptive to arguments that have any legal foundation that will result in value being transferred from the debtor (directly or indirectly) to creditors. While the trust may fare better on appeal, those decisions are probably years away and there is no guaranty how any appellate court will decide these difficult issues with complex facts.[xxxiii]

Here, the Bankruptcy Court tells us once again that the "similar device" language of Section 548(e) is to be interpreted "broadly" so that "even if crafty lawyers draft devices not technically "self-settled trust[s]," court[s] will have the power to scrutinize them under the 'similar device' provision." In other words, if something starts to smell like an asset protection trust, then 548(e) potentially becomes implicated. This creates very dangerous ground from the outset for clients and planners alike who are considering asset protection planning using trusts.

Optics play a huge role in trials; if enough things look bad, then everything is evaluated in a cynical light. Here, the bad optics were found in making Linda's nephew, J.T., the Trustee, and with the beneficiaries signing a release that essentially acknowledged Linda had a share but wanted her nephew to keep it in further trust.

It also rubbed the Bankruptcy Court wrong that J.T. apparently set up the Merrill Lynch account on the indirect urging of Linda, or as the Bankruptcy Court put it, "using the Spendthrift Trustee as her cat's paw to create the Spendthrift Trust, rather than setting it up directly." Of course, this presumes that the Merrill Lynch account rose to the dignity of a "Spendthrift Trust," which isn't exactly clear as previously discussed. But the takeaway is this -- Linda acted, J.T. reacted, and together they appeared to be working in concert, and this belied that J.T. was a true independent Trustee instead of simply Linda's nominee.

So was a second Trust, called the "Spendthrift Trust" created? The Bankruptcy Court implicitly admits that it was not formally created, but then goes on to say that under 548(e), setting up the Merrill Lynch account was a "similar device" under 548(e), and therefore just as good as a self-settled trust for fraudulent transfer purposes.

Similarly confusing was the Bankruptcy Court's position that because Faith created a trust that was self-settled as to herself, it also meant the trust was self-settled as to

Linda as a beneficiary. In the context of trust law generally, that sort of reasoning doesn't rise to the level of respectable nonsense. In the context of this case in particular, the argument is a non-starter because Faith created and funded the Trust well more than 10 years before Linda filed for bankruptcy, and thus was barred by the Statute of Limitations. In other words, at best Footnote 5 to this effect is dicta, and highly dubious dicta at that.

Which is to say that even if this opinion stands, it should not be expected that the full breadth of its amazingly liberal interpretation of Section 548(e) will be adopted as a majority position by other courts. Like most other things, Section 548(e) is going to shake out somewhere in the middle -- not as broadly construed as creditors hope, and not as tightly construed as debtors hope -- and we may well later mark this opinion as an extreme example of a liberal interpretation of the statute.

But we'll have to wait and see where the courts go with this. Often, the first opinions on a subject are given more weight than they might otherwise merit, and thus swing the law disproportionately to the merits of their reasoning.

The bottom line is that Section 548(e) is a fearsome part of the Bankruptcy Code, which not only neuters DAPTs in bankruptcy, but also has the tremendous potential to eviscerate asset protection strategies which are somewhat like DAPTs, and maybe even some things that aren't like DAPTs at all.

A good guess would be that some aspects of this opinion will be reversed or at least significantly cut back upon review by the U.S. District Court, or on appeal to the Seventh Circuit. But there is probably about an equal probability that this opinion will survive in major part.

What also stands out about this opinion is the lack of guidance with respect to the law of trusts and estates in the bankruptcy court setting. The various mischaracterizations of the law of trusts and estates only support the observation that bankruptcy courts are becoming even more pro-creditor and exhibit disdain towards debtors who rely on estate and/or asset protection plans to avoid paying debts.[xxxiv]

Castellano is a wake-up call for planners who believe that they can simply include a spendthrift clause in their trust documents, and the trust assets will then never become available to creditors of a beneficiary. The truth is that protecting a surviving beneficiary’s interest is much more complicated than one would think, and it requires several different provisions to work closely in tune with the others so that the beneficiary's interest never quite vests, the beneficiary doesn't have any access to the

trust assets, and the trust doesn't terminate so long as a debtor-beneficiary has creditor difficulties. *Castellano* is also a wake-up call as to the possibly amazing breadth of Bankruptcy Code 548(e) as it applies to “self-settled trusts and similar devices.”

One thing we do know is that heartburn and ulcers are imminent. So stay tuned.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Jay Adkisson

David Slenn

Philip Martino

TECHNICAL EDITOR: DUNCAN OSBORNE

CITE AS:

LISI Asset Protection Planning Newsletter #258, (September 8, 2014) at http://www.LeimbergServices.com Copyright 2014 Leimberg Information Services, Inc. (**LISI**). Reproduction in Any Form or Forwarding to Any Person Prohibited – Without Express Written Permission

CITE:

In re Castellano, 2014 WL 3881338 (Bk.N.D.Ill., Aug. 6, 2014).

The opinions expressed are those of the authors and do not necessarily reflect the views of Quarles & Brady LLP or its clients. This commentary is for general information purposes and is not intended to be and should not be taken as legal advice.

CITATIONS:

---

[i] The spendthrift clause in Article 10.03 provides that a beneficiary's interest terminates and is held in a discretionary trust *for the beneficiary*. There are various forms of "protective clauses," including interests that become discretionary upon certain events (see Restatement (Third) of Trusts § 57). A spendthrift clause should be distinguished from a cessor clause. "Plaintiff relies, not upon the doctrine of spendthrift trusts, but upon the totally different and distinct doctrine of "cessor" or defeasance upon the happening of a specified contingency. Although a cessor is sometimes employed to terminate a spendthrift trust- indeed, under the English rule a cessor is necessary to give such a trust any validity-yet the two doctrines are wholly separate and distinct." *Lynch v. Lynch*, 161 S.C. 170, 159 S.E. 26, 28 (1931). *See also, Van Osdell v. Champion*, 89 Wis. 661, 62 N.W. 539, 540 (1895). "The authorities are very generally agreed that property cannot be conveyed, devised, or bequeathed with a restriction against it, or any portion of it, going to assignees in bankruptcy or in any form to creditors, although a grant may be made which shall be determinable by way of cesser, or by limitation of the estate over to another upon the occurrence of a certain event; such as insolvency, bankruptcy, or the occurrence of any other act or event arising or growing out of the conduct or neglect of the grantee or devisee. The bounty of a grantor or testator may, however, be secured to another by means of a trust,--a "spendthrift's," as it is sometimes called; so that the periodical income of the estate cannot be anticipated by the cestui que trust, but may be paid to him from time to time, beyond the power of creditors to intercept or reach it."

[ii] *See* Professor Jeffrey N. Pennell, *Special Needs Trusts: Reflections on Common Boilerplate Provisions*, NAELA J., Fall 2010, at 89, 130. "No grant of sole, exclusive, absolute, unrestricted, unfettered, non-reviewable, or any other similar grant of authority is valid. Drafters regularly say this but presumably know that a fiduciary's exercise of discretion must be subject to review. If it were otherwise there would be no enforceability, and that would mean that there would be no trust. See Restatement (Third) of Trusts § 50, comment c: "It is ... a contradiction in terms, to permit the settlor to relieve a 'trustee' of all accountability .... Once it is determined that the authority over trust distributions is held in the role of trustee ..., words such as 'absolute' or 'unlimited' or 'sole and uncontrolled' are not interpreted literally." Scott and Ascher, *supra* note 18, §§ 13.2.3, 18.2 (5th ed. 2007): "The terms of the trust may enlarge the trustee's discretion by use of qualifying adjectives or phrases such as 'absolute,' 'sole,' 'uncontrolled,' or 'unlimited.' Such terms are not, however, interpreted literally; they do not confer on the trustee unlimited discretion," citing

Uniform Trust Code § 814(a): “Notwithstanding the breadth of discretion granted to a trustee in the terms of the trust, including the use of such terms as ‘absolute,’ ‘sole,’ or ‘uncontrolled,’ the trustee shall exercise a discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.”

[iii] The Bankruptcy Court did not use the term “vest” but instead, made several references to “her share” and Linda’s testimony regarding “her one-quarter share of the assets.”

[iv] If a beneficiary’s interest has not vested, the spendthrift clause should operate to exclude the property from the bankruptcy estate. *See In re Schonteich*, 91-36111, 1993 WL 730743 (D.N.D. June 10, 1993) aff'd sub nom. *Drewes v. Schonteich*, 31 F.3d 674 (8th Cir. 1994). (“Furthermore, provisions in the agreements clearly indicate an intent to restrict the beneficiary's ability to assign or use the trust res. The court concurs with the bankruptcy court's statement that “the corpus of the trust is not [the debtor's] property, and consequently her creditors cannot attach any interest until her rights to the payments are vested.” *In re Schonteich*, No. 91–36111, slip op. at 7 (Bankr.D.N.D. Dec. 16, 1992). “[O]nce income is received by the beneficiary or once the beneficiary is entitled to receive the income under the terms of the trust, that income is no longer protected by the spendthrift provision and the beneficiary's creditors can reach those funds.” Id. at 8.)

[v] Section 541(a) of the Bankruptcy Code.

[vi] The debtor must report such inheritance, bequest or devise to the trustee pursuant to Section 541(a)(5)(A) of the Bankruptcy Code.

[vii] *Frazier v. Wasserman*, 263 Cal. App. 2d 120 (1968) “It is undisputed the testamentary trust of Jennie L. Mayer terminated on January 1, 1961, and the Probate Court of Orange County ordered distribution on February 10, 1961. The date of Dempsey's bankruptcy was February 9, 1961. Assuming January 1, 1961, was the date the property vested, then the trust corpus was property in which Dempsey had an interest on the date of bankruptcy which became transferable by him within six months of bankruptcy. Or, assuming the property did not vest until the proceeds of the Mayer Trust were placed in Dempsey's hands on February 10, 1961, then the bequest vested within six months after the date of bankruptcy and it was no longer exempt under the state law of trusts from claims of either creditors or the trustee in bankruptcy. Consequently, under either alternative, title to Dempsey's share of the

Mayer trust proceeds also vested in respondent as Dempsey's trustee in bankruptcy."

[viii] *See* Sec. 5.3.3.3(c) of *Loring and Rounds: A Trustee's Handbook* (2014), pages 352-353.

[ix] "The key inquiry is whether the debtor has any ability to obtain access to the trust funds or to control the timing or manner of distribution. *In re Comp*, 134 B.R. 544, 551 (Bankr.M.D.Pa.1991). Once access is triggered, the interest in the trust can no longer be properly excluded under Section 541(c)(2) because of the debtor's present right to payment. *Id*. The actual exercise of control by the debtor is not necessary. It is the debtor's right to exert control that is dispositive. *McCullough*, 259 B.R. at 518." *In re Hawley*, 02-83674, 2004 WL 330098 (Bankr. C.D. Ill. Feb. 20, 2004).

[x] *See Ross v. CMR Mortgage Fund, LLC*, A109354, 2006 WL 668577 (Cal. Ct. App. Mar. 16, 2006). "We are bound by the terms of the trust instrument to treat the trust as existing until actual distribution of the trust estate to beneficiaries. CMR cites language in two cases apparently referring to transfer of ownership on the date of death of a testator (*Kuenzel v. Grettenberg* (1948) 88 Cal.App.2d 656, 659) and the death of the beneficiary of a marital trust (*County Nat. Bank etc. Co. v. Sheppard* (1955) 136 Cal.App.2d 205, 216), but this imprecise language does not create a rule of law terminating a trust on the death of the surviving settlor. Such a rule would ignore actual trust language and create chaos in the administration of trust estates. Again, CMR cites authority dealing with the vesting of a remainderman's interest in a trust following the death of a life beneficiary (*Salvation Army v. Price* (1995) 36 Cal.App.4th 1619, 1624; *Estate of Newman* (1964) 230 Cal.App.2d 158, 163-164) and the vesting of testamentary beneficiary's rights "at the time distribution could and should have occurred" (*Estate of Taylor* (1967) 66 Cal.2d 855, 858), but the vesting of a beneficiary's contingent right is not equivalent to termination of the trust itself. ***Second, CMR contends that the restraint on the alienation of Martin's beneficial interest under the spendthrift clause ceased to be effective upon entry of the order of December 5, 2002, because the order gave Martin a right to demand distribution of his share of the trust estate. It relies on Probate Code section 857, which gives a person entitled to property under a probate court order the right to possession before actual conveyance.2 (Cf. Evid.Code, § 642; Civ.Code, § 1091.) Alternatively, it cites authority giving a beneficiary the right to transfer property "once the corpus of the spendthrift trust vests in the beneficiary and is placed in his hands, or under his direct control...." (*Frazier v. Wasserman*, *supra*, 263 Cal.App.2d 120, 127; *see also* Rest.3d Trusts, § 58, com. d(1) and (2), reporter's notes, pp. 386-387.) In either case, CMR argues that the spendthrift restriction ceases to apply when the distribution is in effect

due and payable.”

[xi] *See* Restatement (Second) of Trusts § 153 (1959). *See also*, Restatement (Third) of Trusts § 58 (2003). “That a restraint on the alienation of the interest of a beneficiary, who was initially entitled to receive trust principal at a future time, ceases to be effective once that time has arrived even though the trustee has not yet made distribution, *see Boston Safe Deposit & Trust Co. v. Paris*, 15 Mass. App. Ct. 686, 447 N.E.2d 1268 (1983), and *First Nat'l Bank v. First Cadco Corp.*, 189 Neb. 734, 205 N.W.2d 115 (1973); and compare *Frazier v. Wasserman*, 263 Cal.App.2d 120, 69 Cal.Rptr. 510 (1968) (after death of life beneficiary, remainder beneficiary of spendthrift trust became bankrupt; bankruptcy estate includes his right to principal), and *Brent v. Maryland Central Collection Unit*, 311 Md. 626, 537 A.2d 227 (1988). *See also In re Bottom*, 176 B.R. 950 (N.D. Fla. 1994) (bankruptcy estate included property of trust subject to purported spendthrift restraint where bankrupt was both sole beneficiary and sole trustee). Surprisingly, there is also contrary authority in similar contexts holding that a spendthrift restraint remains valid and effective until the beneficiary actually receives the trust property. *See, e.g.*, *Ober v. Dodge*, 210 Iowa 643, 231 N.W. 444 (1930), noted 29 Michigan L. Rev. 493; *Hoffman Chevrolet, Inc. v. Washington Cty. Nat'l Sav. Bank*, 297 Md. 691, 467 A.2d 758 (1983); and *Domo v. McCarthy*, 66 Ohio St.3d 312, 612 N.E.2d 706 (1993).”

[xii] “Although the question is dependent on statute, and the authorities are not uniform, the more general rule appears to be that the interest of a devisee or legatee, when vested, is subject to attachment, although the interest of the beneficiary under a will is a future rather than a present interest, and the property is still in the hands of the executor or administrator for the payment of debts.” 7 C.J.S. Attachment § 82.

[xiii] The Joint Pre-Trial Statement provided, “[t]hus, a cessor clause can apply to property which the debtor has full legal title to, such as a fee simple estate.”

[xiv] The spendthrift clause provided as follows, “No interest of my wife or of any lineal descendant of mine in income or principal shall be anticipated, encumbered or assigned. No such interest shall be subject to claims of such person's creditors, spouse or divorced spouse or others. If any part or all of any such interest, but for this provision, would vest in or be enjoyed by any other individual or entity, other than by disclaimer or release, such interest shall terminate. Thereafter the Trustees from time to time may, in their discretion, but shall not be obligated to, pay to or expend for such person, any dependent of his or any other lineal descendant of mine, such amounts of the income or principal comprising such interest as the Trustees in their discretion deem proper * * *. Upon the death of such person all such income or

principal, if any, then held by the Trustees shall be treated as provided in this agreement for disposition upon his death. * * *" *Domo v. McCarthy*, 66 Ohio St. 3d 312, 315-16, 612 N.E.2d 706, 709 (1993).

[xv] "It is obvious to us that when appellant filed his original creditor's bill in 1988, he triggered the spendthrift provision, converting [the beneficiary's] interest from an absolute right in income and principal to an interest in which the trustee must administer the trust as a purely discretionary trust for [the beneficiary, his dependents and the settlor's descendants]. As such, the newly created discretionary trust cannot be reached by appellant as a creditor of [the beneficiary]." *Domo v. McCarthy*, 66 Ohio St. 3d 312, 317-18, 612 N.E.2d 706, 711 (1993).

[xvi] *See* 3A Bankr. Service L. Ed. § 29:552; *In re Fitzsimmons*, 896 F.2d 373, 20 Bankr. Ct. Dec. (CRR) 173, Bankr. L. Rep. (CCH) ¶73273 (9th Cir. 1990). Since Arizona did not have a statute or case law specifically addressing the validity of forfeiture-on alienation clauses, Arizona courts have turned to the Restatement (Second) of Trusts (1959) §§ 150 and 153.

[xvii] *But see Murphy v. Delano*, 95 Me. 229, 49 A. 1053 (1901). "But the stipulation whereby [the beneficiary] became absolutely entitled to receive one-fourth of the income quarterly is not in conformity with the terms of the trust, and, if held operative, would have the effect to defeat the manifest purpose of the testator by making this income subject to the claims of creditors. The trust should have been administered by the trustees in accordance with the directions of the testator. The law will not permit it to be destroyed by a separate indenture between the trustees and the cestui que trust."

[xviii] "[A]n intermediate gift of income accruing during the term of an active trust at the end of which the corpus is to be distributed among the beneficiaries, is conclusive, nothing else appearing, of the intention of the testator that an equitable, transmissible estate in fee should vest in the beneficiaries immediately upon his death." *Harris v. France*, 33 Tenn.App. 333, 232 S.W.2d 64, 72 (1950). *See also*; *Nat'l Bank of Commerce v. Dortch*, 1987 Tenn.App. LEXIS 3051, at *7–*8, 1987 WL 19510, at *3 (citing 96 C.J.S. Wills § 932 (1957))."The law favors the vesting of testamentary estates. If an intention to the contrary does not clearly appear, an interest will always be construed as vested rather than contingent." "[T]he court agrees with the Plaintiff that on the date that he filed his bankruptcy petition, the Debtor held a vested equitable interest in both the income and corpus of the Residuary Trust created under Mrs. Wachter's Will. The Will expressly states that in the event that the Debtor did not outlive his father, who was the Residuary Trust's other named beneficiary, the

Debtor's share would be distributed to his descendants, or if he died without issue, to the Co–Trustees. Mrs. Wachter clearly intended for the Debtor, or his children, to be fully vested with legal title in both the income and corpus after termination of the Residuary Trust." *In re Wachter*, 314 B.R. 365, 374 (Bankr. E.D. Tenn. 2004). "The law favors the vesting of estates (*Sheridan v. Blume*, 290 Ill. 508, 125 N. E. 353; *Kohtz v. Eldred*, 208 Ill. 60, 69 N. E. 900; *Kellett v. Shepard*, 139 Ill. 433, 28 N. E. 751, 34 N. E. 254), and the estate granted under a will will be deemed to vest upon the death of a testator, unless words are found in the will clearly manifesting an intention of the testator that the estate granted shall not vest except upon the happening of a certain contingency (*Dustin v. Brown*, 297 Ill. 499, 130 N. E. 859; *Hull v. Hull*, 286 Ill. 75, 121 N. E. 239; *Knight v. Pottgieser*, 176 Ill. 368, 52 N. E. 934). The mere fact that the distribution is postponed does not render the estate of the beneficiary contingent. *People v. Allen*, 313 Ill. 156, 144 N. E. 800; *Scofield v. Olcott*, 120 Ill. 362, 11 N. E. 351." *Martin v. McCune*, 318 Ill. 585, 589, 149 N.E. 489, 491-92 (1925).

[xix] *See Wilson v. Rhodes*, 258 S.W.3d 873, 877-78 (Mo. Ct. App. 2008). "A spendthrift provision prevents alienation of trust property that a beneficiary is entitled to receive 'only until the beneficiary actually receives the property or the beneficiary's right to receive the property accrues.' *State ex rel. Nixon v. Turpin*, 994 S.W.2d 53, 59 (Mo.App.1999). Here, the dispositive issue is when Winchester's right of distribution accrued. Neither trust explicitly required a beneficiary to survive until the date of distribution in order to receive trust assets. In the absence of language clearly expressing such an intent, the law favors the vesting of legal or equitable estates at the earliest possible time. *Lehmann v. Janes*, 409 S.W.2d 647, 656 (Mo.1966); *Friedman v. Marshall*, 876 S.W.2d 745, 748–49 (Mo.App.1994). Therefore, Winchester's right to receive a distribution of trust assets accrued on the date of Wife's death. This vested equitable estate passed to Winchester's estate upon her death."

[xx] 90 C.J.S. Trusts § 268.

[xxi] The Trustee cited *In Re: Hilgers* for this proposition, where the court stated "[h]ad the settlers of the Trusts wanted to continue the spendthrift protection for one more generation, they would have provided a successive life estate in the children with ultimate distribution postponed until the children's deaths. They did not do so and we cannot, by our construction, rewrite these Trusts." *See also, Scott v. Bank One Trust Co., N.A.*, 62 Ohio St. 3d 39, 44, 577 N.E.2d 1077, 1081 (1991). The Ohio Supreme Court was faced with a similar issue, where the trust agreement provided for outright distribution unless the beneficiary was insolvent, and if so, such property would be held in a discretionary trust (like the Living Trust). "[The trust] provides

that Bank One shall distribute the trust property outright to McCombe unless he is, *inter alia*, insolvent ("the insolvency clause"), has filed a petition in bankruptcy ("the bankruptcy clause"), or would not personally enjoy the property ("the nonenjoyment clause"). When any of these things occurs, the trust becomes a discretionary trust. Only when all the conditions cease to exist will McCombe again be entitled, under the terms of the trust, to outright distribution of the trust property."

[xxii] For more on "debtor friendly" trust provisions, *see Miller v. Kresser: Lessons Learned From a Creditor Attack on a Third-Party Spendthrift Trust*, **LISI** Asset Protection Planning Newsletter #155 (June 9, 2009).

[xxiii] *See* Spero, *Asset Protection: Legal Planning, Strategies and Forms*, Section 6.02, citing *Blardone v. McConnico*, 604 SW2d 278, 281 (Tex. Civ. App. 1980). "Generally, creditors cannot reach a beneficiary's interest in a trust subject to a condition precedent until the condition has been met." *See also, Baldwin v. Branch*, 888 So. 2d 482, 487 (Ala. 2004) "Whether a remainder is vested or contingent depends on the language employed. If the conditional element is incorporated into the description of, or into the gift to, the remainderman, then the remainder is contingent; but if, after words giving a vested interest, a clause is added divesting it, the remainder is vested."

[xxiv] *See Spero, Asset Protection: Legal Planning, Strategies and Forms*, Section 6.02[5]. "In most jurisdictions a remainder that will vest on the passage of time, such as the beneficiary's attaining a certain age, is a vested remainder; whereas a remainder interest that requires the beneficiary to survive the death of a holder of a preceding estate is a contingent remainder."

[xxv] "If asset protection for a beneficiary is an issue, a trust should never be drafted to provide for outright distribution of income or principal to a beneficiary. Instead, the income should be accumulated and added to principal, and held in trust for the lifetime of the beneficiary." Drafting Trusts for Maximum Protection from Creditors, 30 ESTPLN 290, 297.

[xxvi] Notwithstanding the outcome in *Castellano*, "protective" trust provisions have some support. "The terms of a trust can validly provide that the interest of a beneficiary other than the settlor shall cease upon voluntary or involuntary alienation of the interest and that, instead, the trustee shall thereafter have discretionary authority with respect to any further payments to the beneficiary. These are often called "protective" provisions, and often authorize discretionary distributions also to the original income beneficiary's family or other relatives. These arrangements are

particularly common in England and in states that reject or severely restrict spendthrift trusts, but they are also used elsewhere to prevent creditors from seizing spendthrift trust funds following distribution (§ 58, Comment d).” Restatement (Third) of Trusts § 57 (2003).

[xxvii] The Trustee received a letter from Linda’s attorney asserting it was the Trustee’s obligation to exercise his authority consistent with the provisions of the Living Trust.

[xxviii] *See Ed Morrow & Steve Oshins on Ferri v. Powell-Ferri: Asset Protection Lessons, Perils and Opportunities with Decanting*, **LISI** Asset Protection Planning Newsletter #240 (March 12, 2014).

[xxix] “The cardinal rule of testamentary construction in this state is to ascertain and give effect to the intention of the testator unless he has attempted to make a disposition of his property contrary to law or public policy.” *In re Schmidt's Will*, 256 Minn. 64, 66, 97 N.W.2d 441, 444 (1959).

[xxx] We’re still looking for all the consumers who were “protected” by BAPCPA.

[xxxi] Here, the Bankruptcy Court noted in Footnote 4. “At the time sec. 548(e) was added to the Bankruptcy Code, five states (Alaska, Delaware, Nevada, Rhode Island, and Utah) had enacted statutes permitting debtors to shield their assets from creditors by transferring them to self-settled spendthrift trusts. *Quality Meat Prods., LLC. v. Porco, Inc. (In re Porco, Inc.)*, 447 B.R. 590, 595 (Bankr.S.D.Ill.2011).”

[xxxii] One would think that this language would be limited to DAPTs and their close variants, such as so-called Power of Attorney Trusts and Hybrids Trusts, but we found out in the Thomas case than an IRA is a form of self-settled trust within the orbit of 548(e). *See In re Thomas*, 2012 WL 2792348 (Bkrtcy.D.Idaho, Slip Copy, July 9, 2012) (full Opinion at http://goo.gl/4x01T) and Jay Adkisson’s article on that opinion, “Thomas: Pre-Bankruptcy Exemption Planning Survives And An IRA Is A Self-Settled Trust Or Similar Device”

[xxxiii] The cost to appeal would be a costly gamble, especially in light of recent decisions. *See Clark v. Rameker*, 134 S.Ct. 2242 (2014); *But cf*., *Law v. Siegel*, 134 S. Ct. 1188 (2014) (Supreme Court held in favor of bankruptcy debtor.)

[xxxiv] The late Professor Gray would welcome such a trend. *See Stephen A. Siegel, John Chipman Gray and the Moral Basis of Classical Legal Thought*, 86 Iowa L.

Rev. 1513, 1554 (2001). “Gray knows, however, that his position, and the common law that instantiates it, are neither eternal nor transcendent. Social mores change, and not necessarily for the best. ‘Spendthrift trusts,’ he wearily concludes, ‘have no place in the system of the Common Law. But I am no prophet, and certainly do not mean to deny that they may be in entire harmony with the Social Code of the next century. Dirt is only matter out of place; and what is a blot on the escutcheon of the Common Law may be a jewel in the crown of the Social Republic.’” For more on the history of spendthrift trusts, see *Domestic Asset Protection Trusts: Pallbearers to Liability?*, 35 Real Prop. Prob. & Tr. J. 479, 592 (2000). “Dean Griswold observed that the rationale supporting Justice Miller's opinion in *Nichols v. Eaton* was attractive to judges who had grown up in the middle of the nineteenth century, which Griswold described as “a pioneer period” during which the spirit of individualism was paramount. A person could do with one's property as that person saw fit. Dean Griswold observed that the interests of the donee or of the public at large were not regarded as compelling at that point in history. Griswold went on to criticize the Miller rationale, however, by observing that the major premise of the Miller opinion, that the owner of property may dispose of it as desired, is patently incorrect.” For a great discussion of the effectiveness of spendthrift clauses in the context of divorce, including drafting recommendations, *see* Professor Jeffrey N. Pennell, CLE Presentation, *Third Party Trusts in Divorce; Is a Beneficiary’s Interest Marital Property?* (Tampa Bay Estate Planning Council, May 21, 2014).