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Safeguard Trusts from Future Ex-Spouse of Beneficiary

*A recent Massachusetts case has important divorce planning lessons *

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Trusts are ubiquitous in planning, and one of the most common motivations for the use of trusts is to minimize the risk that a future divorce of a trust beneficiary will

expose trust assets to the reach of that ex-spouse.

A recent Massachusetts case, *Pfannenstiehl v. Pfannenstiehl*,[1] potentially undermines the use of trusts to safeguard assets from attack in divorce in Massachusetts. But practitioners in many other jurisdictions should consider the warning signs of this case. Whether or not the case was appropriately decided, it highlights many practical steps practitioners should take in all jurisdictions to make trusts safer from attack by the future ex-spouse of a beneficiary.

Typical vs. Modern Trust

The typical or traditional trust done for a child or grandchild is unlikely to provide the desired protection. Applying common modern trust planning and drafting techniques (summarized in a checklist at the end of the article) will place the client's heirs in a much safer position.

Typical trust: Child is a trustee of her own trust and has the right to make distributions to herself pursuant to an ascertainable standard (health education maintenance or support (HEMS)), the trust is formed in the family's home state and the trust ends by distributing all trust assets to the heir at some specified age, say 50.

Modern trust: A completely discretionary trust, with a corporate trustee, organized in a trust friendly state that continues for a long term or in perpetuity and makes irregular distributions that don't follow a particular pattern. Clients sometimes complain about the cost, complexity, duration or other aspects of a modern trust. But as this recent case makes clear, and as other cases suggest, clients who want their divorce protection goals achieved should weigh the benefits of those negative factors against the more important goal of protecting trust assets.

Move to Less Favorable Jurisdictions

Practitioners should recognize the risk that clients may relocate. So even if a trust is created in a jurisdiction that has more favorable law (for example, New Jersey, as

discussed briefly below), if the couple relocates to a new jurisdiction and the trust is administered there, that new jurisdiction's laws may be applied in a later divorce thereby undermining the planning. Further, there's no certainly in many states that the law favorable to the protection of a trust from a later divorce won't be changed after the trust is created.

About 40 million people move annually in the United States. Nearly three-fourths of the U.S. population moves an average of once every five years. Is it realistic to rely on a settlor's home state law applying to protect a beneficiary years or decades in the future? Wouldn't prudence suggest a more conservative or safer approach be used when a trust is first drafted to enhance the likelihood of protection in the future?

Pfannenstiehl

In *Pfannenstiehl*, the court held that the assets of a trust would be considered as part of the marital estate. Massachusetts law takes an expansive view of what constitutes a marital estate. The court ruled that a portion of a trust created by the parents of the divorcing husband for his benefit and for the benefit of his siblings, was to be considered as a marital asset in his divorce.

The couple had two children with special needs for whom the wife provided most care. Almost one-half of the family's income came from distributions from the family trust in question. The husband's brother and the family attorney were co-trustees of the trust. Distributions from the trust stopped just prior to the divorce filing.

The trust included a standard of distribution based on HEMS. The court reasoned that this standard gave the husband a present enforceable right to distributions. The court also noted that the husband would receive an outright distribution of his share of the trust at a specified future date and determined that one half of that should be distributed to the wife.

The trust had 11 beneficiaries to whom distributions could be made, and the class was open in the sense that future descendants would be added. While this was a

positive fact, the court didn't appear to restrict its holding based on this.

The dissent, consisting of two of the five judges, argued that the distribution standard was too speculative to value. The dissent wasn't swayed by the cessation of distributions on the eve of the divorce and argued that the focus should be on the terms of the trust, not on the actions taken.

As a caution to attorneys serving as trustees, the court didn't view the attorney as independent in light of the business his firm did with the family.

Although the trust included a spendthrift provision, the court was influenced by the pre-divorce pattern of distributions and the cessation of distributions just prior to the divorce. It held that it wasn't appropriate for the husband to have benefitted from the asset and then have a spendthrift provision apply to protect the trust while he neglects to provide for the family he has a legal obligation to support. The court also viewed the cessation of distributions on the eve of the divorce as a "machination."

The husband borrowed money from his father to make payments as required under the divorce settlement, and when those payments ran out, he requested distributions from the trust. To no ones' surprise, the brother and family lawyer as trustees refused distributions.

Support Versus Discretionary Trusts

To understand the essence of many of the matrimonial decisions addressing trusts, the distinction between a "support" and a "discretionary" trust needs to be clarified. A "support" trust directs the trustee to make distributions to support the beneficiary. A common support standard is HEMS. This is the type of trust that was reached in the *Pfannenstiehl* case. A "discretionary" trust grants the trustee the discretion to determine if, when and how much to distribute from the trust to the beneficiary.

As a generalization, if a trust were characterized as a pure support trust, the court might be inclined to enforce the beneficiary's interests in the trust in a matrimonial action. If the trust is a pure discretionary trust, the courts would be harder pressed to find an interest to enforce, and the trust would be less likely to be reachable. In reality, many trusts are combinations of the two standards, and that makes the decision process murkier.

Other states take a different view of the protections afforded by a trust. For example, New Jersey reached a very different result in *Tannen v. Tannen*.[2] The significance of the *Tannen* decision is the rejection of the *Restatement Third of Trusts* provision that a discretionary trust can be enforced as a support trust (based on the notion that the trustee must act in the best interests of the beneficiary). Instead, the decision reaffirmed that New Jersey will follow the *Restatement Second of Trusts* position that a purely discretionary trust will be honored as giving the trustee unfettered discretion to distribute or not distribute, regardless of the support needs of the beneficiary.

A recent Delaware case makes suggests that having a trust formed in a trust friendly will automatically assure that the courts in that jurisdiction will hear the case.[3] The fact that a Delaware court may have jurisdiction doesn't mean that another court outside of Delaware can't exercise jurisdiction over the case. Also, even if a Delaware court has primary jurisdiction over administrative issues relating to Delaware trusts, courts in other states may still exercise jurisdiction over matters of trust administration so long as doing so wouldn't constitute "undue interference" with Delaware's primary jurisdiction. In this case, the husband was a trustee of a Delaware trust. His wife sought to have the trust treated as marital property in their Kentucky divorce. The husband had served as a special trustee with distribution and investment powers. The husband resigned those positions, and the Delaware trustee endeavored to have the Delaware courts rule that the Delaware courts had exclusive jurisdiction. The court declined to do so.

A Florida court permitted the former spouse of a beneficiary to access distributions, as they were made from a discretionary trust.[4]

Checklist of Lessons

The following is a checklist of planning suggestions based on *Pfannenstiehl* :

- Use a true independent trustee, such as a corporate trustee. If counsel serves as trustee, consider adding an assuredly independent co-trustee.
- Form the trust from inception in a trust-friendly jurisdiction that's less likely to undergo a possible transformation in case law (for example, Nevada). If the trust is situsedin a jurisdiction whose law may be less certain, evaluate whether a change of situs could be completed.
- Eliminate distributions pursuant to an ascertainable standard in favor of fully discretionary distributions held by an independent trustee. In *Pfannenstiehl*, that would have been problematic because the brother was also a co-trustee, but this could have been addressed by having separate trusts for each child or including provisions preventing an interested trustee, such as a trustee/beneficiary, from making distributions or limiting those distributions to an ascertainable standard (not the optimal approach).
- If distributions are to be made, avoid a pattern of regular distributions to support a beneficiary's lifestyle and instead plan distributions to be erratic and not correlated with major life events (for example, beneficiary buying a house, beneficiary's child marrying, etc.).
- Use long term or perpetual trusts, not trusts that end when a beneficiary attains a specified age or at some other ascertainable time period.
- Don't make radical changes in distributions on the eve of a divorce and expect a court to be sympathetic.
- Clients should sign prenuptial agreement that disclose and exclude interests in family trusts.

If any of the aspects of the trust aren't optimal, endeavor to decant the trust into a newer and more favorably structured trust well in the advance of any challenge, including divorce. The wider use and availability of decanting has post-dated many of the unfavorable matrimonial/trust decisions and presents an opportunity for practitioners to improve older client trusts that aren't optimal.

Review Existing Trusts

Advise clients to review the terms of all existing trusts, and the administration of those trusts, to ascertain whether improvements can be made to enhance the likelihood of the trust withstanding a matrimonial challenge.

Endnotes

1. *Pfannenstiehl v. Pfannenstiehl,* Mass. App. Ct., Nos. 13-P-906, 13-P-686 & 13-P-1385 (Aug. 27, 2015).
2. *Tannen v. Tannen*, 416 N.J. Super. 248 (App. Div. 2010), aff'd, --- N.J. ---, --- A.3d ----, 2011 WL 6090130 (2011).
3. I*MO Daniel Kloiber Dynasty Trust U/A/D Dec.*, 2002 C.A. No. 9685-VCL (Aug. 1, 2014).
4. *Berlinger v. Casselberry*, Case No. 2D12-6470 (Fla. 2d DCA Nov. 27, 2013).