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Bankruptcy and Trusts

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When a bankruptcy estate includes a trust, bankruptcy trustees pay attention. Whether the debtor is a settlor or beneficiary, such trusts can easily bring potential assets into the estate to and for the benefit of creditors, often because such trusts almost never were created with concern about bankruptcy avoidance powers. This article first delivers a cursory review of trusts, then delves into some bankruptcy effects upon certain trusts.[1]

Irrevocable or Revocable

Boiled down to simplest terms, the trusts of this article are either irrevocable or revocable. Irrevocable trusts are those in which the creator has made every attempt to divest himself/herself from ownership interest in assets and deliver the same to the beneficial interest of named parties. Revocable trusts do not create divestment.[2] Instead, the grantor has rights to retract from delivering the assets or has the right to rename the beneficiaries. Because it is difficult to part from one's assets, the majority of trusts are revocable, and because of such a fact, the delivery of a revocable trust to the bankruptcy trustee becomes a legitimate concern for administration of an estate.

Irrevocable Trusts Are Usually, But Not Always, Immune

Irrevocable trusts are rarely the subject of bankruptcy trustee attack, because the debtor divested interest in the property prior to the bankruptcy filing. Even when the debtor is the trustee of an irrevocable trust, as long as there is no fraudulent intent or other fraudulent or preferential transfer involved in the delivery of assets to the trust or its beneficiary(ies), the bankruptcy trustee would have no interest in the assets that are now being held in the name of another.[3] However, as always, where there is a rule, there is an exception.

The greatest exception is § 505[4] of the Uniform Trust Code (UTC), which provides that if a grantor retains the income of an irrevocable trust, the grantor's creditors could make a demand upon the trustee for the full amount of the debt owed to the creditor, as opposed to having the remedy being limited to the monthly, quarterly or annual income delivered to the grantor-beneficiary.[5] In such circumstances, the seemingly immunized trust could be the subject of an attack by a trustee stepping into the shoes of the hypothetical creditor of the grantor/debtor.

Majority of the Cases Concern Revocable Trusts

The majority of the cases involving a bankruptcy trustee attack concern revocable trusts. Because many different factual circumstances can arise from the same, the exhibit accompanying this article outlines no less than 19 situations that may arise with a revocable trust in a bankruptcy filing. The exhibit describes three ultimate circumstances: (1) the debtor will almost certainly lose his/her trust interest to the bankruptcy trustee; (2) the debtor will almost certainly not lose his/her trust interest to the bankruptcy trustee; and (3) the debtor cannot know because case law is too uncertain to determine whether or not his/her trust will be subject to bankruptcy trustee attack or turnover.

The Debtor Will Almost Certainly Lose Trust Interest to the Trustee

Grantor-Trustee-Beneficiary = Self-Settled Trust [Hypotheticals 1 and 2]

In bankruptcy, the trustee's initial concern is what interest the debtor holds. When the debtor is the settlor/trustee/beneficiary of a revocable trust, such trust is called a "self-settled trust," which is "fish in a barrel" from a bankruptcy trustee's per-

1 This entire article is based upon broad principles of the trustee having a uniform power. Each trust creates unique power and character to the trustee. The author and publisher forewarn that these described examples could easily deliver very different outcomes by a mere delicate change made in an otherwise seemingly identical trust.

2 This article does *not* address testamentary trusts, which are specifically given different treatment under 11 U.S.C. § 541(a)(5).

3 Included in the "fraud review" is a trustee's reduction in the exemption. *See* 11 U.S.C. § 522(o) and its long-armed 10-year reach to strip exemptions for transfers (including those into trusts) if four criteria are met: "(1) [T]he debtor disposed of property within [10] years preceding the bankruptcy filing; (2) the disposed property was nonexempt; (3) some or all of the proceeds from the disposition of this nonexempt property were used to buy a new homestead, to improve an existing homestead, or [to] reduce the debt associated with an existing homestead; and (4) the debtor disposed of the non-exempt property with the intent to hinder, delay, or defraud a creditor." *In re Cowin*, No. 13-30984, 2014 Bankr. LEXIS 1119, at *44 (Bankr. S.D. Tex. March 21, 2014)

4 Whether or not the terms of a trust contain a spendthrift provision, the following rules apply:

(1) During the lifetime of the settlor, the property of a revocable trust is subject to claims of the settlor's creditors....

(3) After 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].

For purposes of this section:

(1) during the period the power may be exercised, *the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power* (emphasis added).

5 Many states have statutes incorporating this UTC provision. These apply only to irrevocable trusts.

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19 Proposed Variations of Revocable Trusts and the Debtor

	Character	Projected Result
1	Debtor is the Settlor, Trustee and Beneficiary.	"Self-Titled Trust." "If the Trust is self-settled and void under the applicable law, then the transfer would be ineffective and this action could be resolved with little need for a finder of fact." *Walker v. Weese*, 286 B.R. 294, 298 (D. Md. 2002). *Also see* 11 U.S.C. § 542(c)(1), which addresses this issue.
2	Debtor is the Settlor, Trustee and Beneficiary. Defective anti-alienation.	"Self Settled Trust" — defect does not control the issue.
3	Debtor is the Settlor and Trustee. Beneficial interest to third party(ies) has not been triggered.	Because the debtor still controls, trust is a bankruptcy asset. *Olsen v. Reuter (In re Reuter)*, 499 B.R. 655, 670 (Bankr. W.D. Mo. 2013). The power to amend or revoke delivers more than the trust assets to the trustee or estate.
4	Debtor is the Settlor and Trustee. Beneficial interest to third party(ies) has been triggered.	The debtor no longer has interest in assets. Does the debtor have power to revoke? *In re Reuter* at 670; *In re Johnson*, 513 B.R. 333, 343 (Bankr. S.D. Ill. 2014).
5	Debtor is the Settlor and Trustee. Defective anti-alienation; beneficial interest to third party(ies) has not been triggered.	Because the debtor still controls, trust is a bankruptcy asset; defect does not control the issue. *In re Reuter* at 670; *In re Johnson* at 343.
6	Debtor is the Settlor and Trustee. Defective anti-alienation; beneficial interest to third party(ies) has been triggered.	The debtor has no more interest in assets: defect may only arise if the beneficiary's creditor approached the debtor, who is trust's trustee. Does the debtor have power to amend or revoke? *In re Reuter* at 670; *In re Johnson* at 343.
7	Debtor is the Settlor and Trustee. Treated assets as own equals power to revoke.	Substance over form or alter-ego. Alter-ego concept. "Court entered a declaratory judgment and found that the Soad Wattar Trust was the alter-ego of the Debtor-Defendant ... because he treated its assets as his own property and it would be unjust to allow him to maintain the Trust as a separate entity." *In re Sharif*, 564 B.R. 328, 342 (Bankr. N.D. Ill. 2017). *Also see Brace v. Speier (In re Brace)*, Nos. CC-16-1041-LNTa, 6:11-bk-26154-SY, 6:11-ap-02053-SY, 2017 Bankr. LEXIS 697, at *1 (B.A.P. 9th Cir. March 15, 2017).
8	Debtor is the Settlor and Beneficiary.	Because the debtor will always control, trust is always a bankruptcy asset. *In re Reuter* at 670. Interestingly, an opposite result occurs if trust is irrevocable. *In re Vess*, No. 17-31092, 2018 Bankr. LEXIS 298, at *10-11 (Bankr. N.D. Ohio Feb. 5, 2018).
9	Debtor is the Settlor. Beneficial interest to third party(ies) has not been triggered.	Because the debtor still controls, trust is a bankruptcy asset. *In re Reuter* at 670; *In re Johnson* at 343.
10	Debtor is the Settlor. Beneficial interest to third party(ies) has triggered.	The debtor no longer has interest in assets. Does the debtor have power to amend or revoke? *In re Reuter* at 670; *In re Johnson* at 343.
11	Debtor is the Beneficiary. Beneficial interest to third party(ies) has not been triggered.	SPLIT: Debtor has not yet received interest in assets. Some allow contingent interest to be estate property, while others do not. Here are some examples: Is property of the estate (*In re Smith*, 189 B.R. 8 (N.D. Ill. 1995); *In re Crandall*, 173 B.R. 836, 839 (Conn. 1994); *Fouts v. United States*, 107 F. Supp. 2d 815, 817 (W.D. Mich. 2000)); is not property of the estate (*Burton v. Ulrich (In re Schmitt)*, 215 B.R. 417, 422 n.1 (B.A.P. 9th Cir. 1997); *Anderson v. Rainsdon (In re Anderson)*, 572 B.R. 743, 747 (B.A.P. 9th Cir. 2017)) (hereinafter referred to as "Split of Authority List").
12	Debtor is the Beneficiary. Beneficial interest to third party(ies) has been triggered.	SPLIT: Courts are divided about future interest being § 541 property. But anti-alienation should keep the asset out of the bankruptcy estate. 11 U.S.C. § 542(c)(2). In addition, "a contingent interest in a revocable trust is not an enforceable property right because it was subject to complete divestment by the trustor during her lifetime on the petition date." *Ellis v. Vetsch (In re Vetsch)*, 620 B.R. 150, 156 (Bankr. W.D. Wash. 2020). If the trust is irrevocable, the contingent future interest is property of the estate. *See Hernandez v. Hopper (In re Hernandez)*, No. 12-24502, 2013 Bankr. LEXIS 4670, 2013 WL 1490995 (B.A.P. 9th Cir. April 11, 2013); *In re Schmitt*, 215 B.R. 417, 421 (B.A.P. 9th Cir. 1997).
13	Debtor is the Beneficiary. Defective antialienation; beneficial interest to third party(ies) has not been triggered.	SPLIT: The debtor has not yet received interest in assets. Defect is not the issue. *See* Split of Authority List. But assuming the future interest is property of the estate, a second hurdle exists: the spendthrift clause. If valid, then the asset is not property under 11 U.S.C. § 541(c)(2).
14	Debtor is the Beneficiary. Defective antialienation; beneficial interest to third party(ies) has been triggered.	Defect controls the issue.
15	Debtor is the Trustee.	Debtor never held interest in assets.
16	Debtor is the Trustee and Beneficiary. Beneficial interest to third party(ies) has not been triggered.	SPLIT: The debtor has not yet received interest in assets. The debtor being in the trustee/beneficiary position is not a good idea. *See* Split of Authority List. "The doctrine of merger is properly applicable only if all beneficial interests, both life interests and remainders, are vested in the same person, whether in the settlor or someone else. An example of a trust to which the doctrine of merger would apply is a trust of which the settlor is sole trustee, sole beneficiary for life, and with the remainder payable to the settlor's probate estate." *Welch v. Crow*, 2009 OK 20, ¶ 16, n.24, 206 P.3d 599, 605 (hereinafter referred to as "*Welch v. Crow* Statement").
17	Debtor is the Trustee and Beneficiary. Beneficial interest to third party(ies) has been triggered.	The debtor controls, trust is a bankruptcy asset. The debtor being in the trustee/beneficiary position is not a good idea. Doctrine of Merger concern. *See Welch v. Crow* Statement.
18	Debtor is the Trustee and Beneficiary. Defective anti-alienation; beneficial interest to third party(ies) has not been triggered.	SPLIT: The debtor has not yet received interest in assets: defect is not an issue until delivery of interest. Some jurisdictions include future interests as property, in which case the defect may control the issue. The debtor being in the trustee/beneficiary position is not a good idea. *See* Split of Authority List; *Welch v. Crow* Statement.
19	Debtor is the Trustee and Beneficiary. Defective antialienation; beneficial interest to third party(ies) has been triggered.	The debtor controls, trust is a bankruptcy asset. Defect does not control the issue. The debtor being in the trustee/beneficiary position is not a good idea. *See Welch v. Crow* Statement.

Color Key: Brown (probably becomes a bankruptcy asset); Yellow (probably not a bankruptcy asset); Red (assets passed to third party or beneficiary); and Green (assets not passed and still under control of the settlor).

spective. When a self-settled trust is delivered to a bankruptcy estate, the bankruptcy trustee will quickly freeze the assets and gather the same to the estate's benefit under either a turnover action or an adversary to turnover (assuming that the trustee position of the debtor is a party other than the debtor) and seek to avoid the spendthrift clauses associated with the same.

Anti-Alienation Clauses Explained
[Hypotheticals 7 and 8]

In an attempt to protect revocable trust assets from creditor attack, boilerplate language is used to prevent creditors of the beneficiary from touching the same. These clauses are commonly known as "anti-alienation" or "spendthrift" clauses. The language is relatively simple.[6] Put in blunt terms, such a clause alerts others that the assets of the trust cannot be touched by creditors of the beneficiaries.[7] In the end, even if the debtor/beneficiary came begging and groveling to the trustee and asked to have some of the money from the trust delivered to pay a creditor, that cannot be done without the trustee's consent.

It is the strength of the spendthrift clause that makes trusts so attractive to people with money. Essentially, if a loved one, child or grandchild is going to benefit from a settlor's money, the settlor wants to assure those involved that the trust's assets will not be squandered by future ex-wives or monetary-judgment creditors.

Abuse of the spendthrift provision will annul its protection. If a debtor invades the trust and uses assets for personal benefit without following trust protocols, the anti-alienation or spendthrift clause's protection will succumb to creditor attack. The assets will be treated as though they had never been put into the trust — or become § 541 property.

Another attempted abuse is naming yourself as a beneficiary and having the trustee answer to the grantor's every wish and whim. If the trust has a sycophantic trustee who never can say "no" to a beneficiary's request, the anti-alienation clause might be defeated. If the spendthrift clause is defeated, the bankruptcy trustee, stepping into the debtor's shoes, can demand that the trustee turn over the corpus of the trust to the benefit of the estate's creditors.

Defective Spendthrift Clause
[Hypothetical 9]

If the spendthrift clause is defective, any beneficial interest of the debtor becomes property of the estate. Without a spendthrift clause, there is no lock protecting the trust's assets. Analogously, with a defective spendthrift clause, the lock is broken, creditors and bankruptcy trustees can attach to the debtor's beneficial interest, and the trust's assets are not protected.

Bad Timing
[Too-Early Hypotheticals 14, 3 and 5,
or Too-Late Hypotheticals 17 and 19]

If a trust is created, but events have not triggered transfer to a trustee or to the named beneficiaries, the assets remain with the settlor without trust protection. In such circumstances, filing for bankruptcy for the settlor delivers the assets to the bankruptcy trustee.

Similarly, if the assets are held by the debtor as trustee of the trust, but events have not transpired to deliver interests to beneficiaries, then the debtor still controls the assets. Again, the bankruptcy trustee should prevail in obtaining trust assets.

In the alternative spectrum, if the trust exists and the debtor is both the trust's trustee and trust's beneficiary, the assets are under complete and unfettered control of the debtor (this is a merger). The trust's trustee's alleged enforcement of the spendthrift clause is not held by an independent person. The bankruptcy trustee, as a beneficiary and trustee of the trust, can then seek to use the money for the benefit of the estate's creditors.

The Debtor Will Almost Certainly Not Lose Trust Interest to the Trustee

The Trustee Only
[Hypothetical 15]

If the debtor is merely a trustee who did not create the trust, nor did not deliver assets to the trust, nor has any beneficial interest in the trust, then the bankruptcy estate would have no interest as well.

The Settlor Only
[Hypothetical 10]

If the debtor created a trust and is neither the trustee nor the beneficiary, it appears that the estate has no interest in the trust. The estate's interests might be limited to an avoidance action to "undo" delivery of the assets to the trust (*e.g.*, fraudulent transfer or revocation).

The Settlor and Trustee, but Not the Beneficiary
[Hypotheticals 4 and 6]

If the debtor is a settlor/trustee but names children, grandchildren or loved ones as beneficiaries, the trust should be protected. The debtor under such circumstances does not hold beneficial interest because the estate has no interest. But this trust could be subjected to an avoidance action under circumstances similar to those recited in the preceding paragraph.

The Debtor May (or May Not) Lose Trust Interest to the Trustee

Timing Concept and Spendthrift Clause
[Hypotheticals 11, 12 and 13]

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6 Forms with spendthrift language can be found online.
7 Some states have tweaked this absolute immunity. *See* California Probate Code 15306.5.

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At first glance, if a debtor is *only* a beneficiary who had no control over the creation of the trust, had no control over the trustee and has no right to be the trustee, then the trust would seem out of the bankruptcy trustee's reach. However, there is a split of authority. Some courts read 11 U.S.C. § 541 to allow contingent future interests. If the debtor resides where courts include future contingent interests, the trust interest's inclusion into the estate can only be prevented by a valid spendthrift clause: § 541(c)(2). In short, in jurisdictions that include contingent future interests in estates, the importance of the spendthrift clause increases.

Quasi-Merger Doctrine
[Hypotheticals 16 and 18]

Sometimes, the debtor is named as beneficiary, or trustee and beneficiary, of a wealthy benefactor's benevolent bequest. Unlike the aforementioned self-settled trust, the results of these instruments are split. The division focuses upon § 541, including future interests, as previously outlined.[8] This division prompted pre-emptive action by a few California attorneys in a recent case.

The bankruptcy court in *Steinmann* reviewed a trust created by grandparents in which the debtor grandchild was a named beneficiary.[9] Knowing about the split in the aforementioned case law, and working with an abundance of caution, a debtor's attorney wisely had the debtor's beneficial interest removed before the bankruptcy's filing. Revocable trusts can change the assets and the beneficial interests with merely a writing that complies with the trust laws of the state that govern the trust. This certainly does not pass the smell test, but it is something permissible under revocable trust law.

When Andrea Steinmann's grandparents removed her as a beneficiary from their revocable trust, that was not a violation of the trust laws in California.[10] However, the bankruptcy trustee correctly knew that this act of annulling a debtor's beneficial interest just prior to a bankruptcy filing was inequitable. Moreover, each sibling's share was proportionately increased by the debtor's beneficial interest's termination. The siblings, as a group, received the debtor's inheritance without giving value to the debtor. The bankruptcy trustee sought to avoid the act (the debtor's asking to be disinherited) by filing a fraudulent-action lawsuit against the debtor's siblings and the debtor's parents (trustees of the trust).

Looking into the elements of a fraudulent transfer, the problems for the bankruptcy trustee became clear. The split of authority regarding inclusion in § 541 future contingent interests, as previously mentioned, is vast. The California bankruptcy judge ruled in the negative.[11] In California, because beneficial interests are contingent assets requiring an act to trigger the ownership or beneficial interest to be an asset (in this case, the grandparents' death), there was no asset to transfer. Without an asset, there can be no transfer. Without a transfer, there cannot be a fraudulent transfer.

Conclusion

From these cases, a few maxims arrive. First, a self-settled trust is protective for neither the beneficiary nor the settlor (hypotheticals 1 and 2). Second, analogously, if a party touches the assets of a trust as if they were never put into trust, substance over form will determine that the trust is protective for neither the beneficiary nor the settlor (hypothetical 7). Third, if the debtor will always be the settlor and the beneficiary, again the likelihood of protection is slim (hypothetical 8). Fourth, if the assets have not passed to third parties or beneficiaries in a revocable trust, the settlor's ability to change the trust with a penstroke delivers two conclusions (in *Steinman*-like jurisdictions): (1) If the debtor is the settlor, the trust's assets would be property of the estate (hypotheticals 3, 5 and 9); and (2) if the debtor is a beneficiary who is not a settlor, the debtor's interest has not ripened and the beneficial interest is not an asset of the bankruptcy estate (hypotheticals 11, 13, 16 and 18). Alternatively, other jurisdictions ignore the need for a future event to vest the beneficiary's interest, and the bankruptcy trustee can attack the not-yet-vested beneficial interest — subject to nonbankruptcy (if any) protections. Fifth, if the event to deliver the assets to the beneficiaries occurs pre-petition, two conclusions about the trust can be made: (1) If the debtor is the settlor, the trust's assets would not be property of the estate (hypotheticals 4, 6 and 10); and (2) if the debtor is a nonsettlor-beneficiary, the debtor's interest has ripened and the beneficial interest might be an asset of the bankruptcy estate (a) if the anti-alientation clause is defective (hypothetical 14) and (b) if the debtor is the trustee and beneficiary (hypotheticals 17 and 19), but the interest should not be an asset if only a beneficiary and the anti-alienation clause is proper (hypothetical 12). Sixth, if the debtor merely acts as the trustee and never had either a settlor or beneficial interest, then the trust would not be property of the estate (hypothetical 15). Lastly, naming the debtor as trustee and beneficiary, for whatever reason(s), is not suggested, as the merger doctrine, alter-ego and other equitable arguments may permeate the trust and allow attack to the *res* by the bankruptcy trustee (hypotheticals 16-19). abi

8 Section 541(a)(1) reads:
(a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:
(1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

9 *Casey v. Steinmann (In re Steinmann)*, Case 8:18-1p-01168-SC (Bankr. C.D. Cal. Nov. 17, 2020).

10 *Id.*

11 Some allow contingent interest to be estate property, while others do not. Here are some examples: Is property of the estate (*In re Smith*, 189 B.R. 8 (N.D. Ill. 1995); *In re Crandall*, 173 B.R. 836, 839 (Conn. 1994); *Fouts v. United States*, 107 F. Supp. 2d 815, 817 (W.D. Mich. 2000)); is not property of the estate (*Burton v. Ulrich (In re Schmitt)*, 215 B.R. 417, 422 n.1 (B.A.P. 9th Cir. 1997); *Anderson v. Rainsdon (In re Anderson)*, 572 B.R. 743, 747 (B.A.P. 9th Cir. 2017)).

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