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# Rights of a Trust Beneficiary's Creditors Under the Uniform Trust Code

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*Editor's Synopsis: The Uniform Trust Code has now been enacted in twenty-one jurisdictions. This article discusses how the UTC treats the claims of beneficiaries' creditors and how those provisions of the UTC have been modified in the enacting jurisdictions. The article also addresses criticisms of the UTC provisions on the rights of trust beneficiaries' creditors.*

## I. INTRODUCTION

The Uniform Trust Code<sup>1</sup> was approved by the National Conference of Commissioners on Uniform State Laws (NCCUSL) on August 3, 2000, and by the House of Delegates of the American Bar Association at its mid-year meeting in February, 2001. The UTC was amended in 2001, 2003, 2004, and 2005.<sup>2</sup> At the time this article is written, the UTC has been enacted in 21 jurisdictions (Arizona, Alabama, Arkansas, the District of Columbia, Florida, Kansas, Maine, Missouri, Nebraska, New Hampshire, New Mexico, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Utah, Virginia, and Wyoming).<sup>3</sup> Arizona, the latest jurisdiction to enact the UTC, was also one of the first, having originally enacted the UTC in 2003, only to repeal it before it became effective, after some of its provisions (particularly those dealing with the trustee's duty to inform benefi-

ciaries) became controversial.<sup>4</sup> After a period of study, the UTC was re-introduced in Arizona and was enacted on May 27, 2008, to become effective December 31, 2008.<sup>5</sup>

The provisions of the UTC concerning the rights of a trust beneficiary's creditors are contained mainly in article 5 of the UTC. That issue—the rights of a beneficiary's creditors—has been one of four “hot button” issues in states considering the enactment of the UTC.<sup>6</sup> Existing non-UTC American law on the rights of trust beneficiary creditors is highly diverse.<sup>7</sup> As Prof. David M. English, the Reporter for the UTC, points out, the spendthrift trust is an American invention (England, where the trust was born, does not recognize spendthrift trusts<sup>8</sup>), and the lack of a common English heritage for spendthrift protection may explain this diversity of United States law on creditor rights.<sup>9</sup> In any event, the enactments of the UTC have reflected the existing diversity—the tendency is to modify the uniform provisions to conform them to prior, existing law and practice in the enacting jurisdiction.<sup>10</sup>

Part II of this article summarizes the UTC provisions on the rights of beneficiaries' creditors and the extent to which those provisions codify or modify the common law of trusts. Part II also notes some of the modifications that have been made to the UTC in the enacting jurisdictions. It should be kept in mind that,

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<sup>1</sup> UNIFORM TRUST CODE (2000) [hereinafter UTC].

<sup>2</sup> NCCUSL Drafts and Final Acts, University of Pennsylvania Law School, <http://www.law.upenn.edu/bll/archives/ulc/ulc.htm#uta>, visited June 4, 2008.

<sup>3</sup> Uniform Trust Code Legislative Fact Sheet, National Conference of Commissioners on Uniform State Laws, [http://nccusl.org/Update/uniformact\\_factsheets/uniformacts-fs-utc2000.asp](http://nccusl.org/Update/uniformact_factsheets/uniformacts-fs-utc2000.asp), visited June 4, 2008.

<sup>4</sup> Robert T. Danforth, *Article Five of the UTC and the Future of Creditors' Rights in Trusts*, 27 CARDOZO L. REV. 2551, 2554-55 (April 2006) [hereinafter Danforth, *Article Five*].

<sup>5</sup> 2008 ARIZ. SESS. LAWS 247.

<sup>6</sup> David M. English, *Hot Button Issues Under the Uniform Trust Code*, American College of Trust and Estate Counsel 2007 Annual Meeting, Symposium 1 (2007). The other “hot button” issues are the settlor's power to consent to the beneficiaries' request to terminate an irrevocable trust, the court's power to remove the trustee, and the trustee's duty to inform and report to the beneficia-

ries. *Id.*

<sup>7</sup> *Id.* at 5.

<sup>8</sup> *Id.*; CHARLES E. ROUNDS, JR. & CHARLES E. ROUNDS, III, LORING A TRUSTEE'S HANDBOOK § 5.3.3(c) (2008 ed.) [hereinafter ROUNDS & ROUNDS].

<sup>9</sup> *Id.*

<sup>10</sup> DAVID M. ENGLISH & ROBERT WHITMAN, FIDUCIARY ACCOUNTING AND TRUST ADMINISTRATION GUIDE § 12.11 (2d. ed 2008) (“The greatest number of changes involve the tendency of states to carry over the state's prior law on certain issues, particularly in the area of creditor rights.”); see S. Alan Medlin, *The Impact of Significant Substantive Provisions of the South Carolina Trust Code*, 57 S.C. LAW REV. 137, 177 (Autumn 2007) (“The SCTC [South Carolina Trust Code] eliminates much, if not all, of the controversial UTC provisions—generally retaining, with some refinement, pre-SCTC South Carolina law.”); Suzanne Brown Walsh, Richard E. Davis, Stanley C. Kent & Alan Newman, *What Is the Status of Creditors Under the Uniform Trust Code?*, 32 ESTATE PLANNING 29, 31 (“many states make changes to conform the UTC to their current law.”).

because of the diversity of state law on this subject, the "common law" on these issues may be "difficult to pin down."<sup>11</sup> In addition, case law on trusts is sparse in some jurisdictions. In fact, some of the impetus for the UTC came from less-populated states with little trust law that wanted a code to fill the gaps in their common law.<sup>12</sup> In those states, the courts and lawyers frequently look to the treatises by Scott<sup>13</sup> and Bogert,<sup>14</sup> the *Restatement (Second) of Trusts*, and, more recently, to the *Restatement (Third) of Trusts*<sup>15</sup> when issues arise that have not previously been dealt with by case law.<sup>16</sup>

Part III of the article addresses criticisms that have been leveled against the UTC provisions on the rights of beneficiaries' creditors and responses to those criticisms and considers whether the criticisms are justified. Part IV concludes.

## II. UTC PROVISIONS AFFECTING THE RIGHTS OF BENEFICIARIES' CREDITORS

### A. Mandatory Rules

Most of trust law is default rules, which the settlor may modify or even eliminate,<sup>17</sup> and the UTC codifies this concept.<sup>18</sup> There are some rules, however, that the settlor may not modify.<sup>19</sup> The UTC both adopts this concept and enumerates those provisions that are mandatory rules, not subject to override or modification by the settlor.<sup>20</sup> Included among the mandatory rules is "the effect of a spendthrift provision and the rights of certain creditors and assignees to reach a trust

as provided in" article 5 of the UTC.<sup>21</sup> By making the rules concerning the rights of creditors mandatory, the UTC sets a framework for determining the rights of creditors that applies regardless of the settlor's intent and the terms of the trust. Although the jurisdictions that have enacted the UTC have made a number of changes to article 5 so that the specifics of these rules are not particularly uniform, the enacting jurisdictions have uniformly made the provisions on creditor rights mandatory rules.<sup>22</sup>

### B. Creditor Rights in the Absence of a Spendthrift Provision (UTC Section 501)

Under the UTC, creditors may reach a beneficiary's interest in the trust "[t]o the extent [the] beneficiary's interest is not subject to a spendthrift provision."<sup>23</sup> This language recognizes that a spendthrift provision may apply to the interests of some beneficiaries and not to the interests of other beneficiaries.<sup>24</sup> The language also recognizes that the spendthrift provision may apply to part but not all of a beneficiary's interest; for example, the spendthrift provision may apply to a beneficiary's interest in income but not principal.<sup>25</sup>

To the extent spendthrift protection does not apply to a beneficiary's interest, "the court may authorize a creditor or assignee of the beneficiary to reach the beneficiary's interest by attachment of present or future distributions to or for the benefit of the beneficiary or other means."<sup>26</sup> Note that this section does not authorize the creditor to reach the trust property; it is

<sup>11</sup> Alan Newman, *Spendthrift and Discretionary Trusts: Alive and Well Under the Uniform Trust Code*, 40 REAL PROP. PROB. TR. J. 567, 568 note 2 (Fall 2005).

<sup>12</sup> See David M. English, *The New Mexico Uniform Trust Code*, 34 N.M.L. REV. 1, 2 (Winter 2004) ("Prior to the enactment of the UTC, New Mexico had relatively few trust statutes and even sparser reported case law on trust matters. On numerous topics addressed by the UTC, there was literally no New Mexico law. By enacting the UTC, New Mexico's trust law is more complete, more accessible, and, as additional states enact the UTC, more uniform with the trust law of other states.").

<sup>13</sup> AUSTIN WAKEMAN SCOTT, WILLIAM FRANKLIN FRATCHER & MARK L. ASCHER, *SCOTT AND ASCHER ON TRUSTS* (5th ed. 2007) [hereinafter SCOTT & ASCHER].

<sup>14</sup> AMY MORRIS HESS, GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* (3d ed. 2007) [hereinafter HESS & BOGERT].

<sup>15</sup> The RESTATEMENT (THIRD) OF TRUSTS has not yet been completed, but the provisions concerning the rights of trust beneficiaries' creditors have been finalized in sections 51-60.

<sup>16</sup> David M. English, *The New Mexico Uniform Trust Code*, 34 N.M. L. REV. 1 (Winter 2004).

<sup>17</sup> John H. Langbein, *Mandatory Rules in the Law of Trusts*, 98 NW. U.L. REV. 1105, 1105 (Spring 2004).

<sup>18</sup> UTC § 105.

<sup>19</sup> Langbein, *supra* note 17, at 1105.

<sup>20</sup> UTC § 105(b).

<sup>21</sup> UTC § 105(b)(5).

<sup>22</sup> ALA. CODE § 19-3B-105(b)(5) (Supp. 2006); 2008 ARIZ. Sess. Laws ch. 247, § 16, (to be codified at ARIZ. REV. STAT. § 14-10105(B)(5)); ARK. CODE ANN. § 28-73-105(b)(5) (Supp. 2007); D.C. CODE ANN. § 19-1301.05(b)(5) (Supp. 2006); FL. STAT. § 736-0105(2)(l) (Supp. 2008); KAN. STAT. ANN. § 58a-105(b)(5) (2005); ME. REV. STAT. ANN. tit 18-B, § 105(2)(E) (Supp. 2007); MO. REV. STAT. § 456.1-105(2)(5) (2007); NEB. REV. STAT. § 30-3805(b)(5) (Supp. 2007); N.H. REV. STAT. ANN. § 564-B:1-105(b)(5) (2007); N.M. STAT. ANN. § 46A-1-105(B)(5) (2007); N.C. GEN. STAT. § 36C-1-105(b)(5) (2007); N.D. CENT. CODE § 59-09-05(2)(e) (Supp. 2007); OHIO REV. CODE ANN. § 5801.04(B)(5) (2006); OR. REV. STAT. § 130.020(2)(c) (2005); 20 PA. CONS. STAT. § 7705(b)(5) (Supp. 2008); S.C. CODE ANN. § 62-7-105(b)(5) (Supp. 2007); TENN. CODE ANN. § 35-15-105(b)(5) (2007); UTAH CODE ANN. § 75-7-105(2)(e) (Supp. 2007); VA. CODE ANN. § 55-541.05(B)(5) (2007); WYO. STAT. ANN. § 4-10-105(b)(v) (2007).

<sup>23</sup> UTC § 501.

<sup>24</sup> UTC § 501 comment.

<sup>25</sup> *Id.*

<sup>26</sup> UTC § 501.

the beneficiary's interest in the trust, not the trust property, that is reachable by creditors. In addition, in recognition of the fact that a proceeding against a beneficiary's trust interest in equitable in nature, section 501 expressly provides that "[t]he court may limit the award to such relief as is appropriate under the circumstances."<sup>27</sup> This section of the UTC is in accord with the common law.<sup>28</sup>

### C. Spendthrift Protection (UTC Section 502)

UTC section 502 expressly makes spendthrift provisions valid and enforceable. The beneficiary of a spendthrift trust may not transfer the beneficiary's interest, and, subject to the provisions on exception creditors, described below, the beneficiary's creditors "may not reach the interest or a distribution by the trustee before its receipt by the beneficiary."<sup>29</sup> This is consistent with the common law.<sup>30</sup> Under this provision, if a trustee makes a distribution to a third party for the benefit of the beneficiary, a creditor of the beneficiary may not reach the distribution because it was never received by the beneficiary.<sup>31</sup>

To be valid under the UTC, a spendthrift provision must prohibit both voluntary and involuntary transfers of the beneficiary's interest.<sup>32</sup> That is, a provision that purports to prevent creditors from reaching a beneficiary's interest while allowing the beneficiary to transfer the interest voluntarily is not a valid spendthrift provision under the UTC. This is also consistent with the common law.<sup>33</sup> In their enactments of the UTC, Arizona,<sup>34</sup> Kansas,<sup>35</sup> Missouri,<sup>36</sup> and North Dakota<sup>37</sup> allow spendthrift provisions that restrain either the voluntary or involuntary transfer of the beneficiary's interest. The Ohio version of the UTC allows a trust to restrain involuntary transfers but to allow voluntary transfers with the consent of a trustee who is not the beneficiary.<sup>38</sup> Note

that even in a state that adopts the UTC without modification, the settlor may, in effect, give a beneficiary of a spendthrift trust the power to assign the beneficiary's interest by giving the beneficiary a power of appointment. This is based on the historical distinction between an assignment of an equitable interest in a trust, which is prohibited by a spendthrift provision, and the exercise of a power of appointment, which is not considered to be an assignment.<sup>39</sup>

The UTC makes it easy to create spendthrift protection. It is sufficient for the trust terms simply to include a provision that the trust is a spendthrift trust or to use words "of similar import."<sup>40</sup> This, too, is consistent with the common law.<sup>41</sup>

### D. Spendthrift Exception Creditors (UTC Section 503)

Section 503 of the UTC creates three categories of exception creditors against whom spendthrift protection is not enforceable. The first category of exception creditor comprises the beneficiary's spouse, child, or former spouse but only if he or she has a court order or judgment against the beneficiary for support or maintenance.<sup>42</sup> This exception is consistent with the majority rule<sup>43</sup> and both the Second and Third Restatements.<sup>44</sup> Note that the exception is limited to orders or judgments for support or maintenance and, therefore, does not apply to the division of property in a beneficiary's divorce.<sup>45</sup> The second category of exception creditor is "a judgment creditor who has provided services for the protection of a beneficiary's interest in the trust,"<sup>46</sup> such as a lawyer who represented the beneficiary in litigation concerning the trust. The third category of exception creditor is the state or federal government, but only "to the extent a statute of this State or federal law so provides."<sup>47</sup>

<sup>27</sup> *Id.* See UTC § 501 comment.

<sup>28</sup> RESTATEMENT (THIRD) OF TRUSTS § 56 (2001); RESTATEMENT (SECOND) OF TRUSTS § 147 (1959).

<sup>29</sup> UTC § 502(c).

<sup>30</sup> RESTATEMENT (THIRD) OF TRUSTS § 58(1) (2001); RESTATEMENT (SECOND) OF TRUSTS §§ 152-53 (1959).

<sup>31</sup> See Newman, *supra* note 11, at 570.

<sup>32</sup> UTC § 502(a).

<sup>33</sup> RESTATEMENT (THIRD) OF TRUSTS § 58 cmt. b(2) (2001) ("A spendthrift trust is one that restrains both voluntary and involuntary alienation."); RESTATEMENT (SECOND) OF TRUSTS §§ 152(1) (1959) (a spendthrift trust is one in which "it is provided that his interest shall not be transferable by him and shall not be subject to the claims of his creditors") (Emphasis added).

<sup>34</sup> 2008 Ariz. Sess. Laws ch. 247, § 16 (to be codified at ARIZ. REV. STAT. § 14-10502(A)).

<sup>35</sup> KAN. STAT. ANN. § 58a-103(15) (2005) (defining "spendthrift provision" to be a trust term that restrains either the voluntary or involuntary transfer of the beneficiary's interest).

<sup>36</sup> MO. REV. STAT. § 456.5-502(1) (2007).

<sup>37</sup> N.D. CENT. CODE § 59-13-02(1) (Supp. 2007).

<sup>38</sup> OHIO REV. CODE ANN. § 5805.01(A) (2006).

<sup>39</sup> ROUNDS & ROUNDS, *supra* note 8, at § 5.3.2.

<sup>40</sup> UTC § 502(b).

<sup>41</sup> RESTATEMENT (THIRD) OF TRUSTS § 58 cmt. b(3) (2001); RESTATEMENT (SECOND) OF TRUSTS §§ 152 cmt. c (1959).

<sup>42</sup> UTC § 503(b)(1).

<sup>43</sup> Danforth, *Article Five*, *supra* note 4, at 2570.

<sup>44</sup> RESTATEMENT (SECOND) OF TRUSTS § 157(a) (1959); RESTATEMENT (THIRD) OF TRUSTS § 59(a) (2001).

<sup>45</sup> See part III.F. of this article. For a general discussion of the treatment of trusts in divorce property divisions, see Marc A. Chorney, *Interests in Trust in Divorce: What the Settlor Giveth the Divorce Court May Taketh Away*, 40th ANN. HECKERLING INST. EST. PLAN Chapter 16 (2006).

<sup>46</sup> UTC § 503(b)(2).

<sup>47</sup> UTC § 503(b)(3).

An exception creditor may, despite an otherwise enforceable spendthrift provision, obtain an order "attaching present or future distributions to or for the benefit of the beneficiary."<sup>48</sup> Note that an exception creditor does not automatically have any right to reach trust property:

Only those distributions that would otherwise have been made by the trustee (such as a mandatory distribution of income or principal, or a discretionary distribution of income or principal that the trustee has otherwise decided to make) may be the subject of a court order directing them to be paid to the exception creditor. Thus, for example, if the trust is a discretionary trust, and the trustee determines in its discretion not to make a distribution, in most cases a creditor would be unable to force a distribution in satisfaction of its claim.<sup>49</sup>

In recognition of the fact that a proceeding against a beneficiary's trust interest is equitable in nature, "[t]he court may limit the award to such relief as is appropriate under the circumstances."<sup>50</sup>

The concept of exception creditors is nothing new.<sup>51</sup> Indeed, the idea that there might be creditors who, on public policy grounds, are not barred by a spendthrift provision was reflected in the leading case on the validity of spendthrift provisions, which was decided in 1882: "The founder of this trust was the

absolute owner of his property. He had the entire right to dispose of it...with such restrictions or limitations, not repugnant to law, as he saw fit to impose.... His intentions ought to be carried out, *unless they are against public policy*."<sup>52</sup>

Under the UTC, unlike the Restatements, a provider of necessities to the beneficiary is not an exception creditor.<sup>53</sup> The UTC also does not include tort claimants as exception creditors. The Restatements do not expressly create an exception for tort creditors but indicate that public policy might support such an exception.<sup>54</sup> A 1997 Mississippi case acknowledged an exception for tort creditors,<sup>55</sup> but the case was promptly overturned legislatively.<sup>56</sup> Others cases have refused to recognize an exception for tort creditors.<sup>57</sup>

Most of the states that have enacted the UTC have modified section 503. Arkansas<sup>58</sup> and Kansas<sup>59</sup> omit section 503 entirely so that there are no exception creditors in those states. Maine replaced the text of section 503 with a statement to the effect that there are no exception creditors.<sup>60</sup> Tennessee omits as exception creditors both children and spouses as well as judgment creditors who provided services for the protection of a beneficiary's interest.<sup>61</sup>

Ohio excludes former spouses, but not current spouses, as exception creditors and also limits the application of the exception to trusts allowing distributions for the beneficiary's support or providing mandatory distributions.<sup>62</sup> New Hampshire modified the exception for spouses to limit it to a judgment or court order that "expressly specifies the alimony amount attributable to the most basic food, shelter, and medical needs of the spouse or former spouse."<sup>63</sup>

<sup>48</sup> UTC § 503(c).

<sup>49</sup> Danforth, *Article Five*, *supra* note 4, at 2570-71.

<sup>50</sup> *Id.*

<sup>51</sup> Mary Louise Fellows & Gregory S. Alexander, *Forty Years of Codification of Estates and Trusts Law: Lessons for the Next Generation*, 40 GA. L. REV. 1049, 1073 (Summer 2006) ("UTC § 503 sets out the four traditional common law exceptions to the rule that a settlor can prevent creditors from reaching the interests of a trust beneficiary," apparently counting spouses and children as separate exception creditors).

<sup>52</sup> *Broadway Nat'l Bank v. Adams*, 133 Mass. 170, 174 (Mass. 1882) (emphasis added).

<sup>53</sup> See RESTATEMENT (SECOND) OF TRUSTS § 157(b) (1959); RESTATEMENT (THIRD) OF TRUSTS § 59(b) (2001).

<sup>54</sup> RESTATEMENT (SECOND) OF TRUSTS § 157 cmt. a ("The interest of the beneficiary of a spendthrift trust or a trust for support may be reached in cases other than those herein enumerated, if considerations of public policy so require. Thus it is possible that a person who has a claim in tort against the beneficiary of a spendthrift trust may be able to reach his interest under the trust."); RESTATEMENT (THIRD) OF TRUSTS § 59 cmt. a(2) ("the exceptions to

spendthrift immunity stated in this Section are not exclusive. Special circumstances or evolving policy may justify recognition of other exceptions....").

<sup>55</sup> *Sligh v. First Nat. Bank*, 704 So. 2d 1020 (Miss. 1997).

<sup>56</sup> MISS. CODE ANN. § 91-9-503.

<sup>57</sup> See *Duvall v. McGee*, 826 A.2d 416 (Md. App. 2003); *Scheffel v. Krueger*, 782 A.2d 410 (N.H. 2001).

<sup>58</sup> ARK. CODE ANN. § 28-73-503 (Supp. 2007) [Reserved].

<sup>59</sup> KAN. STAT. ANN. § 58a-503 (2005) Reserved. This is likely a change in Kansas law. David M. English, *The Kansas Uniform Trust Code*, 51 KAN. L. REV. 311, 334 (February 2003) ("This likely represents a change in Kansas law. While the Kansas courts have not ruled specifically on whether exceptions to a spendthrift provision exist, such exceptions are well-established in the Restatement [Second], on which the Kansas courts have traditionally relied.") (footnote omitted).

<sup>60</sup> ME. REV. STAT. ANN. tit 18-B, § 503 (Supp. 2007).

<sup>61</sup> TENN. CODE ANN. § 35-15-503 (2007).

<sup>62</sup> OHIO REV. CODE ANN. § 5805.02(B)(1) (2006).

<sup>63</sup> N.H. REV. STAT. ANN. § 564-B:5-503(b)(2) (2007).

Arizona,<sup>64</sup> the District of Columbia,<sup>65</sup> North Carolina,<sup>66</sup> South Carolina,<sup>67</sup> Utah,<sup>68</sup> Virginia,<sup>69</sup> and Wyoming<sup>70</sup> retain the exception for a child's claim for support but exclude spouses and former spouses as exception creditors. Florida includes not only children but also spouses and former spouses as exception creditors, but its statute provides that those claimants may reach distributions to a trust beneficiary "only as a last resort upon an initial showing that traditional methods of enforcing the claim are insufficient."<sup>71</sup> Pennsylvania includes as exception creditors children with judgments or court orders for support or maintenance "to the extent of the beneficiary's interests in the income and principal of the trust,"<sup>72</sup> and any other person with a judgment or court order for support or maintenance but only "to the extent of the beneficiary's interest in the trust's income."<sup>73</sup> Thus, in Pennsylvania, spouses and ex-spouses with judgments or court orders for support or maintenance may reach distributions of income but not of principal. North Dakota recognizes children, spouses, and former spouses as exception creditors, but provides that the exception does not apply to special needs trusts.<sup>74</sup> South Carolina limits exception creditor status to children, but similarly provides that the exception does not apply to special needs trusts.<sup>75</sup>

#### E. Discretionary Trusts (UTC Section 504)

##### 1. Creditor Protection Provided by a Discretionary Trust

The general rule under the UTC is that a beneficiary's creditors may not reach an interest in a discretionary trust:

whether or not a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution that is subject to the trustee's discretion, even if:

- (1) the discretion is expressed in the form of a standard of distribution; or
- (2) the trustee has abused the discretion.<sup>76</sup>

As discussed below, this general rule is subject to an exception for certain claims of spouses and children.

Under traditional analysis, a beneficiary's creditor could not reach a discretionary trust because of the nature of the beneficiary's interest. Because the trustee had discretion to make or withhold distributions and the beneficiary could not force the trustee to exercise its discretion to make a distribution, the beneficiary's creditor, standing in the beneficiary's shoes, was no better off and likewise could not force distributions from the trust.<sup>77</sup> Two points should be noted about this traditional analysis.

First, the degree of protection provided by a discretionary trust was directly related to the degree of discretion granted to the trustee. Protection from the beneficiary's creditors was greatest if the trustee had broad discretion. The best protection was provided by a purely discretionary trust, and especially if the trust terms included language of "extended discretion" such as "the trustee may distribute to the beneficiary so much of the trust property as the trustee, in its sole discretion, may determine." If the trust terms gave the trustee discretion but also included a standard for making distributions (such as the tax-motivated "ascertainable standard" of health, education, maintenance, and support<sup>78</sup>) the trust was somewhere between a trust with mandatory distributions and a purely discretionary trust. If the trust was characterized as a "support trust," such as a trust from which the trustee was required to make distributions for the beneficiary's support, creditors whose claims were based on having provided support to the beneficiary could reach the trust,<sup>79</sup> but other creditors could not.<sup>80</sup>

<sup>64</sup> 2008 Ariz. Sess. Laws ch. 247, § 16, (to be codified at ARIZ. REV. STAT. § 14-10503).

<sup>65</sup> D.C. CODE ANN. § 19-1305.03 (Supp. 2006).

<sup>66</sup> N.C. GEN. STAT. § 36C-5-503(b) (2007). North Carolina also omits as exception creditors a judgment creditor who has provided services for the protection of a beneficiary's trust interest and the state or federal government to the extent provided by another state statute or federal law.

<sup>67</sup> S.C. CODE ANN. § 62-7-503(b) (Supp. 2007).

<sup>68</sup> UTAH CODE ANN. § 75-7-503(2) (Supp. 2007); see Booth v. Booth, 134 P.3d 1151 (Utah App. 2006) (applying the child support exception under Utah's version of the UTC).

<sup>69</sup> VA. CODE ANN. § 55-545.03(B) (2007).

<sup>70</sup> WYO. STAT. ANN. § 4-10-503 (2007).

<sup>71</sup> FL. STAT. § 736.0503(3) (Supp. 2008).

<sup>72</sup> 20 PA. CONS. STAT. § 7743(b)(1) (Supp. 2008).

<sup>73</sup> 20 PA. CONS. STAT. § 7743(b)(2) (Supp. 2008).

<sup>74</sup> N.D. CENT. CODE § 59-13-03(3) (Supp. 2007).

<sup>75</sup> S.C. CODE ANN. § 62-7-503 (Supp. 2007).

<sup>76</sup> UTC § 504(b).

<sup>77</sup> RESTATEMENT (SECOND) OF TRUSTS § 155(1) and cmt. b (1959) ("the transferee or creditor cannot compel the trustee to pay anything to him because the beneficiary could not compel payment to himself or application for his own benefit.").

<sup>78</sup> INTERNAL REVENUE CODE OF 1986, as amended [hereinafter IRC] § 2041(b)(1)(A).

<sup>79</sup> RESTATEMENT (SECOND) OF TRUSTS § 157(b).

<sup>80</sup> RESTATEMENT (SECOND) OF TRUSTS § 154.

Second, note that the theory that a creditor could not reach the trust because the creditor stood in the shoes of the beneficiary and the beneficiary could not force distributions from the trust was flawed, because no matter how broadly worded the trustee's discretion was, it was always subject to review by a court for abuse.<sup>81</sup>

The UTC decouples the rights of a beneficiary's creditors from the beneficiary's power to enforce the trust, subject only to an exception for certain claims of spouses and children. Under UTC section 504(b), quoted above, creditors are simply prohibited from reaching the trust regardless of whether the trust is purely discretionary or imposes a standard for distributions and even if the trustee has abused its discretion. At the same time, section 504 expressly provides that it "does not limit the right of a beneficiary to maintain a judicial proceeding against a trustee for an abuse of discretion or failure to comply with a standard for distribution."<sup>82</sup> Much of the criticism of the UTC's handling of creditor rights stems from a failure to appreciate this decoupling of creditor rights and the beneficiary's power to enforce the trust.

The UTC also, for purposes of creditor rights, but not for purposes of the beneficiary's power to enforce the trust, eliminates the traditional distinction between discretionary and support trusts. All trusts in which the trustee has discretion over whether to make distributions are treated as discretionary trusts for purposes of creditor rights, regardless of whether they are purely discretionary or impose a standard. Whether a trust is purely discretionary or includes a standard, and the breadth of the trustee's discretion, will continue to be relevant for purposes of the beneficiary's right to enforce the trust but are not relevant for purposes of determining the rights of the beneficiary's creditors, other than exception creditors as discussed below.

## 2. Discretionary Trust Exception Creditors

The UTC creates an exception to the general rule that creditors may not reach a beneficiary's

interest in a discretionary trust. The exception applies if all of these conditions are present: (1) the creditor is a spouse (or former spouse) or child of the beneficiary; (2) the spouse or child has a judgment or court order for support or maintenance of the spouse or child; and (3) the trustee either has not complied with a standard for distribution or has abused its discretion.<sup>83</sup> Even where the exception applies, it does not give the spouse or child unrestricted access to the trust; rather, the court is to order the trustee to pay to the spouse or child "such amount as is equitable under the circumstances but not more than the amount the trustee would have been required to distribute to or for the benefit of the beneficiary had the trustee complied with the standard or not abused the discretion."<sup>84</sup>

## 3. Changes to Section 504 in the Enacting Jurisdictions

There is considerable case law support for an exception for child support and alimony if the trust is a support trust but little authority for such an exception if the trust is a purely discretionary trust.<sup>85</sup> It is perhaps not surprising, then, that most of the states that have enacted the UTC have modified section 504. The District of Columbia,<sup>86</sup> Kansas,<sup>87</sup> and Oregon<sup>88</sup> omit section 504 entirely. Because the UTC is supplemented by the common law,<sup>89</sup> this presumably leaves the protection afforded by discretionary trusts, and the exceptions to that protection, if any, to development by the courts in these three states.

Arkansas,<sup>90</sup> Florida,<sup>91</sup> Maine,<sup>92</sup> Missouri,<sup>93</sup> Tennessee,<sup>94</sup> and Wyoming<sup>95</sup> omit subsection (c) from their versions of UTC section 504, thus eliminating all exception creditors in the context of a discretionary trust. Arizona,<sup>96</sup> North Carolina,<sup>97</sup> South Carolina,<sup>98</sup> and Virginia<sup>99</sup> limit the exception to support claims of children, excluding claims of spouses and former spouses. New Hampshire modified the exception for spouses to limit it to a judgment or court order that "expressly specifies the alimony amount attributable to the most basic food, shelter, and medical

<sup>81</sup> Danforth, *Article Five*, *supra* note 4, at 2581 ("An essential principle of the common law of trusts is that a trustee's exercise of discretion is always subject to judicial review, no matter how broadly the trustee's discretion may be described.") (footnote omitted); RESTATEMENT (THIRD) OF TRUSTS § 50 cmt. c (2001); RESTATEMENT (SECOND) OF TRUSTS § 187 cmt. k (1959); GEORGE GLEASON BOGERT, GEORGE TAYLOR BOGERT & AMY MORRIS HESS, *THE LAW OF TRUSTS AND TRUSTEES* § 560 (rev. 2d ed. Supp. 2007).

<sup>82</sup> UTC § 504(d).

<sup>83</sup> UTC § 504(c).

<sup>84</sup> UTC § 504(c)(2).

<sup>85</sup> Danforth, *Article Five*, *supra* note 4, at 2578.

<sup>86</sup> D.C. CODE ANN. § 19-1305.04 (Supp. 2006) [Reserved].

<sup>87</sup> KAN. STAT. ANN. § 58a-504 (2005) Reserved.

<sup>88</sup> The Oregon Trust Code skips from OR. REV. STAT. §

130.310 (2005), which corresponds to UTC § 503, to OR. REV. STAT. § 130.310 (2005), which corresponds to UTC § 505.

<sup>89</sup> UTC § 106.

<sup>90</sup> ARK. CODE ANN. § 28-73-504 (Supp. 2007).

<sup>91</sup> FL. STAT. § 736.0504 (Supp. 2008).

<sup>92</sup> ME. REV. STAT. ANN. tit 18-B, § 504 (Supp. 2007).

<sup>93</sup> MO. REV. STAT. § 456.5-504 (2007).

<sup>94</sup> TENN. CODE ANN. § 35-15-504 (2007).

<sup>95</sup> WYO. STAT. ANN. § 4-10-504 (2007).

<sup>96</sup> 2008 Ariz. Sess. Laws ch. 247, § 16 (to be codified at ARIZ. REV. STAT. § 14-40504).

<sup>97</sup> N.C. GEN. STAT. § 36C-5-504 (2007).

<sup>98</sup> S.C. CODE ANN. § 62-7-504 (Supp. 2007).

<sup>99</sup> VA. CODE ANN. § 55-545.04 (2007).

needs of the spouse or former spouse.”<sup>100</sup> Ohio allows the settlor to avoid the exception for claims of a child or spouse by explicitly providing in the trust that the beneficiary’s child or spouse, or both, may not benefit from the trust.<sup>101</sup> Ohio also added to its trust code the concept of a “wholly discretionary trust,” which is a trust that grants the trustee extended discretion and does not include any standards for distributions, over which the beneficiary does not have a withdrawal power, and of which the beneficiary is not a trustee.<sup>102</sup> No creditors may reach a beneficiary’s interest in a wholly discretionary trust, nor any distribution from a wholly discretionary trust before it is received by the beneficiary.<sup>103</sup>

#### 4. Beneficiary as Trustee of a Discretionary Trust

A 2004 amendment to the UTC added a provision to address a potential problem raised by the *Restatement (Third) of Trusts*. In certain types of trusts, such as credit-shelter or by-pass trusts, it is common for a beneficiary to be the trustee. To prevent inclusion of the value of the trust property in the beneficiary-trustee’s gross estate for federal estate tax purposes, the trustee’s discretion to make distributions “is limited by an ascertainable standard relating to the health education, support, or maintenance”<sup>104</sup> of the beneficiary-trustee. A comment to the *Restatement (Third) of Trusts* provides that the creditors of a beneficiary who is also a trustee may reach the beneficiary’s interest in the trust.<sup>105</sup>

The original UTC did not specifically address this issue. Because the common law of trusts supplements the UTC,<sup>106</sup> subsection 504(e) was added to the UTC to prevent the Restatement comment from applying in a UTC state. Under that subsection, the creditors of a beneficiary-trustee may not reach the beneficiary-trustee’s interest, nor compel distribution to the beneficiary-trustee, if the trustee’s discretion is limited by an ascertainable standard.<sup>107</sup> The term “ascertainable standard” is defined to have the same meaning that it does for federal transfer tax purposes.

es.<sup>108</sup> Thus, under the UTC, a beneficiary-trustee’s beneficial interest in the trust is protected from claims of the beneficiary-trustee’s creditors to the same extent that the interest is protected from estate tax inclusion by an ascertainable standard.<sup>109</sup> Naming a beneficiary as trustee does not, however, increase the protection afforded to the beneficiary’s interest. For example, if an exception creditor may reach the beneficiary’s interest under another provision of the UTC, the fact that the beneficiary is also a trustee does not prevent that result.<sup>110</sup>

### F. Self-Settled Trusts and Powers of Withdrawal (UTC Section 505)

The UTC follows the traditional rules concerning the rights of creditors of a settlor who retains a beneficial interest in the trust, or the power to revoke the trust, and rejects the approach of the states that have enacted self-settled asset protection trust legislation.

#### 1. Revocable Trusts

During the lifetime of the settlor of a revocable trust, the settlor’s creditors may reach the trust property.<sup>111</sup> At common law, a creditor could not reach a power of revocation,<sup>112</sup> but the modern rule is to the contrary.<sup>113</sup> In the vast majority of revocable trusts, the settlor retains a beneficial interest in the trust that can be reached by his or her creditors, so it does not matter whether creditors could independently reach the power of revocation. At the death of the settlor of a revocable trust, the remaining trust property 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”<sup>114</sup> but only to the extent that the probate estate is insufficient to meet those obligations and subject to the settlor’s right to direct the source of payments.<sup>115</sup>

#### 2. Self-Settled Irrevocable Trusts

The creditors of the settlor of an irrevocable trust who is also a trust beneficiary may reach the maximum amount that could be distributed to the sett-

<sup>100</sup> N.H. REV. STAT. ANN. § 564-B:5-504(c)(2) (2007).

<sup>101</sup> OHIO REV. CODE ANN. § 5805.04(D) (2006).

<sup>102</sup> OHIO REV. CODE ANN. § 5801.01(Y) (2006).

<sup>103</sup> Ohio Rev. Code Ann. § 5805.03 (2006).

<sup>104</sup> IRC § 2041(b)(1)(A).

<sup>105</sup> RESTATEMENT (THIRD) OF TRUSTS § 60 cmt. g (2001).

<sup>106</sup> UTC § 106.

<sup>107</sup> UTC § 504(e).

<sup>108</sup> UTC § 103(2).

<sup>109</sup> UTC § 504, cmt. on 2004 amendment.

<sup>110</sup> *Id.*

<sup>111</sup> UTC § 505(a)(1); see *Sowers v. Luginbill*, 2008 Ohio 1486, 2008 Ohio App. LEXIS 1297 (Ohio App. 2008) (applying Ohio’s

version of the UTC).

<sup>112</sup> RESTATEMENT (SECOND) OF TRUSTS § 330 cmt. o (“Unless it is otherwise provided by statute a power of revocation reserved by the settlor cannot be reached by his creditors.... they cannot compel him to revoke the trust for their benefit.”).

<sup>113</sup> RESTATEMENT (THIRD) OF TRUSTS § 25 cmt. e (2001) (“property held in [a revocable] trust is subject to the claims of creditors of the settlor or of the deceased settlor’s estate if the same property belonging to the settlor or the estate would be subject to the claims of the creditors, taking account of homestead rights and other exemptions.”).

<sup>114</sup> UTC § 505(a)(3).

<sup>115</sup> *Id.*

lor-beneficiary.<sup>116</sup> This is the common law rule.<sup>117</sup> Although this rule has been criticized in the recent past,<sup>118</sup> it remains the majority rule for now, but the trend in recent years has been to legislatively authorize self-settled asset protection trusts.<sup>119</sup> Despite the UTC's rejection of self-settled asset protection trusts, the UTC is not inherently incompatible with that concept, and some of the states that have adopted the UTC also recognize self-settled asset protection trusts.<sup>120</sup>

### 3. Powers of Withdrawal

Holding a power of withdrawal over property of a trust created by a third party is functionally equivalent to being the settlor of a revocable trust with respect to the property subject to the power. Therefore, the UTC treats the power-holder, with respect to that property, as if he or she were the settlor of a revocable trust—that is, property that the power-holder could withdraw is subject to the claims of the power-holder's creditors.<sup>121</sup> If the power of withdrawal is one that lapses, such as a *Crummey*<sup>122</sup> withdrawal power, then this treatment applies while the power remains exercisable, but, when the power lapses, the power-holder continues to be treated as the settlor only to the extent that the value of the property as to which the power lapsed exceeded a certain amount.<sup>123</sup> That amount is the greater of: (1) the amount that can lapse without being treated as a release of a general power of appointment for federal transfer tax purposes—the greater of \$5,000 or 5% of the value of the property out of which an exercise of the power could have been satisfied (the “five and five limits”);<sup>124</sup> or

(2) the amount of the federal gift tax annual exclusion (currently \$12,000).<sup>125</sup> As a result, if a trust's terms include *Crummey* powers that do not exceed the greater of these amounts, then the trust property will be subject to the power-holders' creditors while the powers remain exercisable but not after the powers lapse. Because *Crummey* powers typically lapse at the end of a relatively short time period, such as 30 days, it will be difficult (but not impossible) as a practical matter for a creditor to reach the trust property. If the trust instrument uses “hanging” powers,<sup>126</sup> on the other hand, the withdrawable amount that hangs and remains exercisable will remain exposed to the creditors of the power-holder until the power over that amount lapses.

It is difficult to say whether this treatment of the holder of a power of withdrawal as the settlor of the trust with respect to withdrawable property is consistent with the common law because non-UTC law on this point is not uniform.<sup>127</sup> There is some case law to the effect that property subject to a presently exercisable but unexercised general power of appointment may not be reached by creditors,<sup>128</sup> but the *Restatement (Third) of Trusts*<sup>129</sup> and federal bankruptcy law<sup>130</sup> are to the contrary.

Several enacting states have modified the UTC provision concerning powers of withdrawal. Arizona includes the UTC concept concerning lapses but adds a sentence to the effect that the lapse, release, or waiver of a beneficiary's withdrawal power over a section 2503(c) trust<sup>131</sup> will not cause the beneficiary to be

<sup>116</sup> UTC § 505(a)(2).

<sup>117</sup> RESTATEMENT (SECOND) OF TRUSTS § 156 (1959); RESTATEMENT (THIRD) OF TRUSTS § 60 cmt. f (2001).

<sup>118</sup> See Adam J. Hirsch, *Fear Not the Asset Protection Trust*, 27 CARDOZO L. REV. 2685 (April 2006); Jeffrey A. Schoenblum, *In Search of a Unifying Principle for Article V of the Uniform Trust Code: A Response to Professor Danforth*, 27 CARDOZO L. REV. 2609 (April 2006); Robert T. Danforth, *Rethinking the Law of Creditors' Rights in Trusts*, 53 HASTINGS L.J. 287 (2002).

<sup>119</sup> See Richard W. Nenno, *Planning With Domestic Asset-Protection Trusts: Part I*, 40 REAL PROP. PROB. TR. J. 263 (Summer 2005); Richard W. Nenno, *Planning With Domestic Asset-Protection Trusts: Part II*, 40 REAL PROP. PROB. TR. J. 477 (Fall 2005).

<sup>120</sup> See MO. REV. STAT. 456.1-505(3) (2005); UTAH CODE ANN. 25-6-14 (amended 2003 & 2004).

<sup>121</sup> UTC § 505(b)(1). A power of withdrawal does not include a power exercisable by a trustee and limited by an ascertainable standard. UTC § 103(11). Thus, a beneficiary's creditor may not reach the beneficiary's interest in the trust merely because the beneficiary is also a trustee and has discretion to make distributions to himself or herself under an ascertainable standard. See section ILE.4.

<sup>122</sup> See *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).

<sup>123</sup> UTC § 505(b)(2).

<sup>124</sup> IRC §§ 2041(b)(2) and 2514(c).

<sup>125</sup> IRC § 2503(b).

<sup>126</sup> A “hanging” power of withdrawal is one that exceeds the amount protected by the five and five limits and that lapses in the current year only to the extent the lapse is protected by the five and five limits. The excess remains exercisable and lapses in future years as and to the extent it can lapse within the five and five limits. See JOHN R. PRICE, *PRICE ON CONTEMPORARY ESTATE PLANNING* § 7.38.4 (2d ed. 2000).

<sup>127</sup> Newman, *supra* note 11, at 591-92.

<sup>128</sup> See *Univ. Nat'l Bank v. Rhoadarmer*, 827 P.2d 561 (Colo. App. 1991).

<sup>129</sup> RESTATEMENT (THIRD) OF TRUSTS § 56 cmt. b (2001).

<sup>130</sup> See 11 U.S.C.S. § 541(a) and (b); RESTATEMENT (THIRD) OF TRUSTS § 56 cmt. b. (2001) (“presently exercisable general powers are and long have been assets of donees' bankruptcy estates, see Bankruptcy Code of 1978 § 541(b), 11 U.S.C. § 541(b), and Bankruptcy Act of 1898 § 70(a), which reversed the result of *Jones v. Clifton*, 101 U.S. (11 Otto) 225, 25 L.Ed. 908 (1879). The bankruptcy rule is also acknowledged in Restatement Second, Property (Donative Transfers) § 13.6(2).”).

<sup>131</sup> See IRC § 2503(c).



treated as the settlor of the trust.<sup>132</sup> The North Carolina UTC provides that property subject to a power of withdrawal will be subject to creditor claims only when and to the extent the power is exercised and that the lapse, release, or waiver of a power of withdrawal does not cause the power-holder to be treated as a settlor of the trust.<sup>133</sup> Pennsylvania diminishes the creditor protection afforded by the UTC by providing that property subject to a power of withdrawal may be reached by a creditor of the power-holder both "during the period the power may be exercised and after its lapse, release or waiver."<sup>134</sup> South Carolina omits the portion of UTC section 505 dealing with powers of withdrawal.<sup>135</sup> Tennessee protects property subject to a power of withdrawal from creditors even while the power is exercisable, up to the greater of the five and five limits or the amount of the federal gift tax annual exclusion.<sup>136</sup> Wyoming provides that the holder of a power of withdrawal "shall not be treated as a settlor of the trust regardless of whether the power remains exercisable or has lapsed."<sup>137</sup>

#### G. Overdue Mandatory Distributions (UTC Section 506)

As discussed above, a creditor (other than an exception creditor) of a beneficiary of a spendthrift trust may not reach a distribution until it is actually received by the beneficiary.<sup>138</sup> The UTC prevents a trustee from collaborating with a beneficiary to avoid a creditor by withholding a mandatory distribution. The creditor can reach a mandatory distribution if it has not been made "within a reasonable time after the designated distribution date."<sup>139</sup> The term "mandatory distribution" is defined to mean a distribution (of income or principal) "which the trustee is required to make to a beneficiary under the terms of the trust, including a distribution upon termination of the trust."<sup>140</sup> The term expressly does not include "a distribution subject to the exercise of the trustee's discretion even if (1) the discretion is expressed in the form of a

standard of distribution, or (2) the terms of the trust authorizing a distribution couple language of discretion with language of direction."<sup>141</sup> Coupling language of discretion with language of direction is addressed in the comment to section 506:

An example of such a provision is "my trustees shall, in their absolute discretion, distribute such amounts as are necessary for the beneficiary's support." Despite the presence of the imperative "shall," the provision is discretionary, not mandatory. For a more elaborate example of such a discretionary "shall" provision, see Marsman. [sic] Nasca, 573 N.E. 2d 1025 (Mass. Ct. App. 1991).<sup>142</sup>

Lawyers frequently and habitually use "shall" to mean different things, one of which is "may,"<sup>143</sup> and the UTC comment simply recognizes this common drafting problem.

This provision of the UTC is in accord with the *Restatement (Third) of Trusts*.<sup>144</sup> The *Restatement (Second) of Trusts* supports the concept that delayed distributions of principal may be reached<sup>145</sup> but does not seem to support the concept that delayed distributions of income may be reached.<sup>146</sup> There is little case law.<sup>147</sup> In any event, it seems hard to justify a distinction between overdue income and principal distributions, and the rule of the *Restatement (Third) of Trusts* and the UTC makes sense on policy grounds.

### III. CRITICISMS OF THE UTC CREDITOR RIGHTS PROVISIONS

#### A. Background

The UTC, and especially its provisions on the rights of beneficiaries' creditors, have come under sharp attack from a small but vociferous group of

<sup>132</sup> 2008 Ariz. Sess. Laws ch. 247, § 16 (to be codified at ARIZ. REV. STAT. § 14-10505(B)(2)).

<sup>133</sup> N.C. GEN. STAT. § 36C-5-505 (2007).

<sup>134</sup> 20 PA. CONS. STAT. § 7748 (Supp. 2008).

<sup>135</sup> S.C. CODE ANN. § 62-7-505 (Supp. 2007).

<sup>136</sup> TENN. CODE ANN. § 35-15-505(b) (2007).

<sup>137</sup> WYO. STAT. ANN. § 4-10-506(d) (2007).

<sup>138</sup> UTC § 502(c).

<sup>139</sup> UTC § 505(b); see *In re Hilgers*, 371 B.R. 465 (10th Cir. Bank. App. 2007), aff'd 2008 U.S. App. LEXIS 10921 (10th Cir. 2008) (applying Kansas's version of the UTC).

<sup>140</sup> UTC § 505(a).

<sup>141</sup> *Id.*

<sup>142</sup> UTC § 506 cmt.

<sup>143</sup> BRYAN A. GARNER, A DICTIONARY OF MODERN LEGAL USAGE 939-42 (2d ed. 1995) ("courts in virtually every English-speaking jurisdiction have held—by necessity—that *shall* means *may* in some contexts and vice versa.") (emphasis in original.)

<sup>144</sup> RESTATEMENT (THIRD) OF TRUSTS § 58 cmt. d (2001).

<sup>145</sup> RESTATEMENT (SECOND) OF TRUSTS § 153(2) and cmt. c. (1959) ("if a beneficiary is entitled to have the principal paid or conveyed to him immediately or at any time he may call for it, a restraint on alienation of his interest is invalid.")

<sup>146</sup> RESTATEMENT (SECOND) OF TRUSTS § 152 cmt. h (1959) ("A spendthrift trust protects income which has been received by the trustee but has not been paid by him to the beneficiary.")

<sup>147</sup> RESTATEMENT (THIRD) OF TRUSTS § 58 cmt. d (2001).

practitioners.<sup>148</sup> The critics take the position that the UTC dramatically reduces the creditor protection traditionally available to spendthrift and discretionary trusts. The responses to these critics have been equally sharp and have been unusually caustic for writing on an academic subject.<sup>149</sup> For example, one article responding to the UTC critics said that “[m]any of the criticisms are based on misinterpretations of the UTC, a disregard of pertinent UTC provisions, or a misunderstanding of existing law,”<sup>150</sup> another characterized the criticism as a “diatribe,”<sup>151</sup> another alleged that an article by the lead critic “contains numerous unsupported statements, mischaracterizations and misinformation about the UTC and about American trust law in general,”<sup>152</sup> and yet another concluded that “[t]he [critics’] arguments are based on misinterpretations of the Uniform Trust Code and case law, and can safely be ignored.”<sup>153</sup>

## B. Exception Creditors

The critics argue that the UTC weakens traditional creditor protection by recognizing exception creditors. The critics assert that “[w]hile exception creditors had no claim against a discretionary trust under common law, all exception creditors would be allowed to directly attach the assets of a discretionary trust under the UTC....”<sup>154</sup> This assertion is incorrect:

[A]n exception creditor’s remedies [under the UTC] are quite limited.... [T]he exception creditor’s remedy is to attach the beneficiary’s interest, not the assets of the trust. Moreover, if the

beneficiary’s interest is discretionary, except in the rare case in which a child or spouse is able to establish an abuse of discretion under section 504(c), if the trustee in its discretion withholds distributions to the debtor beneficiary, then the creditor will be entitled to nothing.<sup>155</sup>

The critics also seem to believe that the UTC, by codifying the list of exception creditors, will encourage state legislatures to expand the list.<sup>156</sup> This is a strikingly peculiar argument. Consideration of which, if any, creditors should be included in the list of exception creditors will of necessity be one of the considerations when a state enacts the UTC. The experience in the states that have enacted the UTC shows that legislatures are in fact inclined to restrict, or even eliminate, rather than expand, the list of exception creditors.<sup>157</sup> If a state legislature proposes to expand its state’s list of exception creditors in the future, there is no reason to believe that the proposal would be subject to any less scrutiny than the UTC is now receiving in states where it is introduced. And, of course, a state legislature may add to its list of exception creditors regardless of whether the UTC is in effect in that state.

The critics also believe that the list of exception creditors in a UTC state may be expanded by the courts.<sup>158</sup> On this point, the critics are simply wrong. The UTC provides that a creditor may not reach a beneficiary’s interest or a distribution “except as otherwise provided in this [article].”<sup>159</sup> Consequently, section 503’s list of exception creditors is exclusive and may be

<sup>148</sup> See Mark Merric & Steven J. Oshins, *Effect of the UTC on the Asset Protection of Spendthrift Trusts*, 31 EST. PLAN. 375 (2004); Mark Merric & Steven J. Oshins, *UTC May Reduce the Asset Protection of Non-Self-Settled Trusts*, 31 EST. PLAN. 411 (2004); Mark Merric & Steven J. Oshins, *How Will Asset Protection of Spendthrift Trusts Be Affected by the UTC?*, 31 EST. PLAN. 478, (2004) [hereinafter Merric & Oshins, *Spendthrift Trusts*]; Mark Merric et al., *Malpractice Issues and the Uniform Trust Code*, 31 EST. PLAN. 586 (2004) [hereinafter Merric, *Malpractice*]; Mark Merric & Douglas W. Stein, *A Threat to All SNTs*, 143 Tr. & Est. 38 (2004); Mark Merric et al., *The Uniform Trust Code: A Divorce Attorney’s Dream*, J. PRAC. EST. PLAN., Oct.-Nov. 2004.

<sup>149</sup> Danforth, *Article Five*, *supra* note 4, at 2552-53 (“Article Five of the UTC—concerning creditors’ rights—has generated a veritable war of words....”).

<sup>150</sup> Walsh, Davis, Kent & Newman, *supra* note 10, at 31.

<sup>151</sup> John K. Eason, *Policy, Logic, and Persuasion in the Evolving Realm of Trust Asset Protection*, 27 CARDOZO L. REV. 2621,2638 (April 2006) (“the primary criticisms appeared in a three part diatribe published in late 2004....”).

<sup>152</sup> Danforth, *Article Five*, *supra* note 4, at 2552 (footnote omitted).

<sup>153</sup> Keith A. Herman, *Asset Protection under the New Missouri Uniform Trust Code*, 62 J. Mo. B. 196, 196 (July/August, 2006) (footnote omitted).

<sup>154</sup> Merric & Oshins, *Spendthrift Trusts*, *supra* note 148, at 484.

<sup>155</sup> Danforth, *Article Five*, *supra* note 4, at 2571-72 (footnote omitted).

<sup>156</sup> Merric & Oshins, *Spendthrift Trusts*, *supra* note 148, at 484.

<sup>157</sup> See parts II.D. (as to spendthrift exception creditors) and II.E.3. (as to discretionary trust exception creditors) of this article.

<sup>158</sup> Merric & Oshins, *Spendthrift Trusts*, *supra* note 148, at 484 (“future exception creditors may now be added both judicially and legislatively”).

<sup>159</sup> UTC § 502(c). Compare RESTATEMENT (THIRD) OF TRUSTS § 59 cmt. a(2) (“The exceptions to spendthrift immunity stated in this Section are not exclusive. Special circumstances or evolving policy may justify recognition of other exceptions....”).

expanded only by the legislature, not by the courts.<sup>160</sup>

An exception creditor may reach a discretionary trust only if the trustee "has not complied with a standard of distribution or has abused a discretion."<sup>161</sup> Just as it is extremely difficult for a beneficiary to force a distribution from a discretionary trust on the ground that the trustee has abused its discretion in refusing to distribute, it will be extremely difficult for an exception creditor of the beneficiary to succeed in establishing an abuse of discretion.<sup>162</sup> The UTC weakens creditor protection in some states, however, by including the spouse and child exception creditor provision:

Although there is substantial case law supporting the proposition that a child, spouse, or former spouse may compel distributions from a trust for the support of the beneficiary, there is only modest support for the proposition that such a claimant can compel distributions from a wholly discretionary trust. Thus, states adopting section 504(c) may be changing their law in this respect.<sup>163</sup>

In fact, that was the result in Nebraska. The Nebraska UTC "clearly changes the prior Nebraska rule that creditors of a beneficiary of a pure discretionary trust could not reach the beneficiary's interest in the trust for any reason."<sup>164</sup> This is, of course, a public policy issue. Some states adopting the UTC will agree with the child-and-spouse exception creditor provision and others will not.<sup>165</sup> As discussed earlier, a number of states that have adopted the UTC have either eliminated exception creditors entirely in the context of discretionary trusts or have eliminated former spouses or both current and former spouses as discretionary trust exception creditors.<sup>166</sup> Even in UTC states that retain the child-and-spouse exception, it will be very difficult, as noted above, for an exception

creditor of a beneficiary of a discretionary trust to prove an abuse of discretion.

### C. Effect of Eliminating the Distinction Between Support and Discretionary Trusts

The *Restatement (Second) of Trusts* drew a distinction between support trusts and discretionary trusts. Under the rule of the Second Restatement, a discretionary trust may not be reached by the beneficiary's creditors:

Except as stated in § 156 [concerning self-settled trusts], if by the terms of a trust it is provided that the trustee shall pay to or apply for a beneficiary only so much of the income and principal or either as the trustee in his uncontrolled discretion shall see fit to pay or apply, a transferee or creditor of the beneficiary cannot compel the trustee to pay any part of the income or principal.<sup>167</sup>

The reason for this rule was that "the transferee or creditor cannot compel the trustee to pay anything to him because the beneficiary could not compel payment to himself or application for his own benefit."<sup>168</sup>

In general, a support trust also could not be reached by the beneficiary's creditors:

Except as stated in §§ 156 [concerning self-settled trusts] and 157 [concerning exception creditors], if by the terms of a trust it is provided that the trustee shall pay or apply only so much of the income and principal or either as is necessary for the education or support of the beneficiary, the beneficiary cannot transfer his interest and his creditors cannot reach it.<sup>169</sup>

<sup>160</sup> See *Sheffel v. Krueger*, 782 A.2d 410, 412 (N.H. 2001) (refusing to create a judicial exception to spendthrift protection for tort creditors, because "Where the legislature has made specific exemptions, we must presume no others were intended."); William H. Lyons & John M. Gradwohl, *Discretionary Trusts, Support Trusts, Discretionary Support Trusts, Spendthrift Trusts, and Special Needs Trusts Under the Nebraska Uniform Trust Code*, 86 NEB. L. REV. 231, 271 (2007) ("once a state has adopted a statute dealing with such exceptions, addition of exceptions will have to come from the legislature."); Eason, *supra* note 151, at 2651; Danforth, *Article Five*, *supra* note 4, at 2573.

<sup>161</sup> UTC § 504(c).

<sup>162</sup> Danforth, *Article Five*, *supra* note 4, at 2577.

<sup>163</sup> Danforth, *Article Five*, *supra* note 4, at 2578 (footnotes

omitted). See Newman, *supra* note 11, at 589.

<sup>164</sup> Lyons & Gradwohl, *supra* note 160, at 256.

<sup>165</sup> *Id.* ("the Nebraska UTC position is consistent with the majority rule in other states and, like the similar change in the law of spendthrift trusts, reflects a proper public policy balance between a person's marital obligations and a settlor's interest in protecting a beneficiary from claims of creditors."); Eason, *supra* note 151, at 2643 ("the UTC position simply represents a logical implementation of a public policy choice favoring a class of dependent creditors over a settlor's protective intentions.").

<sup>166</sup> See part II.E.3. of this article.

<sup>167</sup> RESTATEMENT (SECOND) OF TRUSTS § 155 (1959).

<sup>168</sup> *Id.* cmt. b.

<sup>169</sup> RESTATEMENT (SECOND) OF TRUSTS § 154 (1959).

A support trust could be reached, however, by exception creditors.<sup>170</sup> The *Restatement (Second) of Trusts* recognized four classes of exception creditor: claims by the beneficiary's wife or child for support, claims for necessities provided to the beneficiary, claims for services or materials furnished to the beneficiary to protect the beneficiary's interest in the trust, and government claims.<sup>171</sup>

Both discretionary and support trusts give the trustee some degree of discretion in making distributions, and the discretion is expressed in a myriad of ways. A trust may appear to be a nondiscretionary support trust, for example, a trust in which "the trustee shall distribute to the beneficiary as much of the net income and principal of the trust as is necessary for the beneficiary's support." Even in a trust like this, however, the trustee has some degree of discretion because the trustee must decide as a practical matter what items constitute support of the beneficiary. The trust terms may expressly give the trustee discretion but require that the discretion be exercised according to a standard, such as "the trustee may distribute to the beneficiary as much of the net income and principal of the trust as the trustee, in its discretion, determines advisable for the beneficiary's health, education, maintenance, and support." Or the discretion may be subject to no standard, such as "the trustee may distribute to the beneficiary as much of the net income and principal of the trust as the trustee determines advisable in the trustee's discretion."

Sometimes, the grant of discretion is accompanied by language that expands the scope of the discretion, often referred to as language of "extended discretion." Language of extended discretion may be used along with a standard, such as "the trustee may distribute to the beneficiary as much of the net income and principal of the trust as the trustee determines advisable, in the trustee's *sole and absolute discretion*, for the beneficiary's health, education, maintenance, and support." Language of extended discretion may also be added to a grant of discretion that is not subject to a standard: "the trustee may distribute to the beneficiary as much of the net income and principal of the trust as the trustee determines advisable in the trustee's *sole, absolute, and uncontrolled discretion*."

Putting aside the issue of when and why one might want to allow a trustee to exercise discretion and, if so, how broad that discretion should be, what is the standard by which a court should evaluate a

trustee's exercise of discretion? Does it matter whether the grant of discretion is accompanied by language of extended discretion? When and how will a court interfere with a trustee's exercise of discretion? The answers to these questions are not as clear as one might think. "It is an open question...whether in the face [of] a broad grant of discretionary authority the reasonableness of a trustee's actions may be the subject of judicial second-guessing."<sup>172</sup>

There does seem to be consensus that a reasonableness standard applies to a trustee's actions if the trustee has discretion concerning distributions but the grant of discretion is not accompanied by language of extended discretion. The courts generally will not interfere with a trustee's exercise of discretion. As stated in the *Restatement (Second) of Trusts*, "[w]here discretion is conferred upon the trustee with respect to the exercise of a power, its exercise is not subject to control by the court, except to prevent an abuse by the trustee of his discretion."<sup>173</sup> The language of the *Restatement (Third) of Trusts* is similar: "A discretionary power conferred upon the trustee to determine the benefits of a trust beneficiary is subject to judicial control only to prevent misinterpretation or abuse of the discretion by the trustee."<sup>174</sup>

Despite these Restatement provisions indicating a high degree of deference to the trustee, if the trust terms do not include language of extended discretion, the courts will step in to prevent a trustee from acting unreasonably. Under the *Restatement (Second) of Trusts*:

If discretion is conferred upon the trustee in the exercise of a power, the court will not interfere unless the trustee in exercising or failing to exercise the power acts dishonestly, or with an improper even though not a dishonest motive, or fails to use his judgment, or acts beyond the bounds of a reasonable judgment.<sup>175</sup>

And under the *Restatement (Third) of Trusts*: "A court will not interfere with a trustee's exercise of a discretionary power when that exercise is *reasonable* and not based on an improper interpretation of the terms of the trust."<sup>176</sup>

The picture becomes murky when the terms of the trust include language of extended discretion. Scott

<sup>170</sup> *Id.* § 157.

<sup>171</sup> *Id.*

<sup>172</sup> ROUNDS & ROUNDS, *supra* note 8, at § 3.5.3.2(a) (2008 ed.) (footnote omitted).

<sup>173</sup> RESTATEMENT (SECOND) OF TRUSTS § 187 (1959).

<sup>174</sup> RESTATEMENT (THIRD) OF TRUSTS § 50(1) (2003).

<sup>175</sup> RESTATEMENT (SECOND) OF TRUSTS § 187 cmt. e (1959). Emphasis added.

<sup>176</sup> RESTATEMENT (THIRD) OF TRUSTS § 50 cmt. b (2003). Emphasis added.

takes the position that language of extended discretion relieves the trustee of the duty to act reasonably.<sup>177</sup> But even if the trustee need not be reasonable, the trustee is still subject to some judicial review. The courts ordinarily will not interfere "so long as the trustee acts in good faith, in accordance with the terms of the trust, and not capriciously,"<sup>178</sup> but the court will interfere "if the trustee acts dishonestly or in bad faith, with an improper motive, or in any other way that is contrary to the terms of the trust."<sup>179</sup> The *Restatement (Second) of Trusts*, for which Professor Scott was the reporter, not surprisingly expresses the same view:

The mere fact that the trustee is given discretion does not authorize him to act beyond the bounds of a reasonable judgment. The settlor may, however, manifest an intention that the trustee's judgment need not be exercised reasonably, even where there is a standard by which the reasonableness of the trustee's conduct can be judged. This may be indicated by a provision in the trust instrument that the trustee shall have "absolute" or "unlimited" or "uncontrolled" discretion. These words are not interpreted literally but are ordinarily construed as merely dispensing with the standard of reasonableness. In such a case the mere fact that the trustee has acted beyond the bounds of a reasonable judgment is not a sufficient ground for interposition by the court, so long as the trustee acts in a state of mind in which it was contemplated by the settlor that he would act. But the court will interfere if the trustee acts in a state of mind not contemplated by the settlor. Thus, the trustee will not be permitted to act dishonestly, or from some motive other than the accomplishment of the purposes of the trust, or ordinarily to act arbitrarily without an exercise of his judgment.<sup>180</sup>

Bogert, the other major treatise on trust law, disagrees with Scott, concluding that "[i]t would appear

that the difference in the attitude of the courts towards 'simple' discretionary powers, on the one hand, and 'absolute' or 'uncontrolled' discretionary powers, on the other, is one of degree rather than of kind."<sup>181</sup> In contrast to Scott's position, Bogert concludes that:

a standard of reasonableness has been applied by the courts in judging the exercise of a discretionary power (whether simple or absolute), a standard implied from the settlor's intent and the purposes expressed in the trust instrument. With respect to court review of discretionary powers, this standard is consistent with the standard of care and skill of a prudent man and is based upon established fiduciary standards and principles.<sup>182</sup>

The Third Restatement is more consistent with Bogert than with Scott:

Cases...are difficult to find, involving extended discretion relating to distribution of income or principal, in which courts have approved what actually appears to be unreasonable conduct.<sup>183</sup>

Because there are so many ways to express the discretion granted to a trustee, case law that attempts to categorize trusts as either discretionary trusts or support trusts is diverse and conflicting, and the *Restatement (Third) of Trusts* has abandoned the distinction in the context of the rights of a beneficiary's creditors.<sup>184</sup> The UTC similarly abandons the discretionary/support trust distinction in the context of creditor rights, and the UTC critics argue that doing so weakens creditor protection. The critics' argument is flawed, however, both because the argument fails to recognize that, except for claims of exception creditors, the UTC decouples a creditor's ability to reach a trust from the beneficiary's power to enforce the trust, and because, for exception creditors, the UTC does not change the common law standards that will apply in evaluating a trustee's exercise of discretion.

#### I. Creditors Other than Exception Creditors

In fact, the elimination of the discretionary/support trust distinction actually increases protec-

<sup>177</sup> SCOTT & ASCHER, *supra* note 13, at § 18.2.6.

<sup>178</sup> *Id.* (footnote omitted).

<sup>179</sup> *Id.* (footnote omitted).

<sup>180</sup> RESTATEMENT (SECOND) OF TRUSTS § 187 cmt. j (1959).

<sup>181</sup> BOGERT, BOGERT & HESS, *supra* note 81, at § 560.

<sup>182</sup> *Id.* (footnote omitted).

<sup>183</sup> RESTATEMENT (THIRD) OF TRUSTS, Reporter's notes on § 50 cmt. c (2001).

<sup>184</sup> RESTATEMENT (THIRD) OF TRUSTS § 60, cmt. a (2001).

tion from claims of creditors other than exception creditors.<sup>185</sup> Under traditional theory, a creditor who had supplied necessities to the beneficiary of a support trust could recover from the trust.<sup>186</sup> The UTC treats a trust where the trustee's discretion is expressed in the form of a standard of distribution as a discretionary trust,<sup>187</sup> and a creditor (other than an exception creditor) cannot reach such a trust even if the trustee has not complied with the standard or has abused its discretion.<sup>188</sup> The fact that the *beneficiary* might be able to compel a distribution is irrelevant to the creditor's claim.<sup>189</sup> By treating distributions subject to a standard as discretionary, the UTC eliminates the argument that a creditor may stand in the shoes of the beneficiary to force a distribution.<sup>190</sup> That is, by decoupling the creditor's rights from the beneficiary's power to enforce the trust, the UTC eliminates any argument that a creditor who is not an exception creditor may stand in the shoes of the beneficiary of a discretionary trust to argue that the trustee has abused its discretion.<sup>191</sup>

## 2. Exception Creditors

Under UTC section 504(c), exception creditors, on the other hand, do, in a sense, stand in the shoes of the beneficiary because, if a child or spouse with a court order for child support or maintenance can show that the trustee has not complied with a standard or has abused its discretion, then the court is to order a distribution to satisfy the child support or maintenance award, "but not more than the amount the trustee would have been required to distribute to or for the benefit of the beneficiary had the trustee complied with the standard or not abused the discretion."<sup>192</sup> The UTC critics point to UTC sections 504(d) and 814(a) to argue that the UTC gives trust beneficiaries greater rights to force distributions than they had at common law and, therefore, that exception creditors who stand in the shoes of the beneficiary have greater rights than they had at common law.

Section 504(d) says that section 504 "does not limit the right of a beneficiary to maintain a judicial proceeding against a trustee for an abuse of discretion

or failure to comply with a standard for distribution."<sup>193</sup> Section 504(d) does not grant any rights to a beneficiary—it merely says that the restrictions on creditor's rights set out in the rest of section 504 do not limit the beneficiary's power to enforce the trust.<sup>194</sup>

At the heart of the critics' argument is UTC section 814(a), which provides that:

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.<sup>195</sup>

The critics argue that, at common law, a trustee who had extended discretion (that is, the trust used words such as "uncontrolled," "sole," or "absolute" discretion) could not act in bad faith but was not required to act in good faith. That is, they argue that lack of bad faith is a lesser standard than good faith and that, by requiring good faith on the part of the trustee, the UTC is increasing the rights of beneficiaries and, therefore, of exception creditors under UTC section 504(c).

The bad faith standard, according to the critics,<sup>196</sup> is exemplified by the opinion of the Colorado Supreme Court in *In re Marriage of Jones*.<sup>197</sup> *Jones* was a divorce case in which the issue was not whether a trustee had properly exercised its discretion but whether the wife's beneficial interest in a trust created by her mother was property for purposes of dividing the couple's property between them in the divorce. The court held that the wife's interest in the trust was not property for that purpose. In reaching this conclusion, the court examined the scope of the trustees' discretion. Because the trustee had "uncontrolled discretion," the beneficiary could not force the trustee to make dis-

<sup>185</sup> Eason, *supra* note 151, at 2642 ("The UTC...provides clarification and certainty on the issue of creditors' rights in such [discretionary] trusts. That certainty appears to work to the distinct disadvantage of creditors, particularly with regard to discretionary trusts that are other than 'purely' discretionary.") (footnote omitted).

<sup>186</sup> RESTATEMENT (SECOND) OF TRUSTS § 157(b) (1959).

<sup>187</sup> UTC § 504(b); *see* UTC § 506(a).

<sup>188</sup> UTC § 504(b).

<sup>189</sup> *See* Newman, *supra* note 11, at 600 ("section 504(b) extends to support trusts the protection discretionary trusts have traditionally afforded against creditors of beneficiaries seeking to compel distributions they can reach. In this way, the UTC enhances

asset protection planning with trusts."); Danforth, *Article Five*, *supra* note 4, at 2576-77.

<sup>190</sup> Danforth, *Article Five*, *supra* note 4, at 2576.

<sup>191</sup> Danforth, *Article Five*, *supra* note 4, at 2576-77; Walsh, Davis, Kent & Newman, *supra* note 10, at 31.

<sup>192</sup> UTC § 504(c)(2).

<sup>193</sup> UTC § 504(d).

<sup>194</sup> *See* Newman, *supra* note 11, at 602; Danforth, *Article Five*, *supra* note 4, at 2579-80.

<sup>195</sup> UTC § 814(a).

<sup>196</sup> Merric & Oshins, *Spendthrift Trusts*, *supra* note 148, at 479, note 1.

<sup>197</sup> *In re Marriage of Jones*, 812 P.2d 1152 (Colo. 1991).

tributions “unless she could establish fraud or abuse of discretion,”<sup>198</sup> or unless the trustee “acts dishonestly or from an improper motive, or fails to use his judgment,”<sup>199</sup> or unless the trustee “performs dishonestly or does not act at all.”<sup>200</sup> As a result, the court characterized the wife’s beneficial interest as an “expectancy” not rising to the level of a property interest.<sup>201</sup>

The result in *Jones* may well be correct, but the court’s characterization of the wife’s interest as an “expectancy” is unhelpful when analyzing the actual exercise of a trustee’s discretion. Although a beneficiary of a discretionary trust, especially one that uses language of extended discretion, may accurately be said to have only an expectancy in receiving distributions from the trust, that characterization does not mean that the beneficiary has no property interest. Under traditional theory, the beneficiary is still the equitable owner of the trust property,<sup>202</sup> and the trustee is still a fiduciary, owing to the beneficiary the fundamental duties of a trustee, including the duties of loyalty and impartiality and the duty to account to the beneficiary.<sup>203</sup> Thus, the language in *Jones* to the effect that the beneficiary had no property interest in the trust is best read to mean that the beneficiary’s interest was too attenuated to be considered property *for purposes of the divorce statutes*, but is dictum with respect to the standard for evaluating a trustee’s actual exercise of discretion.

This is demonstrated by other pertinent Colorado law that is contrary to the dictum in *Jones*. The year before the Colorado Supreme Court decided *Jones*, Colorado’s intermediate appellate court had decided *Marshall v. Grauberger*,<sup>204</sup> which involved a property settlement in connection with a divorce. The agreement awarded some shares of the husband’s company to the wife immediately, plus an additional 500,000 shares “to be transferred to her within five years, during which time the husband maintained all powers over the stock. He could sell the shares at any time within the five-year period,”<sup>205</sup> and a sale was to be within the husband’s sole discretion.<sup>206</sup> Before the five years were up, the husband sold the remaining

stock in his name except the stock earmarked for the ex-wife. The stock declined in value after the sale, and the ex-wife sued for breach of fiduciary duty. The court held that the husband was trustee of the 500,000 shares for the wife: “The use of the word ‘trust’ is not necessary to establish a legally sufficient trust.... We agree with the trial court that here a fiduciary duty owed by husband to his wife was ‘created by his undertaking’ to hold title to or to sell wife’s 500,000 shares during a maximum period of 5 years.”<sup>207</sup> The court then concluded that “husband had the obligation as a fiduciary to exercise reasonable care and skill in his administration of the trust,”<sup>208</sup> and “to operate within the bounds of prudent judgment, reasonableness, and equity,”<sup>209</sup> and that reasonableness was an external standard.<sup>210</sup>

The court in *Marshall* thus imposed a reasonableness standard on a trustee with extended discretion. A reasonableness standard is a more stringent standard than good faith or lack of bad faith, regardless of whether one views good faith and lack of bad faith as separate standards or simply different ways of expressing the same standard. When the Colorado Supreme Court decided *Jones* the following year, it gave no indication that it disapproved of the Court of Appeals’s analysis in *Marshall*.

The year after the decision in *Jones*, the Colorado Court of Appeals decided *In re Estate of McCart*,<sup>211</sup> involving a trustee-remainder beneficiary who reduced distributions to the decedent-settlor’s husband after the husband remarried. Although the trustee had “sole discretion” as to distributions, the court held that he had “abused his discretion and acted arbitrarily and capriciously,”<sup>212</sup> “acted with improper motives and with a clear conflict of interest,”<sup>213</sup> and was “in breach of his fiduciary responsibilities to act with the *utmost good faith and fairness* toward the beneficiary.”<sup>214</sup> In *McCart*, the Court of Appeals did not even mention *Jones*, let alone consider itself constrained to defer to a trustee with extended discretion based on the “expectancy” analysis in *Jones*. The Colorado Supreme court denied certiorari in *McCart*.<sup>215</sup>

<sup>198</sup> *Id.* at 1156.

<sup>199</sup> *Id.*, quoting AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, *THE LAW OF TRUSTS*, § 128.3 (4th ed. 1987).

<sup>200</sup> *In re Marriage of Jones*, 812 P.2d 1152, 1156 (Colo. 1991).

<sup>201</sup> *Id.* at 1156-57.

<sup>202</sup> SCOTT & ASCHER, *supra* note 13, at § 13.1 (“The beneficiary of a trust has a property interest in the subject matter of the trust, a form of ownership.”).

<sup>203</sup> *Id.* §§ 169-185.

<sup>204</sup> 796 P.2d 34 (Colo. App. 1990).

<sup>205</sup> *Id.* at 35.

<sup>206</sup> *Id.* at 36.

<sup>207</sup> *Id.*

<sup>208</sup> *Id.* at 36-37.

<sup>209</sup> *Id.* at 37.

<sup>210</sup> *Id.*

<sup>211</sup> *In re Estate of McCart*, 847 P.2d 184 (Colo. App. 1992).

<sup>212</sup> *Id.* at 186.

<sup>213</sup> *Id.*

<sup>214</sup> *Id.* Emphasis added.<sup>215</sup> *In re Estate of McCart*, 847 P.2d 184 (Colo. App. 1992) (cert. denied 92SC729 (1993)).

<sup>215</sup> *In re Estate of McCart*, 847 P.2d 184 (Colo. App. 1992) (cert. denied 92SC729 (1993)).

Finally, Colorado has a statute that requires a trustee to act reasonably in exercising any of its powers,<sup>216</sup> and, as noted above, a reasonableness standard is a more stringent standard than a good faith or lack of bad faith standard.

In the end, the argument over whether good faith is something more than lack of bad faith:

place[s] too much emphasis on the language in some cases indicating that a trustee may not act in "bad faith." Court decisions vary considerably in their formulations of the standards of conduct for trustees; the formulations differ from case to case not so much because courts intend to express substantively different standards, but rather because the facts of a specific controversy cause one court to emphasize certain aspects of the standard over others.

...

The critics' assertion that a standard requiring "good faith" is different from—and, more specifically, is more onerous than—a standard prohibiting "bad faith" has no basis in the law.<sup>217</sup>

Under the UTC, a spouse or child with an order or judgment for support against a beneficiary of a discretionary trust, including a trust that would previously have been characterized as a support trust, will have the opportunity to show that the trustee has not complied with a standard or has abused its discretion, and, if the spouse or child is successful in that difficult task, then the court is to order a distribution to satisfy the child support or maintenance award, "but not more than the amount the trustee would have been required

to distribute to or for the benefit of the beneficiary had the trustee complied with the standard or not abused the discretion."<sup>218</sup> The UTC does not, however, change the legal standard of review by which the court is to determine whether the trustee has complied with a distribution standard or abused its discretion.

#### D. Supplemental Needs Trusts and Special Needs Trusts

Critics argue that the UTC weakens the effectiveness of supplemental needs trusts and special needs trusts. Self-settled special needs trusts must comply with the applicable federal law to be effective.<sup>219</sup> Those trusts are not asset-protection trusts and do not need to be to achieve their purpose. The UTC will not change that and will not affect those trusts.<sup>220</sup>

The critics argue that the UTC may cause a third-party settled supplemental needs trust to become an available resource for purposes of determining whether the beneficiary qualifies for public benefits. The critics base this argument on the UTC's elimination of the distinction between support and discretionary trusts, because the case law on third-party SNTs often categorizes trusts as support trusts that are available resources or as discretionary trusts that are not. But the real question is not the label put on the trust but the beneficiary's rights in the trust:

While cases often explain that the assets of support trusts are disqualifying available resources while those of discretionary trusts are not, the underlying rationale for making that classification determinative of whether the trust assets are actually available to the beneficiary is that the beneficiary may compel distributions for support from a support trust but not from a discretionary trust. While the UTC does not classify trusts as 'support' or

<sup>216</sup> C.R.S. § 15-1-804(1) ("In the exercise of any of his powers, whether derived from this part 8 [of title 15, Article 1] or from any other source, a fiduciary has a duty to act reasonably and equitably with due regard for his obligations and responsibilities toward the interests of beneficiaries and creditors, the estate or trust involved, and the purposes thereof and with due regard for the manner in which men of prudence, discretion, and intelligence would act in the management of the property of another.") (emphasis added). Curiously, however, the Colorado appellate courts have never cited this statutory reasonableness standard in a published opinion, despite having decided a number of cases dealing with trustee discretionary powers. See, for example, *Denver Foundation v. Wells Fargo Bank, N.A.*, 163 P.3d 1116, 1123-24 (Colo. 2007), discussing the "bad faith, dishonesty, or arbitrary action" standard for

reviewing a trustee's exercise of discretion, as set out in the Restatement (Second) of Trusts and the Bogert treatise, without mentioning the seemingly controlling statutory standard of reasonableness.

<sup>217</sup> Danforth, *Article Five*, *supra* note 4, at 2582. See Newman, *supra* note 11, at 604-606; Eason, *supra* note 151, at 2640 ("the UTC's pronouncement that a trustee must exercise discretion in good faith does not change the common law, even with respect to the 'purest' discretionary trusts.") (footnote omitted); Walsh, Davis, Kent & Newman, *supra* note 10, at 32.

<sup>218</sup> UTC § 504(c)(2).

<sup>219</sup> Newman, *supra* note 11, at 619.

<sup>220</sup> *Id.* Walsh, Davis, Kent & Newman, *supra* note 10, at 34-35.



'discretionary,' it does not change existing law on the question of whether a beneficiary of a third party created trust may compel a distribution and thus does not affect whether the trust assets will be disqualifying available resources for public benefits eligibility purposes.<sup>221</sup>

If the trust terms expressly limit distributions to providing for the beneficiary's supplemental needs, the trust is not an available resource and the UTC does nothing to change that result.<sup>222</sup> A discretionary trust with no support standards should also not be an available resource, and, again, the UTC will not change this result.<sup>223</sup> The case law on trusts that give the trustee discretion but use a support standard is diverse.<sup>224</sup> The UTC, however, should not adversely affect how these discretionary support trusts are treated by the courts, because the UTC treats support trusts as discretionary trusts and does not increase the beneficiary's right to compel trust distributions.<sup>225</sup> For example, "because it eliminates the concept of the discretionary support trust, the Nebraska UTC should prevent a Nebraska court from finding that a beneficiary's interest in such a trust is an 'available' asset for purposes of qualification for Medicaid or SSI."<sup>226</sup>

The comment to UTC section 814 refers to the position taken by the Third Restatement that a trustee should exercise its discretion so as to preserve public benefits for the beneficiary:

[D]istilling the results of scores of cases, the Restatement (Third) of Trusts concludes that there is a presumption that the 'trustee's discretion should be exercised in a manner that will avoid either disqualifying the beneficiary for other benefits or expending trust funds for purposes for which public funds would otherwise be available.' Restatement (Third) of Trusts Section 50 cmt. e & Reporter's Notes (Tentative Draft No. 2, 1999).<sup>227</sup>

The inclusion of this reference in the comment may, if anything, help prevent discretionary support trusts from being treated as available resources.<sup>228</sup>

The critics also argue that the UTC makes it too easy for the government to make itself an exception creditor and that doing so will allow the government to reach the property of a supplemental needs or special needs trust:

[I]t may be only a matter of time before the state or federal government is able to convince the state legislators to add them as an exception creditor. At this time, a state or federal governmental agency would be able to recover from all trusts in a UTC state, including third-party discretionary Medicaid or special needs trusts.<sup>229</sup>

This argument is puzzling in several respects. Under UTC section 503, the government is an exception creditor only "to the extent a statute of this State or federal law so provides."<sup>230</sup> The critics seem to be saying that not treating the government as an automatic exception creditor will somehow prompt state legislators to enact a future statute to make the government an unqualified exception creditor. But the policy decision of whether the state should be an exception creditor will presumably be made by a legislature in connection with the enactment of the UTC. Moreover, regardless of whether a state adopts the UTC, the state legislature is free to create an exception to spendthrift protection for government claims.

And so far as claims of the federal government are concerned, the critics' argument fails to appreciate the relationship between state and federal law:

No matter what the UTC says, and no matter how the UTC may subsequently be modified by a state legislature, the federal government is not dependent on state law if it chooses to recover from spendthrift trusts. If the federal government wishes to be treat-

<sup>221</sup> Newman, *supra* note 11, at 620 (footnotes omitted); Richard E. Davis & Stanley C. Kent, *The Impact of the Uniform Trust Code on Special Needs Trusts*, NAELA J. 235, 244-53 (2005).

<sup>222</sup> Newman, *supra* note 11, at 621-22.

<sup>223</sup> Newman, *supra* note 11, at 624-25.

<sup>224</sup> CLIFTON B. KRUSE, JR., *THIRD-PARTY AND SELF-CREATED TRUSTS—PLANNING FOR THE ELDERLY AND DISABLED CLIENT* (3d ed. 2002).

<sup>225</sup> Newman, *supra* note 11, at 623-24; Davis & Kent, *supra*

note 221, at 244-53.

<sup>226</sup> Lyons & Gradwohl, *supra* note 160, at 272 (footnote omitted); see Pohlmann v. Neb. Dep't Health & Human Services, 710 N.W.2d 639 (Neb. 2006) (applying Nebraska's version of the UTC).

<sup>227</sup> UTC § 814 cmt.

<sup>228</sup> Newman, *supra* note 11, at 637.

<sup>229</sup> Merrick & Oshins, *Spendthrift Trusts*, *supra* note 148, at 484.

<sup>230</sup> UTC § 503(b)(3).

ed as an exception creditor; a federal statute or a decision favorable to the government by a federal court will suffice.<sup>231</sup>

Further, government agencies that pay needs-based benefits are rarely creditors of a trust beneficiary during the beneficiary's lifetime. The government can recover from certain types of special needs trusts after the beneficiary's death, but that is dictated by federal law. The extent of creditor protection provided or not provided by the trust during the beneficiary's lifetime, either under the UTC or in a non-UTC state, is irrelevant to that result.<sup>232</sup>

#### E. Claims of Creditors in the Bankruptcy of a Trust Beneficiary

The UTC should have no effect on the treatment of trusts in bankruptcy. Federal bankruptcy law provides that "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title."<sup>233</sup> Consequently, a trust that is a valid spendthrift trust under state law will not become part of the bankrupt's estate, and, because the UTC validates spendthrift trusts, it should have no effect on this result.

In the rare case in which the trust terms do not include a spendthrift provision, the beneficiary's interest may still be protected in bankruptcy if the interest is subject to the trustee's discretion, and, as a result, the beneficiary cannot compel distributions.<sup>234</sup> Because the UTC does not change whether beneficiaries may compel distributions, it should also have no effect on how a discretionary trust without a spendthrift provision will be treated in bankruptcy.<sup>235</sup>

The critics argue that the UTC invites changes to federal bankruptcy law that would expose all trusts to creditors:

What if the federal Bankruptcy Code one day references the UTC exception creditor list?... The federal Bankruptcy Code could take advantage of this loophole by enacting a

statute such as, "the Federal Bankruptcy Trustee is an exception creditor pursuant to section 503(c) of any State that has adopted this provision of the Uniform Trust Code."

All a creditor need do is file an involuntary bankruptcy against the debtor, ... and the creditor would have easy access to the trust assets. In essence, this would mean all judgment creditors—not just alimony, child support, necessary expenses of the creditor, federal claims, state claims and tort creditors—but anyone who had a debt greater than \$11,625. Should federal bankruptcy law ever allow recovery against a trust in a UTC state, *there is virtually no asset protection provided by a spendthrift provision.*<sup>236</sup>

UTC section 503(c), cited in the preceding quotation, makes the *government* an exception creditor to the extent that a state or federal statute so provides.<sup>237</sup> The critics' argument makes the leap of logic that a bankruptcy trustee, who is a fiduciary for the creditors in a bankruptcy proceeding, would be considered a governmental agency for purposes of UTC section 503(c).<sup>238</sup> Moreover, enactment of the UTC is irrelevant to whether the federal government may change federal law to subject trusts to creditor claims in bankruptcy. Such a federal law would preempt state law, including the UTC, some other trust code, or state common law.<sup>239</sup> Additionally, it is silly to suggest that federal bankruptcy law would single out states that have adopted the UTC and subject trusts created in those states, but not trusts created in other states, to creditor claims in bankruptcy.<sup>240</sup>

#### F. Treatment of Trusts in Connection with Divorce

The critics argue that the UTC will enhance the ability of a former spouse to reach trust assets to enforce a claim for alimony. That would be true in a state that previously did not have exceptions to spend-

<sup>231</sup> Danforth, *Article Five*, *supra* note 4, at 2572; see Walsh, Davis, Kent & Newman, *supra* note 10, at 33 ("the federal government already has the power to preempt the states to reach the interest of beneficiaries of spendthrift trusts to satisfy claims [owed to] the United States").

<sup>232</sup> Danforth, *Article Five*, *supra* note 4, at 2572-73; Davis & Kent, *supra* note 221, at 237-44.

<sup>233</sup> 11 U.S.C.S. § 541(c)(2).

<sup>234</sup> Newman, *supra* note 11, at 633-34.

<sup>235</sup> *Id.*

<sup>236</sup> Merric & Oshins, *Spendthrift Trusts*, *supra* note 148, at 484-85 (footnote omitted).

<sup>237</sup> UTC § 503(c).

<sup>238</sup> Danforth, *Article Five*, *supra* note 4, at 2574.

<sup>239</sup> *Id.*

<sup>240</sup> *Id.*

thrift and discretionary trust protections for claims for alimony and which adopted the UTC without change.<sup>241</sup> A number of the states that have adopted the UTC have eliminated former spouses as exception creditors, probably to conform their versions of the UTC either to the state's prior law or, in states that did not have case law on this issue, to conform their versions of the UTC to practitioners' conceptions of what pre-existing law was. If a state already recognized former spouses as exception creditors, adoption of the UTC would not increase former spouses' rights.

The critics also argue that the UTC will make a beneficiary's interest in a trust an asset that may be divided in a divorce proceeding, or an interest that may be considered in dividing other assets, or an interest that the court may consider in awarding child support or alimony. These arguments are based on the theory that the UTC increases a beneficiary's ability to force a distribution from a trust, an argument that is incorrect for the reasons discussed above.<sup>242</sup> All of these issues concerning trusts in divorce are governed by state domestic relations law, which varies considerably among the states.<sup>243</sup> The UTC should not affect how trusts are treated in divorce.<sup>244</sup>

#### G. The Argument that Creating a Trust in a UTC Jurisdiction Is Malpractice

The critics argue that a lawyer who drafts a trust subject to the law of a UTC jurisdiction may commit malpractice if he or she does not advise the client that the UTC increases a trust's exposure to creditor claims.<sup>245</sup> This argument is based on the incorrect conclusion that the UTC does in fact increase exposure to creditor claims.<sup>246</sup> Further, whether a lawyer commits malpractice depends on whether the lawyer has failed to satisfy the standard of practice in

his or her particular jurisdiction.<sup>247</sup> Lawyers in the twenty-one jurisdictions that have adopted the UTC who continue to practice in their home states and to create trusts under their home state's law are not committing malpractice. Rather, the malpractice argument seems to be a scare tactic used by the critics to attempt to prevent the adoption of the UTC, a tactic that has been largely unsuccessful.

#### IV. CONCLUSION

All in all, the critics' arguments that the UTC weakens traditional spendthrift and discretionary trust protection have been largely ineffective and have failed to convince lawyers in the jurisdictions that have enacted the UTC.<sup>248</sup> Enactment in 21 jurisdictions within eight years after it was promulgated represents widespread acceptance of the UTC despite the efforts of its critics. The UTC primarily codifies the common law on the rights of trust beneficiaries' creditors, consisting of the basic common law protections for spendthrift and discretionary trusts and the common law exceptions for claims of spouses, children, persons who protect the beneficiary's trust interest, and government claims. At the same time, the UTC narrows the rights of potential creditors by excluding providers of necessities and tort claimants from the list of exception creditors and by making the statutory list exclusive. Because the common law on these issues is diverse among the states, however, most of the enacting jurisdictions have modified the UTC provisions on creditor rights to conform their trust codes to their own prior law. Despite those modifications, the UTC brings clarity, definition, and certainty that often was lacking before the codification of trust law.

<sup>241</sup> See Newman, *supra* note 11, at 626-27.

<sup>242</sup> See part III.C. of this article; Newman, *supra* note 11, at 627-32; Walsh, Davis, Kent & Newman, *supra* note 10, at 36-37.

<sup>243</sup> See Chorney, *supra* note 45.

<sup>244</sup> See Danforth, *Article Five*, *supra* note 4, at 2591-92.

<sup>245</sup> Merric, *Malpractice*, *supra* note 148, at 586.

<sup>246</sup> See Walsh, Davis, Kent & Newman, *supra* note 10, at 37.

<sup>247</sup> RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 52 cmt. b ("The professional community whose practices and standards are relevant in applying this duty of competence is ordinarily that of lawyers undertaking similar matters in the relevant jurisdiction (typically, a state).").

tion (typically, a state).").

<sup>248</sup> See Lyons & Gradwohl, *supra* note 160, at 278 ("Contrary to the often shrill voices of the relatively few critics of the UTC, the Nebraska UTC does not diminish appropriate protection of trust property and beneficiaries from the claims of creditors."); John E. Donaldson & Robert T. Danforth, *The Virginia Uniform Trust Code*, 40 U. RICH. L. REV. 325, 363 (2005) ("The UTC provisions on spendthrift rules and creditors' rights, adopted in Virginia with a few variations, essentially preserve current Virginia statutory and case law concerning these issues.").