

Creditor Claims and the Oregon Uniform Trust Code

The legislature enacted the Oregon version of the Uniform Trust Code (the "OUTC") as part of chapter 348 of the 2005 Oregon Laws. Article 5 of the Uniform Trust Code, now codified in Oregon at ORS 130.300-130.325, deals with creditor claims against trust assets. The OUTC is consistent with many aspects of prior law in the area, but it does make some important changes. This article highlights both the changes and the legal rules that have been preserved.

Rights of Creditors When There Is No Spendthrift Provision

The basic rule involves a simple beneficiary who is neither trustee nor grantor, who is not protected by a spendthrift provision, and who does not owe money to special, favored classes of creditors. The rule is that a creditor may reach the beneficiary's interest in trust distributions by garnishment or other execution against present or future distributions to or for the benefit of the beneficiary. ORS 130.300. However, "[t]he court may limit the award to such relief [to the creditor] as is appropriate under the circumstances." *Id.* This limitation applies because proceedings to satisfy creditors' claims are equitable in nature. The drafters' comments to the section explain that "the court may appropriately consider the support needs of a beneficiary and the beneficiary's family." "The Oregon Uniform Trust Code and Comments," 42 *Willamette L Rev* 187, 284, cmt to ORS 130.300 (2006) ("Code and Comments"). The basic rule of ORS 130.300 is consistent with prior law. See *Restatement (Second) of Trusts* § 147 (1959); *Restatement (Third) of Trusts* § 56 (2003).

The authorization of garnishment simplifies the procedure for creditors. Under prior law, judgment creditors against beneficiaries could not garnish beneficiaries' trust interests because ORS 18.618(1)(a) prohibited garnishment of equitable interests. Creditors instead had to resort to the equitable remedy of a creditor's bill. Creditor's bills should no longer be necessary to reach beneficiaries' interests in Oregon. Section 98a of Chapter 348 of the 2005 Oregon Laws amends ORS 18.618 to permit garnishment of equitable interests to the extent permitted by the OUTC. Also, section 39 of chapter 348 specifically authorizes creditors to use "garnishment or other execution against present or future distributions."

The Uniform Trust Code does not supersede state exemption statutes. UTC Article 5, general comment, 7C ULA 174 (2003). Thus, if an interest in property would be exempt from creditors under non-trust law, then a beneficiary's interest in a trust consisting of the exempt property should also be protected. *Restatement (Second) of Trusts* § 149 (1959); *Restatement (Third) of Trusts* § 56, cmt d (2003). *But see In re Bowers*, 222 BR 191 (Bankr D Mass 1998) (bankruptcy homestead exemption of 11 USC § 522(d)(1) did not protect debtor's home that was owned by his revocable trust). Exemptions provided by Oregon law are set forth in ORS 18.300-18.428.

Spendthrift Provisions

Definition of spendthrift clause. Spendthrift clauses prohibit beneficiaries from selling or borrowing against their trust interests, and prohibit creditors from reaching those trust interests against the beneficiaries' wishes. For example, a trust might provide that a beneficiary's interest is "not subject to claims of creditors, nor to legal process, and may not be voluntarily or involuntarily anticipated, alienated, or encumbered." Or a trust could simply state, "This is a spendthrift trust." See ORS 130.305(2); *Restatement (Third) of Trusts* § 58, cmt b(3) (2003).

Validity of spendthrift clauses. Under prior law, spendthrift clauses of trusts established for beneficiaries by third parties were generally valid. *E.g., Shelley v. Shelley and U.S. Nat. Bank*, 223 Or 328, 354 P2d 282 (1960); *Stein v. U.S. National Bank*, 165 Or 518, 524, 108 P2d 1016 (1941); *Mattison v. Mattison*, 53 Or 254, 100 P 4 (1909). The OUTC preserves this rule. ORS 130.305(1). However, a partial spendthrift clause, which permits the beneficiary voluntarily to transfer his or her interest, is invalid. ORS 130.305(2). Also, funds from a spendthrift trust can be reached by creditors once the funds are distributed, or if the trustee has retained them after the time due for distribution. ORS 130.305(3), 130.320.

Disclaimers. A disclaimer by the beneficiary, because it is a refusal to accept ownership of an interest and not a transfer of an interest already owned, is not affected by the presence or absence of a spendthrift provision. See Code and Comments at 285, cmt to ORS 130.305; see also ORS 105.629(6) (disclaimer made under ORS 105.623-105.649 "is not a transfer, assignment or release").

Exceptions to Spendthrift Provisions

Under ORS 130.310, certain favored classes of creditors may reach a beneficiary's interest despite the presence of a spendthrift provision. The favored claims involve judgments for child or spousal support; judgments in favor of providers of services to protect the beneficiary's interest in the trust; and certain claims of the state of Oregon or the United States.

Spousal support and child support. ORS 130.310(2) permits a former spouse or a child to enforce a support order by attaching the beneficiary's present or future trust distributions, even if the trust contains a spendthrift provision. Distributions subject to execution include mandatory distributions and discretionary distributions that the trustee has otherwise decided to make. However, the Oregon comment to this section notes that it "does not authorize the spousal or child claimant to compel a discretionary distribution from the trust." Code and Comments at 287, cmt to ORS 130.310.

ORS 130.310(2) contains a limitation not present in the uniform version of the Uniform Trust Code: The court may issue an order reaching the beneficiary's interest in "such amount as the court determines to be equitable under the circumstances but not more than the amount the trustee would have been required to distribute to or for the benefit of the beneficiary." For child and spousal support, a reduction in the amount of a collection order, based on the "equitable under the circumstances" part of this limitation, may be the exception, not the rule. As the comment to this section states, "Before fixing this amount, the court having jurisdiction over the trust should consider that in setting the respective support award, the family court has already considered the respective needs and assets of the family." Code and Comments at 287-88, cmt to ORS 130.310.

Expenses to Preserve Beneficiary's Interest in Trust. ORS 130.310(2) permits a judgment creditor who has provided services for the protection of the beneficiary's interest in a spendthrift trust to garnish the present or future distributions to or for the benefit of the beneficiary. This exception enables a beneficiary of modest means to obtain services to defend his or her rights in the trust. The exception is subject to the same equitable limits that apply to claims of spousal or child support.

Federal and State Claims. A spendthrift provision is unenforceable against a claim of the state of Oregon or the United States to the extent an Oregon or federal statute so provides. ORS 130.310(2). This exception is consistent with the Restatement. *Restatement (Second) of Trusts* § 157(d), cmt e (1959); *Restatement (Third) of Trusts* § 59, cmt a (2003). It recognizes that state and federal governments, by statute, have the power to bypass a spendthrift provision

no matter what trust law may say. The federal tax lien is an example. However, the OUTC does not prescribe a rule on when other statutes give supremacy to governmental claims.

Some lawyers in Oregon and elsewhere have expressed concern that the exception for federal and state claims will jeopardize special needs trusts for disabled recipients of public assistance. Compare Mark Merric & Douglas W. Stein, "A Threat to All SNTs," *Tr & Est*, (Nov. 2004), at 38, with Suzanne Brown Walsh, et al. "What is the Status of Creditors Under the Uniform Trust Code?," *Est Plan*, Feb. 2005, at 29, 34. Under current federal law, which is binding on states, special needs trusts funded by a third party (i.e., parent) are not considered "available" for eligibility purposes if they leave distributions solely to the trustee's discretion and (in the view of more cautious practitioners) limit distributions to the beneficiary's supplemental needs not covered by public assistance. Special needs trusts funded with the recipient's own assets are subject to stringent rules and normally do not preserve the assets, after the recipient's death, for other family members. See generally *Special Needs Trusts* (OSB 2003); *Elder Law* chs 8, 9 (Oregon CLE 2000 & Supp 2005); Clifton Kruse, *Third-Party and Self-Created Trusts* (3d ed 2002). The real concern perhaps is that a new express exception for state or federal claims will trigger an open season on special needs trusts. But the Congress, which holds the keys, has long had the power to change Medicaid law. Its recent tinkering with that law has not included a challenge to special needs trusts. The policy reasons still apply that, in the past, persuaded the Congress to respect constituents' wishes, within broad limits, in leaving their life savings to loved ones.

Other Exceptions Excluded. Commentators and courts have sometimes suggested that other classes of creditors, such as tort victims, be permitted to reach assets of trusts with spendthrift provisions. However, the UTC excludes these other exception creditors. See ORS 130.305(3) ("Except as otherwise provided in ORS 130.300 to 130.325, a creditor or an assignee of a beneficiary may not reach the interest of a beneficiary or a distribution by the trustee before the distribution is received by the beneficiary.").

Notable among these unlisted creditors are providers of necessary goods and services to the beneficiary. The comments explain that most of these cases involve claims by governmental entities, which are better handled by special legislation. See Code and Comments at 286, cmt to 130.310.

Discretionary Trusts, Support Trusts, and Forfeiture Clauses

Discretionary Trusts. Section 504 of the Uniform Trust Code generally prohibits creditors from compelling distributions from discretionary trusts. The section includes an exception for creditors who seek to enforce payment of spousal or child support. Section 504 has proved controversial. *See, e.g.,* Mark Merric & Steven J. Oshins, “UTC May Reduce the Asset Protection of Non-Self-Settled Trusts,” *Est Plan*, Sept. 2004, at 411. Oregon did not adopt the section, because of disagreement among interest groups on the proper scope of enforcement of spousal and child support against discretionary trusts. *See* Code and Comments at 289, cmt regarding omitted section 504.

Without section 504, it appears that the governing law in Oregon remains *Shelley v. Shelley*, 223 Or 328, 354 P2d 292 (1960). In *Shelley*, the court held that the trust’s spendthrift provision was ineffective to bar claims of the beneficiary’s children and the former spouse against the beneficiary’s *mandatory* income interest, but the court could consider various factors in making equitable adjustments between the claimants and the beneficiary. On the other hand, the court noted that the beneficiary could not demand discretionary distributions, and therefore the children and former spouse could not either.

Hybrid Trusts. Some trusts call for distributions to beneficiaries in the trustee’s discretion, but based on a standard, such as support. The extent to which creditors of beneficiaries can compel distributions from hybrid trusts is unclear.

Forfeiture Clauses. A trust may provide that the beneficiary’s interest in trust income or future payments of principal will be forfeited if the beneficiary’s creditors attempt to reach the interest. The OUTC does not address forfeiture clauses. However, under common law they are generally valid, unless the beneficiary is entitled to immediate distribution of principal; the principal is payable to the beneficiary’s estate after the beneficiary’s death, *Restatement (Second) of Trust* § 150, cmt b, § 153 (1959); or the grantor has retained a beneficial interest in the trust, *Restatement (Third) of Trust* § 57, cmt b (2003). It is doubtful that the OUTC will be held to overturn the effectiveness of these clauses. *See* ORS 130.025 (common law of trusts and principles of equity supplement the OUTC, except as modified by the OUTC or other law).

Creditor’s Claim against Trust Settlor

During Settlor’s Lifetime. During a settlor’s lifetime, creditors can reach property of a revocable trust, whether or not it contains a spendthrift provision. ORS 130.315(1). This is consistent with prior law. *Restatement (Second) of Trusts*

§ 156(1) (1959); *Restatement (Third) of Trusts* § 58, cmt b (2003). A creditor of the grantor of an *irrevocable* trust may reach the maximum amount that can be distributed to, or for the benefit of, the grantor. If the trust has multiple grantors, the amount the creditor of one can reach may not exceed that grantor’s interest in the portion of the trust attributable to that grantor’s contribution. ORS 130.315(1)(b).

After Settlor’s Death. If a trust was revocable at the settlor’s death, the property of the trust, after a trust settlor’s death, “becomes subject to creditors’ claims as provided in ORS 130.350 to 130.450 when the settlor dies.” ORS 130.315(1)(c). This is consistent with prior law. *See Johnson v. Commercial Bank*, 284 Or 675, 588 P2d 1096 (1978). “The payment of claims is subject to the settlor’s right to direct the priority of the sources from which liabilities of the settlor are to be paid.” ORS 130.315(1)(c).

ORS 130.350 to 130.450 describes the optional, probate-like notice-and-claim procedure that the trustee may initiate. This procedure was previously codified at ORS 128.256 to 128.300. The reference in ORS 130.315(1)(c) might be read to limit the right of recovery against trust assets to instances in which the trustee elects to invoke the procedure. However, that was not the intent of the section drafters. As the comments state: “[The subsection] recognizes that a revocable trust is usually employed as a will substitute. As such, the trust assets, following the death of the settlor, should be subject to the settlor’s debts and other charges as provided in ORS 130.350 through 130.450.” Code and Comments at 291, cmt to 130.315. Moreover, if ORS 130.315(1)(c) left it up to trustees to decide whether revocable trust assets were available to creditors, that section would be meaningless. No trustee would open up trust assets to creditors, because that would likely violate the trustee’s fiduciary duty to beneficiaries.

For purposes of creditors’ claims, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust, to the extent property of the trust is subject to the power. ORS 130.315(2). This, too, is consistent with prior law.

Who Is a Trust Settlor? Sometimes a beneficiary is treated as a settlor, even without having contributed assets. Two common examples involve beneficiaries of Crummey trusts and tort claimants.

With a Crummey trust, one person makes gifts of property to a trust and gives beneficiaries a brief period to elect to withdraw their shares of the assets contributed. Because the beneficiaries have a right of withdrawal, the gifts are present interests that qualify for the annual gift tax exclusion under IRC § 2503(b). Although there is no case law on point, a trust beneficiary with a Crummey power could be treated as a settlor for purposes of creditors’ claims. If so, the spendthrift provision may not protect

property that was subject to the withdrawal power. The IRS already treats a Crummey power holder as a grantor for income tax purposes. *See, e.g.*, PLR 200157044.

The OUTC reduces this potential risk. First, ORS 130.315(2) provides that the holder of a power of withdrawal is treated as the settlor, for purposes of the claims of creditors, only while the power may be exercised. Thus, if the withdrawal power lapses after 30 days, creditors must take action during that brief period. Thereafter, or after the power is released or waived, the trust property that is the subject of the lapse, release, or waiver becomes available to creditors of the holder of the power only to the extent the value of the property exceeds the greater of the amount specified in IRC sections 2041(b)(2) or 2514(e), as in effect on January 1, 2006 (greater of 5 percent or \$5,000), or the amount specified in IRC section 2503(b), as in effect on that date (\$12,000). ORS 130.315(3).

Spendthrift trusts are often established by court decree or by agreement to satisfy tort claims originally presented by the beneficiaries. Even though the beneficiaries are not the nominal grantors, these trusts are treated as self-settled trusts available to creditors. *E.g.*, *In re Jordan*, 914 F2d 197, 198 (9th Cir 1990); *In re Stragalas*, 208 BR 693, 694 (Bankr D Ariz 1997); *see Restatement (Third) of Trusts* § 58, reporter's notes cmt f (2003) (collecting cases).

Powers of Appointment. The OUTC does not address the extent to which creditors can reach property subject to a special power of appointment or a testamentary general power of appointment held by a debtor. Code and Comments at 292. For a summary of creditor rights, see Jonathan Levy and James Cavanaugh, "Creditors' Rights and Spendthrift Clauses," *Administering Trusts in Oregon* §§ 8.12-.20 (OSB CLE 2000 & pending revision).

Personal Obligations of Trustee

Non-Beneficiary Trustee. Normally, assets held by a debtor who is a trustee for others but is not a beneficiary are unavailable to the debtor or the debtor's creditors. 5 *Collier on Bankruptcy* ¶ 541.11[5] (Lawrence P. King ed., 15th ed 2006); *In re Coupon Clearing Service, Inc.*, 113 F3d 1091, 1099 (9th Cir 1997). The OUTC preserves this rule. ORS 130.325.

Beneficiary Trustee. Creditors may have more success if the debtor-trustee is also a beneficiary. In the view of the Third Restatement of Trusts, creditors can reach assets to the extent debtor-trustee could distribute those assets for himself or herself. *Restatement (Third) of Trusts* § 60, cmt g (2003). The OUTC contains a nonuniform provision that narrows the reach of creditors. In essence, the trust assets are protected from creditor claims to the extent the trustee's discretion is limited by an ascertainable standard. ORS 130.315(4). The commentary to this language explains

that the broader availability of assets to creditors under the Restatement would "unduly disrupt standard estate planning." *See* Code and Comments at 287, cmt to 130.315.

An additional safeguard against creditors, when a beneficiary is a trustee, is to name one or more co-trustees whose consent is required for distributions or who have sole discretion for distributions to the trustee-beneficiary. *In re Hersloff*, 147 BR 262 (Bankr MD Fla 1992); *In re Schwen*, 240 BR 754 (Bankr D Minn 1999). If the trustee cannot force distributions, creditors should not be able to do so either.

Trustee Removal Power. There is a risk that a non-trustee beneficiary will be treated as a trustee, or that a spendthrift provision will be treated as illusory, if the beneficiary has the power to remove and replace the trustee with a person under the beneficiary's control. *See In re Baldwin*, 142 BR 210 (Bankr SD Ohio 1992). It is safer to permit the beneficiary to appoint only a bank, trust company, or other independent trustee.

Conclusion

Richard Feynman, the Nobel-laureate physicist, wrote that "[w]e do not yet know all the basic laws; there is an expanding frontier of ignorance." Richard Feynman, *Six Easy Pieces: Essentials of Physics Explained by Its Most Brilliant Teacher* at 2 (1963). For lawyers, the challenge is to keep the frontier of ignorance in check. Trust lawyers now must master the elements of the Oregon Uniform Trust Code. This article is an attempt to introduce the basics of the creditor provisions of the OUTC.

For further reading, useful resources include the comments of the National Conference of Commissioners on Uniform State Laws ("NCCUSL") and comments of the committee that drafted the OUTC. The NCCUSL comments are available in volume 7C of the Uniform Laws Annotated and at the Web site of the University of Pennsylvania Law School, www.law.upenn.edu/bll/ulc/ulc.htm. The Oregon comments have been published in volume 42, number 2 of the Willamette Law Review, cited in this article. For a more detailed treatment of creditors' rights against trusts assets, see Jonathan Levy and James Cavanaugh, "Creditors' Rights and Spendthrift Clauses," *Administering Trusts in Oregon*, ch 8 (OSB CLE 2000 & pending revision).

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