Estate & Succession Planning Corner

The YinYang of Current Developments in the Law of Spendthrift Trusts

By Lawrence I. Richman

In the November–December 2017 issue of the Journal, the Estate and Succession Planning Corner introduced our readers to the conceptual framework of spendthrift trust provisions in third party-created irrevocable trusts and the near universal inclusion and acceptance of those provisions as a way to protect a discretionary beneficiary of an irrevocable trust created by someone other than that beneficiary from such beneficiary's creditors. This issue's column tackles the harder issue of self-settled spendthrift trusts: an irrevocable trust with a third-party trustee of which the settlor/grantor ALSO is a discretionary beneficiary that includes a spendthrift provision for the protection of the beneficiary/grantor from such beneficiary/grantor's creditors.

In Chinese philosophy, there is the concept of yinyang, which is literally interpreted as dark/bright or negative/positive and is used to explain how the rise of one force can see the rise of an opposite complementary force. In today's planning world, planners confront these opposing forces in the form of the "Yang" states with powerful pro-self-settled trust legislation,[1] like Nevada, the strength and scope of which was most recently affirmed by its Supreme Court in the *Klabacka v. Nelson*[2] decision issued earlier this year. To Nevada's Yang is the Yin expressed in the hostility to planners making use of approaches that have debtor protective ramifications voiced by the National Conference of Commissioners on Uniform State Laws in its approval of the Uniform Voidable Transactions Act (the "Act") and the current enactment of the Act in some jurisdictions along with the Official Comments of the Commissioners.

In *Klabacka v. Nelson,*[3] the Supreme Court of Nevada considered the treatment of self-settled spendthrift trusts created when a married couple resident in Nevada divided their community property into separate trusts. Each self-settled trust was irrevocable, named a Nevada resident as distribution trustee and named the settlor/beneficiary as investment trustee with custody of the trust's assets. Eight years after creating the self-settled spendthrift trusts, the couple filed for divorce. In connection with its consideration of various spousal claims, the Court considered the validity of the separate property agreement by which the couple divided their marital community property and the validity of the self-settled trusts created with

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each's separate property. The Court recognized the validity of the arrangement by which each's separate property was created and noted how the couple had met the requirements for a valid Nevada self-settled spendthrift trust[4] by (1) evidencing an intention to create such a trust, (2) naming a Nevada resident as trustee, (3) making the trust irrevocable, (4) authorizing but not requiring distributions to the settlor and (5) evidencing no intent to undermine the rights of creditors.

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The *Klabacka* decision is significant because the Supreme Court considered the effect of a lower court order (1) to equalize the relative value of the couple's self-settled trusts as part of the divorce and (2) to require that the husband's personal obligations arising from the divorce be paid from his self-settled spendthrift trust. In *Klabacka*, the Nevada Supreme Court ruled that a spendthrift trust may *only* benefit the beneficiary of such trust and that in the absence of specific statutory language allowing a self-settled spendthrift trust to be reached for alimony or child support, the personal obligations of a beneficiary/settlor/debtor may not be ordered satisfied from the property held in such a trust as long as these obligations were not known to the beneficiary/settlor at the time of the trust's creation. Accordingly, the Court vacated an order of the lower court imposing a constructive trust for the wife's benefit over certain assets held in the husband's self-settled spendthrift trust. Thus, valid self-settled spendthrift trusts in Nevada may neither be reached to satisfy a beneficiary's obligation at law or in equity.

While *Klabacka* affirms the "yang" of Nevada's "light" for its residents, certain aspects of the recently adopted Uniform Voidable Transactions Act ("UVTA") cast a dark "yin" on the flexibility planners seek in meeting their clients' goals. Chief among these is the issue of choice of law. Historically planners considered irrevocable trusts resident in the state in which they were validly formed and administered so that if an irrevocable trust were validly created under Nevada law with a Nevada trustee having custody of the trust's assets in Nevada, then Nevada law ought to apply with respect to the property held in trust regardless of the state of residence of the trust's beneficiary/settlor. This approach is consistent with the situs rule of the First Restatement of Conflict of Laws and is reflected as an important factor for consideration in the Second Restatement of Conflict of Laws. However, the UVTA does away with the simplicity of the First Restatement and the nuanced approach of the Second Restatement by adopting its own simple rule in Section 10: namely, that the debtor's location determines the choice of law. The change is significant because it strengthens the full faith and credit argument a creditor can make under the Constitution against a debtor resident in a UVTA state. What the UVTA cannot and does not do, however, is determine the state of residence of a debtor. Given how relatively easy it is for an individual to become a resident of a new debtor protective state, regardless of whether the former creditor friendly state of the debtor acknowledges that chance of residency, planners should expect an increase in litigation to result from this so described "simplification."

Another development in the UVTA that is of particular concern to planners involves Section 4 regarding transfers voidable as to present or future creditors. That section reflects the traditional principle that a debtor must have actual intent to hinder, delay or defraud a creditor in order for a transfer to be voidable as to a creditor. However, in paragraph 3 of Official Comment 8 to Section 4, the Commissioners omitted any mention of intent when they explained:

> A transaction that does not place an asset entirely beyond the reach of creditors may nevertheless "hinder, delay or defraud" creditors if it makes the asset more difficult for creditors to reach. Simple exchange by a debtor of an asset for a less liquid asset, or disposition of liquid assets while retaining illiquid assets, may be voidable for that reason.

This language is significant because planners, as part of a normal planning process, often may take an asset owned outright by a client and recommend that the client place that asset in a limited partnership thereby, in effect, making that asset less reachable by a future creditor of the client. Traditionally, that was good planning if the client had no known creditors and the planning was not done with intent to hinder, delay or defraud. If paragraph 3 of Official Comment 8 to Section 4 is adopted by the state of

a resident debtor in connection with the state's adoption of the UVTA and becomes part of the legislative history of Section 4, then the "exchange by a debtor of an asset for a less liquid asset … may be voidable for that reason." The omission of the need for intent and the fact the Comment can be read to apply not only to present but also future creditors raises concern.

It is hard to imagine virtually any planning that is done which does not have as a consequence a discount for lack of marketability, illiquidity or being a minority interest that potentially would not be impacted by the point of view expressed by the Commissioners. In case planners have any doubt that the Commissioners actually are thinking about the choice of entity decision planners routinely make, paragraph 6 of Official Comment 8 to Section 4 contemplates a breadth of voidable transactions that could include an investor in a new LLC or other creditor remote entity:

> By contrast, if owners of an existing business were to reorganize it as an LLC under such a statute when the clouds of personal liability or financial distress have gathered over some of them, and with the intention of gaining the benefit of that creditor-thwarting feature, the transfer effecting the reorganization should be voidable under Section 4(a)(1), at least absent a clear indication that the legislature truly intended the LLC form, with its creditor thwarting feature, to be available even in such circumstances.

Query whether the Commissioners really intend that states allow the undoing of a partnership, LLC or corporation if a minority owner has "clouds of personal liability or financial distress."

As with all Uniform Acts, states need not enact the UVTA in its entirety. For planners, concerned about flexibility and the viability of current mainstream planning approaches that means that states *should not adopt the Official Comments* of the Commissioners when and if a state adopts all or any portion of the UVTA. On the national landscape of multiple valid planning techniques, planners should not only focus on the brightness of the "yang" but also be aware of the darkness of the "yin" as they navigate the current planning environment.

ENDNOTES

1. These states include, for example, Alaska, Delaware, Missouri, Nevada, Ohio, South Dakota, Tennessee and Wyoming.
2. *Klabacka v. Nelson*, 133 Nev. Adv. Op. 24 (May 25, 2017), Supreme Court of Nevada No. 66772, No. 68292.
3. *Id.*
4. NRS 166.015, 166.040 and 166.050.

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