

Title

Absent a history of meticulous fiduciary recordkeeping and asset segregation, trusteeship can bring with it some serious personal financial risk for the trustee who is divorcing his/her spouse

Text

The subject of this posting is the trustee who is neither the trust's settlor nor one of its beneficiaries. The trustee also possesses no non-fiduciary powers of appointment, such as a right of revocation. The trustee and his/her spouse are divorcing.

It is settled law that physically the trust property is outside the marital estate and must remain so. Were the court to include it physically in the marital estate, the parties to the divorce action would merely hold the title jointly as co-trustees for the benefit of the trust's beneficiaries with a fiduciary duty to keep the trust property physically segregated from the rest of the marital estate. Were the court, an instrumentality of the state, to attempt to force an actual physical commingling of the trust property with the other assets of the marital estate we would have a taking and re-allocation of the equitable property rights of the trust's beneficiaries in violation of the 5th and 14th amendments to the U.S. Constitution. The beneficiaries themselves should have nothing to fear, at least as a matter of black-letter law and equity, from the trustee's personal marital problems. See generally §8.3.1 of *Loring and Rounds: A Trustee's Handbook* in this regard, which section is reproduced in its entirety in the appendix below. The Handbook is available for purchase at <https://law-store.wolterskluwer.com/s/product/loring-rounds-a-trustees-handbook-2022e-misb/01t4R00000OVWE4QAP>.

While the beneficiaries may have nothing to fear, the trustee who has failed to maintain careful records of the trust's administration, as well as a strict segregation of personal and fiduciary assets, risks having the divorce court, whether out of pique or ignorance, deem the title-holding trustee to possess the trust property not in trust but outright, *but only for purposes of computing the value of the marital estate*. The court then notionally assigns the value of the entrusted property to the trustee's side of the equitable-division ledger and the orders that whatever the trustee personally owns that is not nailed down be transferred over to the soon-to-be-ex-spouse. As the equitable property rights of the trust's beneficiaries remain unaffected by the notional assignment, they have no say in the matter.

Such deeming on the part of the judiciary can have devastating and life-changing consequences, financial and otherwise, for the trustee personally, particularly when the value of the trust corpus is substantial. The trustee is deemed to own property that in equity belongs entirely to others, namely the trust's beneficiaries.

Appendix

§8.3.1 The Trustee's Personal Creditors and the Trustee's Spouse

[from *Loring and Rounds: A Trustee's Handbook* (2022), available for purchase at <https://law->

store.wolterskluwer.com/s/product/loring-rounds-a-trustees-handbook-2022e-misb/01t4R00000OVWE4QAP].

*Although a beneficial interest in a trust may generally be reached by creditors of the beneficiary..., the trustee's personal creditors or trustee in bankruptcy may not reach either the trust property or the trustee's nonbeneficial interest therein.*⁸

*In the early law of uses, it was held that, on the death of a trustee, the trustee's surviving spouse was entitled to dower or curtesy, free of the use. Thus it was stated as late as 1656, that the tenant in dower, and by curtesie, should not be seised to uses in being, for all these wanted privity of estate....Today,...it is clear that the trustee's surviving spouse has no interest in the trust property, whether by dower, curtesy, or otherwise.*⁹

As a general rule, an attachment of the trust property in a judicial proceeding by the trustee's personal creditors is subject to the rights of the beneficiaries.¹⁰ In other words, the personal creditors of a nonbeneficiary trustee who resort to the courts are not BFPs¹¹ and thus may not acquire a beneficial interest in the trust property.¹² "A creditor who seizes a debtor's property under judicial process is not entitled to assume that the debtor holds the property free of equities."¹³ Thus, it cannot be said that a trust is a form of contract:

The main difficulty in the obligational view of trusts is that it does not explain the effect of the trust in relation to the rights of creditors—the "insolvency effect." This (the priority which the beneficiaries have over the trustee's creditors) is surely the central fact of the trust which any theory must recognize and explain. If the trust is in its essence a contract, it will not defeat the rights of the owner's...[, i.e., the trustee's]...other creditors.¹⁴

In any case, if a trustee in breach of trust voluntarily or involuntarily transfers trust property to a third

⁸Restatement (Third) of Trusts §42 cmt. c. *See generally* §9.11 of this handbook (the bankruptcy trustee).

⁹5 Scott & Ascher §29.1.6.1 (Devolution on Death of Trustee) (citing to Compleat Attorney 310 (1656)).

¹⁰*See, e.g.*, 4 Scott & Ascher §§25.2.7.2 (Trustee-Beneficiary's Creditors), 25.2.7.3 (Transfer of Trustee-Beneficiary's Interest); 5 Scott & Ascher §29.3.11 (Creditors of Trustee). Note, however, that "[w]ith respect to trusts of land and other equitable interests in land, recording statutes may affect the question of whether the equitable interests of the beneficiaries or other claimants are entitled to priority over the rights of the trustee's creditors." 5 Scott & Ascher §29.3.11 (Creditors of Trustee).

¹¹"The policy in favor of encouraging sales and security transactions does not apply." 5 Scott & Ascher §29.3.11 (Creditors of Trustee). *See generally* §8.15.63 of this handbook (doctrine of bona fide purchase; the BFP).

¹²Restatement (Third) of Trusts §42 cmt. c; Restatement (Second) of Trusts §308. *See generally* 4 Scott on Trusts §308. *See also* UTC §507. *See, e.g.*, Universal Bonding Ins. Co. v. Gittens & Sprinkle Enters., 960 F.2d 366 (3d Cir. 1992).

¹³5 Scott & Ascher §29.3.11 (Creditors of Trustee).

¹⁴George L. Gretton, *Trusts Without Equity*, 49 Int'l & Comp. L.Q. 599, 602–603 (July 2000).

person, the third person may only retain the property if the third person is a bona fide purchaser for value or BFP.¹⁵ In order to qualify as a BFP, the third person has to have taken title, given value, and had no actual or constructive notice of the breach.¹⁶ With some exceptions, see §8.15.63 of this handbook, the satisfaction (cancellation) of an antecedent (preexisting) debt which the transferor owes the transferee will not satisfy the BFP value requirement.¹⁷ The creditor-transferee thus not being a BFP, the property must be returned to the trust estate. Likewise, an assignment of trust property for the benefit of the trustee's personal creditors is ineffective.¹⁸ "When a debtor makes an assignment for the benefit of creditors, the assignee is not a purchaser for value."¹⁹ Neither is the trustee in bankruptcy of another trustee's personal estate.²⁰

Because a trustee holds the legal title to the trust estate and as to the world is its owner, it is easy to see how the trust estate could end up in the hands of the trustee's personal creditors, albeit wrongfully, if the trustee were not careful.²¹ The trustee would then have a fiduciary duty to get it back.²² If the cause of the diversion were a failure on the part of the trustee to adequately segregate and earmark,²³ then the trustee might have to personally shoulder the burden of the retrieval costs.²⁴

Certain attachments of real estate, however, may be exempted by statute from the general rule that trust property is off limits to the trustee's personal creditors.²⁵ Many states, for example, now have statutes subordinating the interest of the beneficiary to that of the trustee's personal creditor when the attached real estate is held in an unrecorded trust.²⁶ Thus, it is of critical importance for the trustee of an inter vivos trust containing real estate to record the governing instrument; timely recording effectively deprives the personal creditor of the trustee of any access to the trust's real estate.²⁷ Under most such statutes, the attaching creditor who has no notice of an unrecorded trust of real estate will prevail over the beneficiary even though

¹⁵See generally §8.15.63 of this handbook (doctrine of bona fide purchase; the BFP).

¹⁶See generally §8.15.63 of this handbook (doctrine of bona fide purchase; the BFP).

¹⁷See generally §8.15.63 of this handbook (doctrine of bona fide purchase; the BFP).

¹⁸See generally 5 Scott & Ascher §29.3.9.

¹⁹5 Scott & Ascher §29.3.9.

²⁰See generally 5 Scott & Ascher §29.3.10 (Trustee in Bankruptcy).

²¹See generally §3.5.1 of this handbook (nature and extent of the trustee's estate).

²²See generally §6.2.1 of this handbook (duty to take active control of, segregate, earmark, preserve and protect trust property).

²³See generally §6.2.1.2 of this handbook (duty to segregate and earmark trust property (not to commingle)).

²⁴See generally §3.5.2.3 of this handbook (right in equity to exoneration and reimbursement, *i.e.*, indemnity; payment of attorneys' fees).

²⁵See generally 5 Scott & Ascher §29.3.11 (Creditors of Trustee).

²⁶See 5 Scott & Ascher §29.3.11 (Creditors of Trustee); Restatement (Second) of Trusts §308 cmt. b. See generally §8.3.2 of this handbook (bona fide purchaser for value of trust property: what constitutes notice that a transfer is in breach of trust).

²⁷See generally §8.3.2 of this handbook (bona fide purchaser for value of trust property: what constitutes notice that a transfer is in breach of trust).

the creditor receives notice before taking the property on execution.²⁸ The statutes that give this unusual right do not ordinarily apply to personal property.²⁹

As a general rule, the trustee's spouse will have no present or future rights to the trust property.³⁰ This holds true, both in the divorce context and upon the death of the trustee.³¹ In neither case would the spouse qualify as a BFP.³²

²⁸*See generally* 5 Scott & Ascher §29.3.11; 4 Scott on Trusts §308.2.

²⁹*See generally* Bogert §884; 3 Scott & Ascher §13.1. *See also* 5 Scott & Ascher §29.3.11.

³⁰*See generally* Bogert §146.

³¹Bogert §146.

³²*See generally* 5 Scott & Ascher §29.1.6.1 (Devolution on Death of Trustee); §8.15.63 of this handbook (doctrine of bona fide purchase).