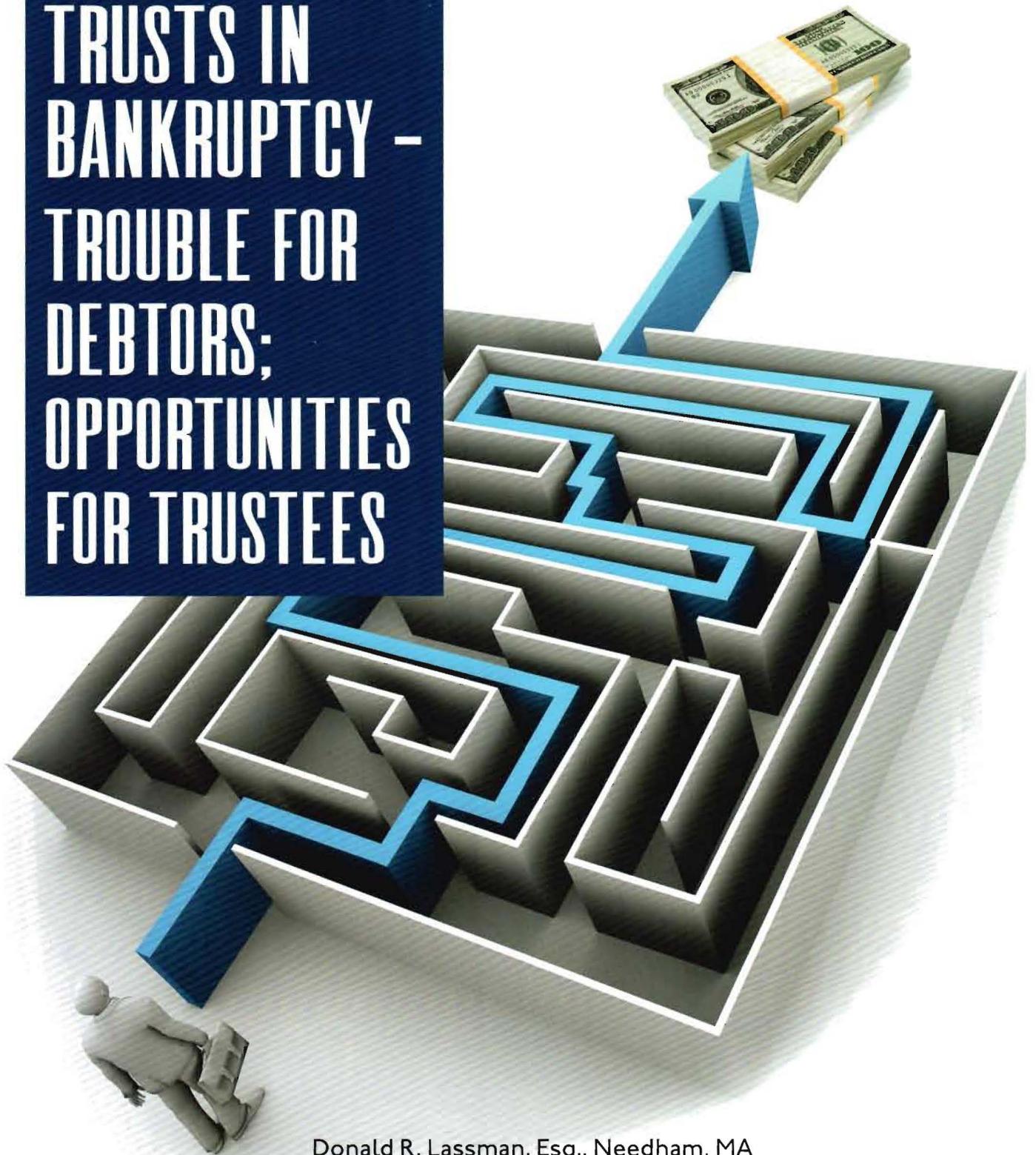


# TRUSTS IN BANKRUPTCY – TROUBLE FOR DEBTORS; OPPORTUNITIES FOR TRUSTEES



Donald R. Lassman, Esq., Needham, MA  
James L. Liston, Esq., Meyer Orlando, LLC  
Houston, TX

## KEY POINTS

1. The debtor and his/her counsel may often be unaware of what interests the debtor has in a trust, if any. Thorough investigation by the trustee may be necessary.
2. Spendthrift trusts and discretionary clauses can potentially shield a debtor's trust interest from the estate, depending on applicable state law and whether the trust is self-settled.
3. Fraudulent transfer and turnover actions can sometimes be used to obtain property in a trust that the debtor settled or controls.

### Introduction

One of the most fertile areas for asset discovery and recovery in chapter 7 cases today involves trusts. Trust law is complicated and the terminology is confusing. Compounding the complexity in this area, the answers to many trust questions may only be available from someone other than the debtor because the debtor's interest arises as a result of something that a non-debtor friend or relative has done for his or her benefit. In many cases when the debtor is questioned about a trust, the debtor, and often times debtor's counsel, is completely baffled. The purpose of this article is to provide you with the tools necessary to identify trust types and the nature of the debtor's interest in the trust, and how to recover the debtor's trust interest for the benefit of the bankruptcy estate.

### A Bankruptcy Trustee's Rights with Respect to a Debtor's Interests in Trusts

There are many types of trusts that a bankruptcy trustee may encounter when reviewing a debtor's assets. The debtor may be a trust settlor, a beneficiary or a trustee of the trust. The bankruptcy trustee may be able to monetize the debtor's interest in the trust depending upon the terms of the trust and the nature of the debtor's interest in the trust.

The following sections of the Bankruptcy Code are commonly applicable in cases involving trusts: 11 U.S.C. §541 (property of the estate); 11 U.S.C. §542 (turnover); and 11 U.S.C. §§544 and 548 (state and federal law fraudulent transfer avoidance). Section 541(c)(2) specifically protects the debtor's beneficial interest in a certain type of commonly encountered trust known as a "spendthrift trust." Section 541(c)(2) provides:

A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy law is enforceable in a case under this title.

Section §541(c)(2) prevents a trustee from liquidating a debtor's beneficial interest in a spendthrift trust "that is enforceable under applicable nonbankruptcy law." A spendthrift trust is a tool by which a party, usually someone other than the debtor, establishes and transfers property to a trust for the purpose of shielding the trust assets from the potential creditors of the beneficiaries, one of which may be the debtor. The following language was found sufficient to create a spendthrift trust by the Supreme Court of New Hampshire:

No principal or income payable or to become payable under any of the trusts created by this instrument shall be subject to anticipation or assignment by any beneficiary thereof, or to the interference or control of any creditors of such beneficiary or to be taken or reached by any legal or equitable process in satisfaction of any debt or liability of such beneficiary prior to its receipt by the beneficiary.

*Scheffel v. Krueger*, 146 N.H. 669, 671, 782 A.2d 410, 411 (2001).

Another device commonly used by trust settlors to shield trust assets from beneficiaries' creditors is a discretionary clause. The clause typically grants a trustee (someone other than the debtor) the power to simply withhold distributions to the beneficiaries if the trustee determines that doing so is in the best interest of the trust. Thus, if a debtor/beneficiary does not receive any assets from the trust, the bankruptcy trustee also cannot reach them.

In the absence of a spendthrift or discretionary clause in a trust, the beneficial interest of a debtor may be reachable by the bankruptcy trustee. See M.G.L.A. 203E § 501 (court may authorize a creditor of the beneficiary to reach the beneficiary's interest).

State statutes may also specify the language that must be present in a spendthrift trust in order for it to be effective and so they must be consulted. An issue that may arise is whether a spendthrift clause is effective if it restrains only involuntary transfers of the beneficiaries' interests but not voluntary. See M.G.L.A. 203E § 502(a) (providing that "[a] spendthrift provision shall be valid only if it restrains both voluntary and involuntary transfer of a beneficiary's interest."); N.H. Rev. Stat. §564-B:5-502 (similarly requiring a spendthrift trust to restrain voluntary and involuntary transfers); 18-B M.R.S.A. §502 (accord); R.I. Gen. Laws § 18-9.1-1 (accord).

One longstanding rule that has evolved over the years in most



### About the Authors

Donald R. Lassman is a sole practitioner in Needham, Massachusetts concentrating in the areas of bankruptcy, insolvency and business reorganization since 1983. Mr. Lassman is a member of the bar of the Commonwealths of Pennsylvania and Massachusetts, the Boston Bar Association, the National Association of Bankruptcy Trustees and the American Bankruptcy Institute, and has been a member of the panel of Chapter 7 Trustees for the U.S. Bankruptcy Court for the District of Massachusetts since 1995. He has earned the "Preeminent" Peer Review Rating by Martindale-Hubbell, the highest rating available. Since 2008, Mr. Lassman has been co-leading the effort of the Boston Bar Association to provide legal assistance to members of the military and their families, traveling to VFW posts throughout Massachusetts to provide informational seminars. He can be reached at [Don@LassmanLaw.com](mailto:Don@LassmanLaw.com) or 781-455-8400.

James T. Liston (Meyer Orlando LLC) has been an attorney for the past 25 years over which time he has seen firsthand how the lawsuit and appeals process can be effectively navigated by someone whose experience with courts helps ensure that a case is properly presented at trial and on appeal and in posture for review. He has over 50 published appeals and has handled close to 75. His expertise in appellate matters carries over into his work in trial courts. James also has a particular interest and strong background in admiralty and maritime law, and is admitted to the State Bar of Texas as well as the bars of the US Court of Appeals for the Fifth Circuit and the US Supreme Court. He can be reached at [jliston@meyerorlando.com](mailto:jliston@meyerorlando.com) or 713-460-9800.

jurisdictions is that a "self-settled" spendthrift trust is not enforceable to protect the interest of a beneficiary of the trust who was also the settlor of the trust. Where a debtor transfers his or her property into a trust in which the debtor is the beneficiary, a spendthrift clause in that trust will usually not shield the debtor's beneficial interest in the trust from his/her creditors or bankruptcy trustee. *Matter of Shurley*, 115 F.3d 333, 337 (5th Cir. 1997); *In re Felice*, 494 B.R. 160, 172 (Bankr. D. Mass. 2013); *In re Tosi*, 383 B.R. 1, 11 (Bankr. D. Mass. 2008).

Also, where the debtor is a trustee of a trust, but not necessarily a beneficiary, and the debtor retains discretionary control over the trust property and/or can use it for his/her own benefit under the terms of the trust, the trust property may be reachable by the bankruptcy trustee. This may occur where the trust grants the trustee/debtor a general power of appointment; the power to sell, lease, mortgage, or otherwise dispose of the trust property and use the proceeds for the debtor's benefit; to amend, terminate or revoke the trust and thereby receive the trust res or to appoint the debtor as beneficiary. Such powers reserved by a debtor, especially as trustee of a self-settled trust, may be exercised by the debtor's chapter 7 trustee for the benefit of the debtor's bankruptcy estate. See *In re Marrama*, 316 B.R. 418, 423 (1st Cir. BAP 2004) (bankruptcy trustee revoked realty trust); *In re Morgenstern*, 542 B.R. 650, 655-56 (Bankr. D. N.H. 2015) (trust property is property of bankruptcy estate); *In re Peirce*, 483 B.R. 368, 380-81 (Bankr. D. Mass. 2012) (bankruptcy trustee amended trust to make bankruptcy estate beneficiary of remainder interest).

Over the past twenty years, in response to the general rule that creditors can reach a debtor's beneficial interest in a self-settled spendthrift trust, at least fifteen states (Ala., Del., Colo., Miss., Mo., Nev., Ohio, Okla., R.I., Utah, S.D., Tenn., Va., N.H., and HI.) have enacted some form of "Domestic Asset Protection Trust" legislation. In these states, self-settled spendthrift trusts created in accordance with these statutes may shield the beneficiaries' interests from their creditors and bankruptcy trustees. Statutes authorizing asset protection trusts usually contain extensive requirements in order for a trust to come within the protection of the statute including, among others, that the trust must be irrevocable, that the trustee must have certain connections to the state, and that the trust res may not be established by way of fraudulent transfers of assets. Each state statute has different requirements and must be carefully analyzed. At least two states in the First Circuit have enacted such statutes. See N.H. Rev. Stat. Ann. §564-D:1 through D:18 and R.I. Gen. Laws 1956, §§18-9.2-1 through 18-9.2-7.

In response to state legislation allowing the creation of such self-settled asset protection trusts, Congress, in 2005, enacted 11 U.S.C. 548(e). Section 548(e)(1) allows a bankruptcy trustee to avoid a transfer of property where: (1) the transfer occurs within ten years of the filing of the bankruptcy petition; (2) the transfer is to a self-settled trust or similar device; (3) the transfer is by the debtor; (4) the debtor is a beneficiary of the self-settled trust or similar device; and (5) the debtor made the transfer with the actual intent to hinder, delay, or defraud any entity to which the debtor was or became indebted.

Also, in certain instances, distributions made to a debtor from an otherwise protected spendthrift trust may be reachable by a

trustee in bankruptcy. See *In re Massillon*, BAP No. MB 10-024, 2011 WL 1496101, at \*6-7 (1st Cir. BAP Jan 11, 2011); M.G.L.A. 203E § 506.

### **A Bankruptcy Trustee's Remedies to Reach a Debtor's Interests in Trusts**

A bankruptcy trustee may utilize 11 U.S.C. §548 and state fraudulent transfer laws under 11 U.S.C. §544 to avoid the transfer of the debtor's/settlor's property into a self-settled trust. These statutes generally have reach back periods of between 2 and 10 years and in certain instances, discovery rules may apply to extend those time periods.

A bankruptcy trustee may also in certain circumstances utilize 11 U.S.C. §§ 541 and 542 to obtain turnover of assets in a trust over which the debtor has sufficient control. *In re Tougas*, *supra*; *In re Beatrice*, *supra*; *In re Schultz*, 324 B.R. 722 (Bankr. D. Ark. 2005) (bankruptcy trustee not required to bring fraudulent transfer action where trust assets are determined to be property of the bankruptcy estate under 11 U.S.C. §541).

Using 11 U.S.C. §§ 541 and 542 to recover property allows a bankruptcy trustee to sidestep fraudulent transfer statutes of limitation and other concerns since the trust property is already deemed to be the debtor's property so that no avoidance action by the bankruptcy trustee is required. These provisions will also be useful if the legal and equitable interests in the trust have merged such that the debtor has become the outright owner of the property by operation of law. See *In re Szywd*, 370 B.R. 882, 890 (1st Cir. BAP 2007).

At least one Court has used its civil contempt powers to order incarceration of a debtor until trust property transferred offshore is returned. See *FTC v. Affordable Media, LLC*, 179 F.3d 1228 (9th Cir. 1999).

### **A Bankruptcy Trustee's Investigatory Process**

How will you determine if the debtor has a disclosed, or more commonly undisclosed, interest in a trust? Item 25 on Schedule A/B of the bankruptcy schedules is captioned "Trusts, equitable or future interests in property (other than anything listed in line 1), and rights or powers exercisable for your benefit" and is where the debtor's trust or estate interests should appear. Clues may also appear on (a) the debtor's most recently filed tax return provided to the trustee prior to the 341 meeting; (b) Schedule I, which may include a line item for trust income; and (c) Statement of Financial Affairs Question 5, which requires the debtor to list income from any source other than employment, and Question 19, which requires the debtor to disclose any transfer made to a self-settled trust (or similar device) within 10 years of the bankruptcy filing. Many debtors may not know that they have an interest in a trust or estate (or understand what the words mean) and debtor's counsel may never have even asked the question. Therefore, it is recommended to use the following line of questioning during the first meeting of creditors.

- Have you ever inherited any property?
- Do you anticipate an inheritance from anyone at any time in the future, and if so, why, when and from whom?
- Are you a settlor, grantor, beneficiary or trustee of any trust

that you established or was established by someone else for your benefit?

Having established the existence of an interest of the debtor in trust property, trustees should obtain information from the debtor and/or non-debtor third parties, enabling trustees to determine the type of trust and the debtor's interest in the trust. Below is a checklist of documents to request at the conclusion of the 341 meeting, which should be continued to permit further questioning of the debtor about trust documents remitted to you after the initial 341 meeting has been held:

- Declaration of Trust or other similar document
- Trustee Certificates
- Schedule of Beneficiaries
- Inventory of Trust property, Deed or Bill of Sale evidencing property owned by trust
- Trust Bank Account Statements
- Mortgages and other instruments evidencing the liabilities of the trust
- Trust tax returns
- Debtor and non-debtor beneficiary tax returns and K-1's
- Amendments to trust documents
- Trustee Resignations
- File of attorney that established the trust
- Evidence of all prior year's distributions from the Trust

Additional areas of inquiry after receipt and review of the trust documents described above should include the following in order to determine whether the trust property is likely to generate a meaningful return for creditors in light of the cost and expense expected to be incurred in the recovery process, and the action that may have to be taken by the trustee to protect and preserve the trust assets until recovery is achieved:

- Is the trust property insured?
- Who is managing trust property?
- Who is living in/utilizing the trust property and what are the terms and conditions of occupancy?
- What are the tax attributes of the trust?
- What are the tax consequences to the bankruptcy estate of selling trust property?
- Watch for inconsistencies in trust documents (title of person not correct, trustees not identified correctly, dates are wrong).

### **Conclusion**

An aging population will result in greater levels of wealth transfer from one generation to the next. Trusts are typically employed to accomplish generational wealth transfers. Trustees will want to remain vigilant as trust and estate assets appear with increasing frequency in the future wave of bankruptcy filings. 🏠