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Guest Article

The Limits Of Asset Protection Trusts: A Helpful Reminder

By Jeffrey A. Baskies

The California Court of Appeal recently compelled the trustee of a spendthrift trust to make distributions to satisfy the trust beneficiary's child support obligations - even though the trust had a spendthrift clause that expressly authorized the trustee to make no distributions at all. *Ventura County Department of Child Support Services v. Brown*, No. B168108 (Cal. 2nd Dist., March 29, 2004).

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While this is not the first court to circumvent a spendthrift clause, the decision is an important reminder to planners of the limits of asset protection trusts and the importance of properly advising clients.

Two aspects of the California decision are particularly interesting.

First, in this case the trust had a spendthrift provision allowing the trustee to suspend all distributions,

and indeed make none at all. The court found, however, that the trustee did so in bad faith.

Second, not only did the court direct that any distributions made from the trust could be "garnished" to meet child support, but the court required the trustee to pay the amount of the arrearages of principal to meet all the back unpaid support.

Background

In 1990, Helen Marinos ("settlor") established an irrevocable life insurance trust ("ILIT") for the benefit of her sons, Kenneth and Daniel Marinos. The mother died on Nov. 27, 2002.

Under the terms of the ILIT, the trust was divided into separate shares for the two Marinos brothers. The assets in Kenneth's share are worth approximately \$535,000.

Kenneth has seven children ranging from 8-15. The children have three different mothers. Child

support orders have been issued against Kenneth. However, he has failed to pay child support for approximately 15 years.

Accordingly, the Ventura County Department of Child Support Services ("DCSS"), acting with the various mothers, obtained court judgments against Kenneth for arrearages and ongoing monthly support in excess of \$140,000.

One month after the settlor's death, one of the mothers of Kenneth's children went to the probate court and obtained an order enjoining trust distributions to Kenneth.

The DCSS filed pleadings seeking payment of the \$140,000 of child support arrearages and assurance of further payments in the future.

The trial court granted the DCSS petitions and the trustee appealed.

The Trust Terms

Under the terms of the ILIT, the trust is primarily for the benefit of Kenneth and his brother. Under an ascertainable standard, the trustee was directed to administer the trust to "provide for the proper support, care, maintenance and education" of the beneficiaries. Further, the trustee has discretion to "distribute so much of the net income or principal, or both, of [the] trust . . . to or for the use and benefit of [Kenneth and his brother], at any time and from time to time."

As do many trusts we draft, this ILIT also contained a spendthrift clause. The spendthrift provision exempted the trust assets from court process. The provision stated:

"The income or principal of any trust hereunder shall not be subject to transfer by operation of law, and shall be exempt from the claims of creditors or other claimants, and from orders, decrees, levies, attachments, garnishments, executions and other legal or equitable process or proceedings to the fullest extent permissible by law."

The spendthrift clause also had a suspension clause in case a beneficiary had a creditor problem. The clause stated:

"If any creditor or other claimant attempts by any means to subject to the satisfaction of the claim of such creditor or claimant, the interest of any beneficiary ... during such time thereafter as the TRUSTEE in its absolute discretion, shall deem advisable, shall not be entitled to receive payments from the trust; provided, however, that during the time payments are so suspended, the TRUSTEE, in its absolute discretion, may pay to or expend for the benefit of such beneficiary as much of the trust net income, ... as the TRUSTEE deems necessary for the support and education of such beneficiary."

In a semi-ironic twist, the ILIT also provided that upon Kenneth's death, his share was to be administered for the benefit of his children - those same children he refused to support himself. One can wonder why the trustee was fighting so hard not to make distributions when ultimately these children may wind up receiving the very funds the trustee was refusing to distribute.

Interesting Issues

The fundamental issue on appeal was whether the court could order satisfaction of child support from the trust even though the beneficiary could not compel distributions and the trustee did not make any distributions.

Like many states, in California, the general rule is that creditors cannot reach the interest of a beneficiary in trust assets before the beneficiary has a right to receive a distribution of assets. However, California's probate code (again, like many states) has a special provision regarding

so-called "support judgments," such as spousal support or child support.

What makes this case so interesting is the California statute only authorizes a court to order the trustee to satisfy a support judgment out of "all or part of future payments that the trustee, pursuant to the exercise of the trustee's discretion, determines to make to of for the benefit of the beneficiary." See California Probate Code Sect. 15305 and 15306.

The beneficiary, Kenneth, argued that he had no ability to compel distributions because the trustee had express authority to withhold all distributions. Accordingly, Kenneth argued, he could not be compelled to satisfy the obligation of support and his trust could not be compelled to either.

In the end, the court disagreed with Kenneth. The court found a way to pierce the spendthrift clause by creating a distinction between good faith and bad faith exercises of discretion. By doing such, the court seems to have added a new element to the statutory rules on reaching trust assets.

In the end, the court held that trustees making discretionary distribution decisions in good faith cannot be compelled to turn over trust assets to pay support obligations. In that case (where a trustee of a discretionary trust is making discretionary distributions in good faith), it appears that any claim for support can only be satisfied out of future distributions.

However, the court ruled, the limitation will not apply when the trustee makes distribution decisions - in this case where the trustee refuses to make any distributions - in bad faith.

However, good faith is not part of the statute. Further the court does not provide accurate tools to establish what criteria are essential to determining the good or bad faith of the trustee's decision-making. So those practicing in California have this holding to consider without accurate information to evaluate its application.

Conclusion

Ultimately, it would appear that public policy (and there is a strong public policy in favor of enforcing support obligations) trumped statutory law. That's an important reminder for those of us in the estate planning and asset protection world. After all, much of the estate planning and asset protection planning we do - including essentially mundane actions like including spendthrift clauses in ILITs - depends on statutory nuance trumping notions of equity.

While nobody will argue against a public policy favoring payment of child support, there is also a fundamental public policy in favor of allowing citizens with property some latitude in deciding how that property will be used after their deaths.

Naturally, there are limits to the right to control the disposition of one's assets. We have a wealth transfer tax system that impedes control. We also have rules against perpetuities and other rules of construction that may constrain grantors of trusts or testators of wills. And more recently we have seen developing rules of construction voiding unconscionable clauses - like ones limiting charitable gifts only for the use of white students.

And, as presented by this case, there are limits on the power of spendthrift clauses. However, what makes the California case worthy of our attention is that here, not only will future distributions from the trust be garnished but also the trust corpus itself was disgorged to satisfy the back child support.

While that may not be the law in every state, the fact that this decision was decided that way by this one court in California should make all of us aware of the potential for it to happen in our states.

Ventura County Department of Child Support Services v. Brown (Lawyers Weekly USA No. 99284488) Cal. 2nd Dist. No. B168108. March 29, 2004.

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