

## Title

Vulnerability of a trust that had been revocable and funded by settlor inter vivos to postmortem spousal election generally subject to “exhaustion” of settlor’s probate estate, which may never happen

## Text

In an ever-increasing number of jurisdictions, the surviving spouse of the settlor of an inter vivos trust, via the spousal election statute, may be afforded postmortem access to the trust property, provided the deceased spouse had reserved a general inter vivos power of appointment, such as an unrestricted right to revoke or amend. The Uniform Probate Code is in accord, as is the Restatement (Third) of Property and the Restatement (Third) of Trusts. So is the UTC.

Upon the death of the settlor of a self-settled revocable inter vivos trust, the settlor’s surviving spouse, assuming he or she makes the statutory spousal election, will first seek *full satisfaction* from the settlor’s probate estate. It is “traditional doctrine” that the assets of a settlor’s probate estate must have been “exhausted” for the assets of the self-settled revocable inter vivos trust to become accessible in satisfaction of the election entitlement, and only to make good on any shortfall. *See* UTC §505(a)(3) & cmt. *See also* UPC §6-102(b) & cmt. Exhaustion is not inevitable in such situations. Take, for example, *Matter of Estate of Dower*, 405 Mont 443, 495 P.3d 1083 (2021), the court concluding that the husband’s probate estate was sufficient to satisfy the wife’s statutory allowances, this due to the abatement of the specific devises made to her under the husband’s will. A surviving spouse invoking his or her election rights does not make him or her a postmortem creditor of the deceased spouse’s estate. That having been said, the default law is that the postmortem creditors of the settlor of a revocable inter vivos trust also must look to the settlor’s probate estate in the first instance before turning their sights on the property of the revocable inter vivos trust. The default primary vulnerability of the probate estate in the creditor-accessibility context is taken up generally in §5.3.3.1 of *Loring and Rounds: A Trustee’s Handbook* (2022), the relevant parts of which are reproduced in the appendix below. The Handbook itself is available for purchase at: <https://law-store.wolterskluwer.com/s/product/loring-rounds-a-trustees-handbook-2022e-misb/01t4R00000OVWE4QAP>.

## Appendix

*§5.3.3.1 Reaching Settlor’s Reserved Beneficial Interest or Even the Entrusted Property Itself* [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>].

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**The settlor-beneficiary’s postmortem creditors.** It is self-evident that the legitimate postmortem creditors of the settlor of a testamentary trust will have access to that portion of the settlor’s probate estate that is destined to fund the trust, *i.e.*, to the extent their lawful claims have not been or cannot be satisfied from other estate assets. Whether by statute or decision, the probate estate is generally where postmortem

creditors are expected to look to first. Under certain circumstances, however, the postmortem creditors also may have access to the underlying property of a trust that the decedent had established during his or her lifetime. This is likely to be the case if the settlor had reserved a general inter vivos power of appointment, such as a right of revocation, or possibly even a general testamentary power of appointment. Finally, the proceeds of any insurance on the life of a settlor of a revocable inter vivos trust that are paid to the trustee also might be vulnerable to the claims of the settlor's postmortem creditors, unless there is a statute that provides otherwise.

*The postmortem implications for creditor access if the deceased settlor-beneficiary had held a general inter vivos power of appointment.* Although the “traditional thinking” was otherwise,<sup>170</sup> the current trend of the law favors allowing the settlor's postmortem creditors, as well as the surviving spouse, access to the principal of an inter vivos trust if the settlor reserved a personal power to consume<sup>171</sup> the underlying property *at the time of the settlor's death*.<sup>172</sup> By power to consume, we mean an express or constructive general inter vivos power of appointment. This should be contrasted with the lot of the inter vivos creditor where the focus traditionally was on the retention of a beneficial interest, rather than a power to consume.<sup>173</sup> Thus, we traditionally had such anomalies as the naked reserved right of revocation exposing trust assets

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<sup>170</sup>See 3 Scott & Ascher §14.11.3.

<sup>171</sup>See generally Unif. Nonprobate Transfers on Death Act §102(a) (defining a nonprobate transfer to include “a valid transfer effective at death by a transferor...to the extent that the transferor immediately before death had power, acting alone, to prevent the transfer by...withdrawal and instead to use the property for the benefit of the transferor or apply it to discharge claims against the transferor's probate estate.” The Act provides that retention alone of a general testamentary power of appointment would not expose the subject property to attack by the settlor's postmortem creditors. Unif. Nonprobate Transfers on Death Act §102(a).

<sup>172</sup>Restatement (Third) of Trusts §25(2) cmt. e. See, e.g., *In re Est. of Nagel*, 580 N.W.2d 810 (Iowa 1998); *State St. Bank & Tr. Co. v. Reiser*, 7 Mass. App. Ct. 633, 389 N.E.2d 768 (1979) (creditor access because of power of consumption at time of debtor's death); *Sullivan v. Burkin*, 390 Mass. 864, 460 N.E.2d 572 (1984) (spousal access because of power of consumption during marriage). See Clifton B. Kruse, Jr. (compiler), *Summary of Case Law: Rights of Creditors Following Death of Settlor-Beneficiaries of Revocable Trusts*, 23 ACTEC Notes 155 (1997). See also UTC §505(a)(3) (providing that “[a]fter the death of a settlor, and subject to the settlor's right to direct the source from which liabilities will be paid, the property of a trust that was revocable at the settlor's death 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 to the extent the settlor's probate estate is inadequate to satisfy those claims, costs, expenses, and allowances”); Restatement (Second) of Property (Wills and Other Donative Transfers) §34.3 (rejecting the principle of *Jones v. Clifton*, 101 U.S. 225 (1879), that a trust settlor's reserved power to revoke is not an asset subject to creditors' claims and instead providing that a settlor's creditors may reach the assets of a revocable trust even when the trust transfer to the trustee was not fraudulent); UPC §6-102(b) (Revised 1998) (establishing liability of nonprobate transferees for creditor claims and statutory allowances). See generally Wellman & Brucken, *NCCUSL To Your Rescue: New UPC Sec. 6-102*, 26 ACTEC Notes 361 (2001).

<sup>173</sup>See 4 Scott on Trusts §330.12; Restatement (Second) of Trusts §330 cmt. o.

to the reach of the settlor's postmortem creditors, but not the inter vivos ones;<sup>174</sup> or the property of a self-settled “irrevocable” discretionary trust being subject to the reach of the settlor's inter vivos creditors, but not the postmortem ones.<sup>175</sup> (In the latter case, surely it can be said that the trust, as a practical matter, was actually not irrevocable at the time of the settlor’s death, a topic we take up in §4.1.3 of this handbook.) In any case, the law is now quickly evolving to the point where the settlor-beneficiary's inter vivos and postmortem creditors have coextensive access to the property of a revocable inter vivos trust.<sup>176</sup> The Restatement (Third) of Property is fully there, in letter and in spirit.<sup>177</sup> Until this process is complete, however, such subtle divergences in the law will continue to complicate the already complicated life of the trustee.<sup>178</sup>

The UTC would provide that the property of a trust that was revocable at the settlor's death 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 to the extent the settlor's probate estate is inadequate to satisfy those claims, costs, expenses, and allowances.<sup>179</sup> The UTC defines “revocable” as meaning “revocable” by the settlor “without the consent of the trustee or a person holding an adverse interest.”<sup>180</sup> The settlor, of course, would retain the right to direct in his or her estate planning documents the source from which postmortem liabilities shall be paid.<sup>181</sup> On the other hand, the UPC (specifically §6-102(a)) and the Uniform Nonprobate Transfers on Death Act (specifically §102(a)) are somewhat less creditor-friendly. They provide by implication that if the settlor at the time of death possessed a right of revocation jointly *with a nonadverse party*, his or her postmortem creditors will not have access to the subject property. One “puzzled” commentator explains how easily “Section 102” can be “manipulated to avoid creditors”:

To avoid the reach of Section 102, the trustor simply could require that to revoke the trust the nonadverse party must join the trustor in making the revocation. The

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<sup>174</sup>See *State St. Bank & Tr. Co. v. Reiser*, 7 Mass. App. Ct. 633, 638, 389 N.E.2d 768, 771 (1979) (in the postmortem context, a reserved general inter vivos power may be enough to expose trust property to creditor attack); Restatement (Second) of Trusts §330 cmt. o (in inter vivos context a naked reserved general inter vivos power may not be enough to expose property to creditor attack).

<sup>175</sup>See generally Elaine H. Gagliardi, *Remembering the Creditor at Death: Aligning Probate and Nonprobate Transfers*, 41 Real Prop. Prob. & Tr. J. 819, 858–859 (2007).

<sup>176</sup>See, e.g., *De Prins v. Michaelles*, 486 Mass. 41, 154 N.E.3d 921 (2020) (In which Massachusetts’ version of the Uniform Trust Code having failed to “address the situation at issue,” its Supreme Judicial Court articulates an equitable principle of Massachusetts equity, namely that the assets of a self-settled, discretionary, spendthrift, ostensibly “irrevocable,” inter vivos trust are nonetheless accessible to the deceased settlor’s creditors via equitable reach and apply action). See generally Elaine H. Gagliardi, *Remembering the Creditor at Death: Aligning Probate and Nonprobate Transfers*, 41 Real Prop. Prob. & Tr. J. 819 (2007).

<sup>177</sup>See Restatement (Third) of Property (Wills and Other Donative Transfers) §22.2, cmt. f.

<sup>178</sup>See, e.g., UTC §505(a)(1) (providing that during the lifetime of the settlor, the property of a revocable trust is subject to the claims of the settlor's creditors).

<sup>179</sup>UTC §505(a)(3).

<sup>180</sup>UTC §103(14).

<sup>181</sup>UTC §505(a)(3).

trust could then give the trustor the power to replace at will the joint powerholder with another powerholder of the trustor's own choosing. As a result, the trustor could remove and replace the joint powerholder until the trustor found one willing to agree with trustor that the trust should be revoked. Such a provision would be no more than a minor inconvenience in light of the greater benefit bestowed by the possibility of avoiding creditor claims following death.<sup>182</sup>

Because procedures for affording a decedent's postmortem creditors access to nonprobate assets, such as those in the hands of trustee transferees, are state specific, one is loath to generalize. With that caveat, it is probably safe to say that in most U.S. jurisdictions, the current state of the default procedural law is that the postmortem creditors of a decedent must (1) “pursue probate administration, even in the absence of probate assets, prior to pursuing the nonprobate transferee[s] directly” and (2) “pursue probate assets before pursuing nonprobate transferees.”<sup>183</sup> This two-step process can pose a real problem for the postmortem creditor: “At times, the creditor's search for a decedent's assets resembles a game of hide-the-ball, with the trustee distributing assets before being notified of any judgment on the creditor's claim, as was the case in *Dobler v. Arluk Center Industrial Group*. In that case, the trustee of decedent's revocable trust was able to evade creditors by transferring assets to beneficiaries prior to a judgment being issued in the probate court.”<sup>184</sup>

*The post mortem implications for creditor access if the deceased settlor-beneficiary had held a general testamentary power of appointment.* If a settlor establishes an inter vivos trust, reserving only a naked general testamentary power of appointment over the underlying trust property, then would the settlor's postmortem creditors have access to the property were the settlor to die not having exercised the power? The traditional answer was no. Only to the extent that the power was actually exercised by the terms of the settlor's will would the subject property become vulnerable to the claims of the settlor's postmortem creditors.<sup>185</sup> Thus, if the deceased settlor by the terms of a valid will were to actually exercise the power over, say, 50 percent of the subject property, then the settlor's postmortem creditors would have access to that 50 percent, and only that 50 percent. What was left over from that 50 percent would then pass to the appointees. It should be borne in mind that the postmortem creditors would have had no need to turn to the assets of the inter vivos trust had there been sufficient assets in the settlor's probate estate to satisfy their

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<sup>182</sup>Elaine H. Gagliardi, *Remembering the Creditor at Death: Aligning Probate and Nonprobate Transfers*, 41 Real Prop. Prob. & Tr. J. 819, 856 (2007). “The comments to Section 102...[of the Uniform Nonprobate Transfers on Death Act]...indicate, however, that liability under Section 102 might attach regardless of whether the decedent holds the sole power to revoke ‘if the trust is named as beneficiary of a nonprobate transfer, such as of securities registered in [transfer-on-death] form.’” *Id.* at 855–856 (citing to Uniform Nonprobate Transfers on Death Act §102 cmt. 7).

<sup>183</sup>Elaine H. Gagliardi, *Remembering the Creditor at Death: Aligning Probate and Nonprobate Transfers*, 41 Real Prop. Prob. & Tr. J. 819, 822–823 (2007). *See, e.g.*, *State St. Bank & Tr. Co. v. Reiser*, 7 Mass. App. Ct. 633, 389 N.E.2d 768 (1979) (the court requiring an exhaustion of the probate estate before affording creditors access to the assets of a trust over which the decedent held a general inter vivos power of appointment at the time of death).

<sup>184</sup>Elaine H. Gagliardi, *Remembering the Creditor at Death: Aligning Probate and Nonprobate Transfers*, 41 Real Prop. Prob. & Tr. J. 819, 881 (2007) (citing to *Dobler v. Arluk Med. Ctr. Indus. Grp.*, 107 Cal. Rptr. 2d 478 (Ct. App. 2001), *aff'd*, 11 Cal. Rptr. 3d 194 (Ct. App. 2004)).

<sup>185</sup>*Cf.* *State St. Tr. Co. v. Kissel*, 302 Mass. 328, 19 N.E.2d 25 (1939) (involving the actual exercise of a general testamentary power of appointment under a trust established by someone other than the deceased powerholder).

claims in the first place. It should also be noted that the law may be trending in the direction of affording the settlor's postmortem creditors access to *all* property subject to the reserved general testamentary power of appointment, *whether or not there had been an actual exercise*.<sup>186</sup> The Restatement (Third) of Property (Wills and Other Donative Transfers) is already there.<sup>187</sup> Section 22.2 provides that “[p]roperty subject to a general power of appointment that was created by the donee is subject to the payment of the claims of the donee’s creditors to the same extent that it would be subject to those claims if the property were owned by the donee.”

The Restatement (Third), however, muddles its explanation of the mechanics of reaching entrusted appointive property. It suggests in an illustration supporting §22.2 that on the donor-donee’s death, the claims against the donor-donee’s estate “can be satisfied *out of the remainder*...to the same extent as if the Donor-Donor owned the remainder interest at Donor-Donor’s death.”<sup>188</sup> Because the *full legal title* to entrusted appointive property is in the trustee, it is the entire legal interest in the hands of the trustee *at the time of the donor-donee’s death*, not just the equitable quasi-remainder, that is vulnerable to the claims of the donor-donee’s postmortem creditors. That the underlying trust property itself is vulnerable to the claims of the donor-donee’s creditors is buttressed by the wording of §22.2: It is the property that is “subject to a general power of appointment” that is vulnerable to external claims. There is nothing about going after the equitable property interests. Nor can there be a legal remainder in the traditional sense, full legal title to the entrusted appointive property, as we said before, being in the trustee.<sup>189</sup> The bottom line: The Restatement (Third) appears to have conflated and confused reaching entrusted property subject to an equitable power of appointment and attaching the equitable property interests that are thrown off incident to the trust relationship itself.

**Life insurance proceeds.** Life insurance proceeds paid to the insured's revocable inter vivos trust upon the death of the insured may, by statute, be beyond the reach of the settlor's postmortem creditors.<sup>190</sup> Prior to paying the settlor's postmortem creditors from life insurance proceeds payable to the trustee by reason of the settlor's death, the trustee should consult counsel.

**Domestic asset protection havens.** *The Domestic Asset Protection Trust (DAPT) is taken up in §9.28 of this handbook.*

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<sup>186</sup>See generally 3 Scott & Ascher §15.4.1.

<sup>187</sup>See Restatement (Third) of Property (Wills and Other Donative Transfers) §22.1, cmt. a.

<sup>188</sup>See Restatement (Third) of Property (Wills and Other Donative Transfers) §22.2, illus. 4.

<sup>189</sup>See generally §8.27 of this handbook (comparing and contrasting legal and equitable property interests).

<sup>190</sup>See generally 5 Scott on Trusts §508.4; Bogert §243. Cf. *In re Est. of Clotworthy*, 742 N.Y.S.2d 168 (App. Div. 2002) (involving a commercial structured settlement annuity).