

# Spendthrift Trusts: The Real (but Not Unlimited) Benefits in Bankruptcy

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Under California law, the assets contained in a valid spendthrift trust are generally protected from the reach of the beneficiary's creditors. Further, in the event a beneficiary under a valid spendthrift trust files for bankruptcy, the trust assets will not become part of the beneficiary's bankruptcy estate and, accordingly, will not be administered and liquidated by the beneficiary's bankruptcy trustee.



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An individual filing a bankruptcy petition is entitled to retain certain minimal, exempt property. This exempt property is outside of the reach of the individual's bankruptcy trustee and creditors. Further, certain property rights, such as a beneficiary's interest in a valid spendthrift trust, that do not become part of the individual's bankruptcy estate may be retained by the individual free and clear of creditors' claims and the reach of the individual's bankruptcy trustee and outside the scope of the severe limitations imposed on exempt property. The availability and extent of spendthrift trust protection is determined by state law.

## California Spendthrift Trust Law

California law recognizes the validity of spendthrift trusts. California Probate Code §§15300 and 15301 specify that if a trust provides the beneficiary's interest in income or principal is not subject to voluntary or involuntary transfer (*i.e.*, a "spendthrift trust"), the beneficiary's interest in such a trust's income or principal is not subject to enforcement of a money judgment until paid to the beneficiary. The exceptions to this general rule are set out in California Probate Code §§15304 through 15307. Section 15304 provides that a settlor may not create a spendthrift trust for himself or herself. That is, a settlor of a spendthrift trust cannot simultaneously be a beneficiary of the same

spendthrift trust under California law. The policy against the so-called "self-settled" trust voided by California law is to prevent an individual from placing his or her property beyond the reach of creditors while still enjoying the use and benefits of such property. *See In re Moses*, 167 F.3d at 473.

California Probate Code §§15305, 15305.5 and 15306 provide exceptions to the general spendthrift trust protection from creditors under very specific circumstances. Probate Code §15305 pertains to money judgments for support of a beneficiary's spouse, former spouse or minor children. Probate Code §15305.5 pertains to restitution for crime victims or for damages incurred as a result of contact for which the defendant beneficiary was convicted of a felony. Section 15306 permits governmental entities in certain circumstances to obtain reimbursement for public support furnished to a beneficiary or beneficiary's family.

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Under Probate Code §15306.5, a creditor may obtain an order directing the trustee of a spendthrift trust to satisfy all or part of a judgment out of the payment to which the beneficiary is entitled under the trust instrument so long as the payment does not exceed 25 percent of the payment that otherwise would be made to the beneficiary and is not necessary for support of the beneficiary or dependents of the beneficiary. The relevance of §15306.5 is that it removes 25 percent of the debtor's interest in the trust from traditional spendthrift trust status to the extent not necessary for support of the beneficiary and all the persons the beneficiary is required to support. *See In re Newton*, 922 F.2d 1379 (9th Cir. 1990).

Probate Code §15307 permits a judgment creditor to execute against a beneficiary's interest in a spendthrift trust for "any amount to which the beneficiary is entitled under the trust instrument or that the trustee, in the exercise of trustee's discretion, has determined to pay the beneficiary in excess of the amount that is or will be necessary for the education and support of the beneficiary...." To obtain relief under

§15307, a judgment creditor must file a petition under §709.010 of the California Code of Civil Procedure, and the court may make a continuing order for application for future payments to the satisfaction of the judgment. However, the creditor does not have the power to compel the trustee to exercise discretion.

The critical inquiry in determining whether a spendthrift trust is valid under California law is whether the trust's beneficiaries exercise excessive control over the trust. A beneficiary cannot exercise such control and thereby shield the trust with an anti-alienation provision lacking true substance. The purpose of a spendthrift trust is to protect a beneficiary from himself or herself and his or her creditors. In bankruptcy cases, the debtor's degree of control over the spendthrift trust is often the primary consideration in determining its validity. It is clear that, if a beneficiary under a spendthrift trust has absolute and sole discretion to compel distribution of the trust assets, the spendthrift provision must fail. When spendthrift trusts are shams or otherwise void, the trust property is included in the bankruptcy estate.

## Property of the Estate

When a bankruptcy petition is filed, an estate is created consisting of "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. §541(a). The Bankruptcy Code, however, excludes from property of the estate "any interest in a plan or trust that contains a transfer restriction enforceable under relevant non-bankruptcy law." 11 U.S.C. §541(c)(2); *see, also, Patterson v. Shumate*, 112 S.Ct. 2242 (1992). More specifically, Bankruptcy Code §541(c)(2) provides that "[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 bankruptcy case. There is a strong congressional intent underlying the Bankruptcy Code to protect spendthrift trusts and to exclude assets in such trusts from a bankruptcy estate. The Ninth Circuit Court of Appeals has held that a valid spendthrift trust created under state law is excluded from a bankruptcy estate pursuant to §541(c)(2). *See In re Moses*, 167 F.3d 470 (9th Cir. 1999).

## Fraudulent Transfers

The bankruptcy estate representative (the trustee) has the power to recover for the benefit of the debtor's creditors certain transfers made by the debtor prior to bankruptcy. Bankruptcy Code §548 allows the trustee to avoid and recover transfers

made within one year prior to the bankruptcy with intent to hinder, delay or defraud creditors or made by an insolvent debtor for less than reasonably equivalent value. Further, Bankruptcy Code §544 empowers the trustee to avoid and recover transfers that are recoverable by an existing unsecured creditor under state law. For example, because a bankruptcy trustee enjoys the power of a hypothetical judgment creditor, the trustee can utilize California Probate Code §15306.5 to remove 25 percent of the debtor's interest in a valid spendthrift trust from traditional spendthrift status so long as that amount is not determined by the court to be necessary for the support of the beneficiary or the beneficiary's dependents. See *In re Neuton*, 922 F.2d 1379.

Under the Uniform Fraudulent Transfer Act, a transfer to a trust established to defraud the settlor's creditors is void. Abuse of a trust by a settlor, such as using a purported spendthrift trust as a private bank account, is evidence of intent to defraud creditors and therefore supports setting aside the trust and allowing the settlor's creditors to reach the trust *res*. See *U.S. v. Lawrence*, 189 F.3d 838, 845 (9th Cir. 1999). In determining fraudulent intent, the courts look to badges (or elements) of fraud such as

(1) inadequacy of consideration involved in the transfer, (2) the closeness of the relationship between the transferor and transferee, (3) the transferor's insolvency as a result of the transfer, (4) whether or not the transfer was in the ordinary course, (5) the transferor's retention of control following the transfer and/or (6) the timing/hasty nature of the transfer.

### Offshore and Asset-protection Trusts

Offshore trusts and asset-protection trusts may be used to attempt to place assets beyond the reach of creditors and a bankruptcy trustee. However, even assuming that the establishment of the trust did not constitute a fraudulent transfer, under the Bankruptcy Code's broad definition of the bankruptcy estate, certain assets placed in an offshore trust or in an asset-protection trust may nevertheless be held to be the assets of the bankruptcy estate and subject to the bankruptcy court's jurisdiction. A U.S. Bankruptcy Court may simply refuse to allow laws of foreign jurisdictions or states to control if it finds that such laws are repugnant to public policy. See *In re Brooks*, 217 B.R. 98 (Bankr. D. Conn. 1998).

Since 1997, two states—Alaska and Delaware—have been in competition for asset-protection trusts. The laws in those

states provide certain spendthrift protection to self-settled trusts. However, courts in states that are hostile to self-settled spendthrift trusts are unlikely to enforce spendthrift trust provisions in self-settled asset-protection trusts regardless of the effect that those provisions might have under the law of the trust *situs*. See *In re Portnoy*, 201 B.R. 685 (Bankr. S.D.N.Y. 1996); *In re Brooks*, 217 B.R. 98 (Bankr. D. Conn. 1998); *In re Lawrence*, 227 B.R. 907 (Bankr. S.D. Fla. 1998). Moreover, the nationwide jurisdiction of federal bankruptcy courts operates as a check on the power of states to export asset-protection trust legislation. This diminishes the utility of Delaware and Alaska asset-protection trusts since a federal bankruptcy court, unlike a state court, has the power to directly reach a debtor's assets throughout the United States. While a U.S. Bankruptcy Court does not have power in foreign jurisdictions, it does have the power to deny a debtor trust settlor a discharge (obtaining a discharge is generally the primary goal of an individual debtor when filing bankruptcy). Accordingly, the U.S. Bankruptcy Court can exert substantial leverage over a debtor even with regard to an offshore trust that cannot be reached by a U.S. court. ■