

## Title

A self-settled fully discretionary trust: May the settlor-beneficiary's postmortem creditors reach the entrusted property?

## Text

The U.S. Court of Appeals for the First Circuit has just certified to the Massachusetts Supreme Judicial Court the following question: “On the undisputed facts of this record, does a self-settled spendthrift irrevocable trust that is governed by Massachusetts law and allowed unlimited distributions to the settlor during his lifetime protect assets in the irrevocable trust from a reach and apply action by the settlor's creditors after the settlor's death.” See *De Prins v. Michaelaes*, Nos. 18-2191 & 19-1095 (Nov. 15, 2019). It would seem that the answer is, or ought to be, no. The settlor possessed at the time of his death a constructive general inter vivos power of appointment. See generally *Loring and Rounds: A Trustee's Handbook* §4.1.3 (2019), which section is reproduced in its entirety in the appendix below. That being the case his postmortem creditors should have access to the subject property whether or not there is a spendthrift clause. See *State St. Bank & Tr. Co. v. Reiser*, 389 N.E.2d 768 (Mass. App. Ct. 1979).

## Appendix

### **§4.1.3 *Creditor Accessibility as a General Inter Vivos Power of Appointment*** [from *Loring and Rounds: A Trustee's Handbook* (2019)].

*Thus the Massachusetts Court ... [in Ware v. Gulda]... held that creditors of the settlor-beneficiary could reach the trust assets despite the fact that under the terms of the trust instrument, distributions by the trustee to, or on behalf of, the settlor were completely within its discretion, and even though the interests of the remaindermen beneficiaries would be adversely affected by such action ... The Gulda decision provided the basis for our holding in Paolozzi v. Commissioner ... to the effect that a settlor-beneficiary of a discretionary trust had failed to relinquish dominion and control over such interest for gift tax purposes.*<sup>288</sup>

It is becoming a general rule that a settlor's creditors may reach the trust property to the extent the settlor reserves a beneficial interest.<sup>289</sup> For example, a trust for the benefit of the settlor—fully discretionary as to income and principal—will expose the entire property to creditor attack.<sup>290</sup> The law thus bestows on the settlor the ability to indirectly extract value from the trust by incurring debts and leaving it to the creditors to collect.<sup>291</sup> This right to direct trust property to creditors conforms to the Restatement of

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<sup>288</sup>*Outwin v. Comm'r*, 76 T.C.153, 164–165 (1981) (referring to *Ware v. Gulda*, 331 Mass. 68, 117 N.E.2d 137 (1954) and *Paolozzi v. Comm'r*, 23 T.C. 182 (1954)).

<sup>289</sup>See §5.3.3.1 of this handbook (when the settlor's creditors may reach any beneficial interest that have been reserved).

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<sup>291</sup>See §5.3.3.1 of this handbook (when the settlor's creditors may reach any beneficial interest that have been reserved). See, e.g., *Johnson v. First Nat'l Bank of Jackson*, 386 So. 2d 1112, 1115 (Miss. 1980) (deeming a self-settled irrevocable inter vivos trust to be “in effect revocable” because settlor could borrow money up to the value of the trust estate, donate that amount to the Church of Scientology, and then have the creditor levy on the trust estate in satisfaction of the debt). See generally §5.3.3.1 of this handbook (whether the settlor's creditors may gain access to beneficial interests that have been reserved).

Property's definition of a general inter vivos power of appointment.<sup>292</sup> The possession of such a right may have estate and gift tax consequences<sup>293</sup> and may also bear on the settlor's eligibility for Medicaid and on the rights of the settlor's spouse to reach the trust property.<sup>294</sup> Does it also mean, however, that the settlor may terminate the trust other than by incurring debts? Probably not:

Even if the spendthrift provisions in the trust under consideration are void as to the settlor-beneficiary, this does not mean that the trust is void or that the settlor-beneficiary can terminate the trust without the consent of the other beneficiaries. We think the spendthrift provisions as to the interest of the settlor-beneficiary are severable.<sup>295</sup>

On the other hand, were the settlor the sole beneficiary of the trust, the settlor at any time and notwithstanding the terms of the trust would be able to terminate it and receive back title to the subject property.<sup>296</sup> This would be the case even though the termination would defeat a material trust purpose.<sup>297</sup> There are two qualifications: The settlor must not be under some incapacity at the time of the termination and the terms of the trust must not require that the trustee give consent to the termination.<sup>298</sup>

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<sup>292</sup>Restatement (Second) of Property §11.4 (Wills and Other Donative Transfers). *Cf.* 5 Scott & Ascher §34.3 (When Settlor Is Sole Beneficiary) (“When the settlor creates a trust of which the settlor is the sole beneficiary, the settlor can, at any time, terminate the trust, even if doing so would defeat a material trust purpose”).

<sup>293</sup>*See* §5.3.3.1 of this handbook (reaching the settlor's reserved beneficial interest).

<sup>294</sup>*See* §5.3.4 of this handbook (rights of beneficiary's spouse and children to the underlying trust property or to the equitable interest) and §5.3.5 of this handbook (Medicaid eligibility and recoupment).

<sup>295</sup>*Fewell v. Republic Nat'l Bank of Dallas*, 513 S.W.2d 596, 598 (Tex. 1974).

<sup>296</sup>*See generally* 5 Scott & Ascher §34.3 (When Settlor Is Sole Beneficiary); §8.2.2.1 of this handbook (trust terminations by consent).

<sup>297</sup>*See generally* 5 Scott & Ascher §34.3. *See also* §8.15.7 of this handbook (the *Clafin* doctrine, also known as the material purpose doctrine).

<sup>298</sup>*See generally* 5 Scott & Ascher §34.3.