

EXCERPT FROM PRIMER ON AMERICAN TRUST LAW

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Trust Distribution

What is the difference between a mandatory income provision and a discretionary distribution provision? A mandatory income provision obligates the trustee to distribute all the income whereas a discretionary distribution provision grants the trustee discretion over payment of the income and/or the principal. That discretionary power may be drafted as widely or as narrowly as the settlor desires, with or without an express standard for making distributions. A trustee who has discretion to make distributions has an obligation to inquire into the needs of the beneficiaries; this includes the right to consider other resources available to the beneficiary.

What are the considerations in giving the trustee discretionary powers? One issue is whether there is an express standard. Additionally, the broader the trustee's discretion, the harder it is for the beneficiary to enforce the trust and show that a distribution should be made. The settlor needs to understand these issues in terms of enforcement.

What is a support trust? A support trust is a mandatory trust for the support of the named beneficiary. A support trust is automatically a spendthrift trust, as described below; no spendthrift provision is necessary.

What is the right of the beneficiary's' creditors to reach trust assets? Absent a spendthrift trust, judgment creditors may attach an income interest. Once the trustee is required to make a distribution from principal, she can be compelled to pay the creditor directly. The creditor may not, however, compel the trustee to make a discretionary distribution. Additionally, once a trust-terminating event occurs, the creditor may reach the principal even though it remains in the trustee's hands pending final distribution.

What is a spendthrift trust? A spendthrift trust is one in which the settlor provides that the beneficiary's interest may not be assigned by the beneficiary or reached by the beneficiary's creditors. Most cases focus on creditors' rights issues, but the prohibition on alienation is also noteworthy, especially as it affects the beneficiary's attempts to provide collateral for a loan. The spendthrift trust is a creation of American law and is not recognized in England.

What is the effect of a spendthrift trust on creditors' rights? If there is a valid spendthrift trust, the trustee can make no distributions of interest or principal to persons other than the named beneficiary. The majority view holds that creditors must wait until the distribution is made and then try to attach the assets from the beneficiary. An alternative view is that the creditor can attach the assets from the trustee at the moment of distribution; it is difficult to see how this view gives any effect to the spendthrift provision.

Are there any exceptions to the enforcement of the spendthrift provisions? Yes, usually on policy grounds the courts have carved out several notable exceptions. Debts incurred for the following purposes may be paid out of trust funds despite a spendthrift provision: child support; alimony; necessities of life; federal tax claims. Many cases focus on reimbursement for state institutional care; payment of those claims can be justified as being made to a special class of suppliers of necessary care. There is considerable variation in the individual states on the extent to which particular exceptions are recognized.

Are the above exceptions to enforcement of the spendthrift provision always effective? No, there is a second inquiry as to what kind of property right the beneficiary has in the trust. If the trust is discretionary, the beneficiary has no enforceable property right and therefore the creditor may not reach the trust assets.

What rights do the settlor's creditors have to reach trust assets when the settlor is also the beneficiary (a self-settled trust)? Under any trust, the settlor's creditors can reach any amount which the trustee could distribute to the settlor. The trustee need not have made the determination to make a distribution. A spendthrift provision is invalid as to the settlor because a trust cannot be used to shield the settlor's assets. A small number of states provide by statute that the settlor can be a beneficiary of an irrevocable trust but yet validly prohibit the settlor's creditors from being able to reach the settlor's trust interest.

What rights do the settlor's creditors have to reach trust assets at settlor's death? Traditionally, creditors had no right to reach revocable trust assets once the settlor died, because the trust became irrevocable at that moment and the settlor no longer had a beneficial interest to attach. However, under modern case law and statute, creditors are usually allowed to attach trust assets in recognition of the fact that the revocable inter vivos trust is usually being used to substitute for a will. If creditors can reach assets in a decedent's estate, they should likewise have the opportunity to make claims against (previously) revocable trust assets. As to real irrevocable trusts, the creditor's only option would be to try to invalidate the trust on the ground that property transfers to it were in fraud of creditors.