

Steve Leimberg's Asset Protection Planning Email Newsletter - Archive Message #104

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From: Steve Leimberg's Asset Protection Planning Newsletter

Subject: **Where Should You Situs Your Trust? A Look at South Dakota's New Third Party Discretionary – Support Statute**

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EXECUTIVE SUMMARY:

With close to a trillion dollars at stake, many states strive to improve their trust laws to attract trust business.^[1] Some of the most common states when looking for favorable trust law jurisdictions are Alaska, Delaware, Nevada, Rhode Island, and South Dakota.

South Dakota originally took the lead to attract trust business to its state when it abolished the rule against perpetuities in 1983. In 1996, **Jonathan Blattmachr** led Alaska to become a premiere trust law jurisdiction, and naturally, not to be out matched in the business world, **Dick Nenno's** Delaware expanded its laws not just to encompass corporate and limited liability law, but also trust law. And the race was on...

On March 26, 2007, South Dakota's Governor signed legislation that goes into effect July 1, 2007, codifying beneficiary and creditor rights as primarily developed at common law and explained in the Restatement (Second) of Trusts.

While South Dakota has a self-settled trust statute that is almost identical to Delaware, this new act does *not* deal with self-settled trusts. Rather, this new act covers traditional trusts where a third party, typically parents or grandparents, create a trust for their children and/or grandchildren.

South Dakota's third party beneficiary and creditor right legislation may be downloaded at www.InternationalCounselor.com, then go to "Publications," and then to "Hot Off the Press."

COMMENT:

WHY IS THERE A NEED FOR CODIFICATION OF BENEFICIARY AND CREDITOR RIGHTS?

Unfortunately, the Restatement (Third) of Trusts ("Restatement Third") severely reduces the asset protection of beneficial interests in trusts. In fact, in many areas of creditor rights, it is simply not a restatement of common law, rather the creation of favorable creditor law.

For example, Restatement Third Section 60 provides that *any* creditor may attach a sole trustee/beneficiary's interest. Any creditor includes Visa and Mastercard.

Think of all of the bypass trusts where mom is the sole trustee, and now any creditor, can attach Mom's interest in the bypass trust. There is virtually no case law that supports the Restatement Third's position in this area.

Also, with little common law support, the Restatement Third abolishes the discretionary–support distinction under common law and creates an enforceable right or property interest in almost all discretionary trusts.^[2] Further, both the Uniform Trust Code ("UTC")^[3] and the Restatement Third^[4] allows any creditor to attach and exercise an outstanding inter vivos general power of appointment.^[5]

With the 2005 amendments, the UTC has attempted to distance themselves from the Restatement Third. However, we agree with **Roy Adams** and **Clary Redd** as well as many other practitioners that, even after amendment, the UTC significantly broadens creditor rights.^[6]

WHAT ABOUT PROTECTION UNDER COMMON LAW?

Doesn't current common law in Alaska, Delaware, Rhode Island, Nevada, and South Dakota protect these beneficial interests? Won't a judge apply the common law of these states and ignore the expanded view of creditor rights espoused by the Restatement Third? Many states such as New York, Massachusetts, Texas, Kansas, Colorado, and Minnesota have case law that directly follows the Restatement (Second) of Trusts. In these states, a judge may continue to follow case law.

Surprising as it may seem, Alaska, Delaware, Rhode Island, Nevada, and South Dakota have little discretionary–support trust law on point.

At first blush one might ask, "What do you mean Delaware has little discretionary-support trust law?" Remember, Delaware holds the number one position regarding forming corporations.

While Delaware may be the only state that may claim that its appellate courts have never allowed a plaintiff to pierce the veil of a corporation,^[7] it did not become a trust law jurisdiction until 1997.^[8] Therefore, contrary to what many of us might initially think, these top trust jurisdictions do not have much discretionary-support case law on point, and unfortunately a court in these top trust jurisdictions may inadvertently apply the Restatement Third without knowing that it greatly expands creditor rights over common law.

WHAT ARE THE KEY ISSUES?

While there are many issues that are covered by the South Dakota act, this article will focus on the following three key issues:

1. Retention of the superior asset protection of a discretionary trust under common law;
2. Protection against dominion and control arguments; and
3. Protection against creditor attachment of general powers of appointment.

THE COMMON LAW DISCRETIONARY TRUST

A beneficiary's greatest asset protection is provided by a common law discretionary trust.^[9] With a common law discretionary trust, a beneficiary has neither an enforceable right^[10] to a distribution nor a property interest^[11]; rather the beneficiary has nothing more than a mere expectancy.^[12]

Since a beneficiary does not have a property interest, no creditor may attach such interest.^[13] A beneficiary may only seek judicial review of a trustee's action for (1) an improper motive; (2) dishonesty; or (3) failure to act.^[14] In this respect, a beneficiary has nothing more than an equitable interest to enforce the terms of the trust pursuant to the restricted standard of judicial review.^[15]

Since a beneficiary of a discretionary trust has no enforceable right or property right, no creditor can stand in a beneficiary's shoes and no creditor can attach the beneficiary's interest. It should be noted that under common law, the asset protection of a beneficiary's interest in a discretionary trust has nothing to do with spendthrift protection.^[16] Rather, it is the nature of the beneficiary's interest.

To avoid the problems created by Restatement Third and those that are within the UTC, **Jonathan Gopman** suggested that "planners should strongly consider counseling clients to establish third party trusts in appropriate offshore jurisdictions."^[17] While we highly respect Mr. Gopman, in view of the South Dakota's new trust law SB 98, there is probably little need to go offshore.

The following is a summary of the key provisions supporting the common law

discretionary trust provisions under SB 98:

- ◆ Section 2 provides that "The common law distinction between a discretionary trust and a support trust and the dual judicial review standards related to this distinction shall be maintained."
- ◆ Section 15 defines and classifies mandatory interests, support interests, and discretionary interests. Under this section a discretionary interest is:
 - any interest where a trustee has any discretion to make or withhold a distribution. A discretionary interest includes permissive language such as 'may make distributions' or it may include mandatory language that is negated by uncontrolled language of the trustee, such as 'the trustee shall make distributions in the trustee's sole and absolute discretion.'"
 - Examples of discretionary interests are provided in paragraph (3) of Section 17.

There are two key elements to the asset protection of a common law discretionary trust.

First, paragraph (1) of Section 20 codifies common law and states that "*a discretionary interest is neither a property interest nor an enforceable right. It is a mere expectancy.*"

Second, it is one thing to say a beneficiary does not have an enforceable right in a statute. However, under common law, the reason that a beneficiary of a common law discretionary trust did not have an enforceable right to a distribution (and therefore no creditor can stand in the beneficiary's shoes) was the limited judicial review standard for a discretionary trust. Therefore, paragraph (3) of Section 20 retains the *Scott on Trusts* categories for limited judicial review by a court for only (1) dishonesty; (2) improper motive; and (3) failure to use the trustee's judgment.

In the April 2005 issue of *Practical Drafting*, page 8080, **Richard Covey** noted that the UTC 2005 amendments did not address his, as well as many others' concern with the UTC's judicial review standard for a discretionary trust. In particular, if a discretionary trust is subject to a reasonableness review standard does a beneficiary now have an enforceable right, i.e., a property interest, to a distribution?

In the upcoming issue of *Practical Drafting*, Covey notes that the above

language in the South Dakota standalone statute does adequately address his concerns.

On a similar note, **Charles A Redd** remarked that he had concerns with the reasonableness standard of review imposed by Restatement 3d § 50(2) comment b being applied to a discretionary trust.^[18] Again, the South Dakota statute retains the dichotomy and different judicial review standards for a discretionary and a support trust and solves the same issue inherent in the Restatement Third.

DOMINION AND CONTROL ARGUMENTS

A recently published article in *Trusts & Estates* warns of the problems of giving a beneficiary too much control – in particular where a beneficiary serves as the sole trustee.^[19] As primary authority for its conclusions, the article cites, *In re McCoy*, 2002 WL 161588 (ND. Ill. 2002) an unreported case and the Restatement Third Section 60 comment g.

Under common law, if a beneficiary has too much control over a trust, any creditor may reach the beneficiary's interest. South Dakota's SB 98 negates the Restatement (Third) Section 60 g. and cures the possible expansion of dominion and control arguments with the following provisions:

- ◆ Section 5 states, *"No creditor may attach, exercise, or otherwise reach an interest of a beneficiary or any other person who holds an unconditional or conditional removal or replacement power over a trustee."*
- ◆ Section 5 further states, *"No creditor may reach an interest of a beneficiary who is also a trustee or co-trustee, or otherwise compel a distribution because the beneficiary is then serving as a trustee or a co-trustee. No trust may foreclose against such interest."*
- ◆ Section 9 states, *"In the event that a party challenges a settlor or beneficiary's influence over a trust, none of the following factors, alone or in combination, may be considered dominion and control over a trust:*
 - *A beneficiary serving as a trustee or co-trustee as described in Section 5 of this Act;*
 - *The settlor or a beneficiary holds an unrestricted power to remove or replace a trustee;*
 - *The settlor or a beneficiary is a trust administrator, a general*

partner of a partnership, a manager of a limited liability company, an officer of a corporation, or any other managerial function of any other type of entity, and part or all of the trust property consists of an interest in the entity;

- *A person related by blood or adoption to a settlor or a beneficiary is appointed as trustee;*
- *A settlor's or a beneficiary's agent, accountant, attorney, financial advisor, or friend is appointed as a trustee; or*
- *A business associate is appointed as a trustee."*

GENERAL POWERS OF APPOINTMENT BEING ATTACHED BY ANY CREDITOR

As noted in a few articles^[20], both the UTC and Restatement Third make a great departure from common law allowing creditors to reach outstanding general powers of appointment.

The North Carolina and South Carolina UTC versions removed provisions regarding the attachment of general powers of appointment and leave this matter to case law.

South Dakota's SB 98 affirmatively rejects the UTC and Restatement Third position by codifying common law. SB 98 Section 3 paragraphs (1); (2); and (3) provide that a power of appointment may not be judicially foreclosed, no creditor may attach a power of appointment, and a power of appointment is not a property interest.

CONCLUSION:

The race for settlor favorable trust law continues. In 1983, South Dakota was the first state to abolish the common law rule against perpetuities. Now over twenty states have done something similar.

South Dakota is now the first state to make sure that its courts do not adopt the unfavorable newly created creditor and beneficiary right provisions under the Restatement Third and to a lesser extent the UTC.

As South Dakota and other lead trust jurisdictions codify a "settlor based"

code, more trust business will move to these states, leaving those states that adopt a "beneficiary favored" code or do nothing and risk a judge inadvertently applying unfavorable trust law suggested in Restatement Third.

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

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CITES:

^[1] Rachel Emma Silverman, *States Court Family Trust Business*, Wall Street Journal, Personal Journal, June 22, 2006.

^[2] For a detailed discussion of this issue see Merric, Stein, Stevens, Solem, Stuart, and Osborne, *The UTC – A Continued Threat to Special Needs Trusts*, Journal of Practical Estate Planning, January 2006. This article may be downloaded at www.InternationalCounselor.com, then go to "publications," then "articles," and it is under "Uniform Trust Code."

^[3] Merric and Stein, *The UTC's Effect on ILITs.*, Message 733, October 13, 2004.

^[4] The Restatement (Third) Section 58 comment b.1. even takes that completely

unsupported position of law that even after a withdrawal power has lapsed, a creditor may still attach and exercise it. The UTC allows attachment only to the extent that withdrawal power is currently outstanding at the time of attachment..

^[5] Gopman and Flick, *UTC Section 505(b) – Withdrawal Rights May Expose Trust Assets To Beneficiaries' Creditors*, Leimberg LISI Asset Protection Planning Newsletter #91, November 1, 2006.

^[6] Roy Adams and Clary Redd, July 18, 2006 Teleconference with the Cannon Institute.

^[7] Robert B. Thompson, *Piercing the Corporate Veil*, 76 Cornell Law Review, July 1991.

^[8] In 1996, Alaska and in 1997 Delaware were the first states to pass domestic self settled asset protection legislation. Please note, the South Dakota statute being discussed is not a self settled statute. Rather, it covers asset protection and beneficial interest rights in a third party trust.

^[9] Please note that some authors refer to these as "wholly discretionary trusts," "absolute discretion trusts," and the Restatement (Second) Section 187 j. refers to this as a discretionary trust with extended discretion.

^[10] *Restatement (Second) Section 155* comment b. and almost all case law on point.

^[11] Numerous cases in many states hold a discretionary interest is not a property interest. A few of these cites are *In re Britton*, 300 B.R. 155 (Bankr. D. Conn. 2003); *U.S. v. Grim*, 865 F. Supp. 1303 (N.D.Ind. 1994); *U.S. v. O'Shaughnessy*, 511 N.W.2d 574 (Minn. 1994); *In re Duncan's Will*, 362 N.Y.S.2d 788 (N.Y.Surr. 1974); *Lang v. Comm., Dept. of Public Welfare*, 528 A.2d 1335 (PA. 1987); and *Bass v. Denney*, 171 F.3d 1016 (5th Cir. 1999).

^[12] *U.S. v. O'Shaughnessy*, 517 N.W. 2d 574 (Minn. 1994); *In re Marriage of Jones*, 812 P.2d 1152 (Colo. 1991);); *In re Canfield's Estate*, 181 P.2d 732 (Cal. App. 2 Dist. 1947).

^[13] *Scott on Trusts*, Section 155 footnote 2 and supplement through 2006 citing numerous cases on point. Please note that there is a distinct minority position where a few cases have allowed attachment of a common law discretionary trust.

^[14] The most common judicial review standard for a discretionary trust is provided by the *Restatement (Second) on Trusts* when combining sections 187(e) and 187 (j) of: (1) improper motive; failure of the trustee to use his or her judgment; and (3) dishonestly. Also, see *Scott on Trusts*, 2 *Ad. Section 128.3.*, Fourth Printing through 2006 supplement and the numerous case cites using this judicial standard of review for a discretionary trust. George Taylor Bogert also seems to hold relatively the same definitional analysis as *Scott* in *The Law of Trusts and Trustees*, 2nd Edition 1980, Supplement through 2003 but adds arbitrary action and abuse of discretion to the judicial review standard.

^[15] *Farmers State Bank of Fosston v. Sigellingson & Co.*, 16 N.W.2d 319 (Minn. 1944);

In re Duncan's Will, 362 N.Y.S. 2d 788 (NY Surr. 1974); *Dryfoos v. Dryfoos*, 2000 WL 1196339 (Conn. Super. 2000); *U.S. v. O'Shaughnessy*, 517 N.W.2d 574 (Minn. 1994).

[\[16\]](#) *Restatement (Second) Section 155*, comment b.

[\[17\]](#) Jonathan Gopman, C.C.A. 200614006 – IRS Can Reach Out and Touch Spendthrift Interest, Steve Leimberg's Asset Protection Planning E-mail Newsletter - Archive Message #82, April 26, 2006.

[\[18\]](#) April 24, 2007 Cannon Financial Institute Teleconference, *Important Lessons For Trustees – How and Why to Say Yes or No to A Beneficiary*.

[\[19\]](#) Charles Harris and Tye J. Klooster, *Beneficiary-Controlled Trusts Can Lose Asset Protection*, *Trusts and Estates* Dec. 2006.

[\[20\]](#) Gopman and Flick, *UTC Section 505(b) – Withdrawal Rights May Expose Trust Assets To Beneficiaries' Creditors*, Leimberg LISI Asset Protection Planning Newsletter #91, November 1, 2006; Merric and Collins, *Can the Uniform Trust Code be Fixed?*, *Lawyers Weekly – Heckerling Edition*, January 3, 2005; Merric and Stein, *The UTC's Effect on ILITs.*, Message 733, October 13, 2004.