“These Boots Were Made For Walking”
Is Your Trust Walking Too?
Evaluating the Impact of Divorce on Irrevocable Spendthrift Trusts

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Throughout Anglo-American history, wealthy individuals have explored mechanisms to protect and transfer wealth to their descendants through irrevocable trusts.[1] While irrevocable discretionary and spendthrift trusts are not new to trust law, irrevocable trusts have become significantly more complicated in modern trust law with terms and conditions used within the trust instruments often designed to (i) attain protection against creditors, (ii) maintain silence or privacy of the existence of the trust and its assets, (iii) minimize transfer tax, and (iv) continue in perpetuity over decades (and possibly even forever where the perpetuities period has been abolished) in dynastic trusts. The result of the increased use of these complex trust structures is that family court judges in divorce are now faced more than ever with not only unwinding the complexities of the finances of the marriage, but of also interpreting sophisticated and complex trust instruments that may not be within the usual purview of the family court. Further, family court decisions regarding trusts often impact other trust beneficiaries who are not parties to the divorce proceedings. Adding to this complexity, trusts are no longer limited by administration in a single jurisdiction. Trusts and beneficiaries are now more mobile than ever, having assets in multiple jurisdictions within and outside the United States. Courts in one state may be interpreting trusts and deciding jurisdictional issues related to the impact of a trust in a divorce while the trust is being administered in a different jurisdiction where the trustee does not reside, potentially leading to competing judgments and inconsistent decisions.

The famous lyrics to Nancy Sinatra's 1966 rendition of Lee Hazlewood's song "These Boots Were Made For Walking" detail the pain, anger, and revenge that often accompany divorce, and lead to not only a threat to walk away from the relationship, but also to do so in a manner that "walks all over" the one left behind. Tales of famous divorce proceedings make news on a regular basis with divorcing couples fighting over the kids and assets, bringing out the worst in both parties. While assets of the respective spouses have long been the target of dispute in divorce, a large number of divorce proceedings, especially among the wealthy, now involve a fight over assets that are not in the name of either spouse, but rather are held in the name of one or more irrevocable spendthrift trusts. With the increase in the use of spendthrift trusts, and specifically with the increase in the use of irrevocable dynastic asset protection trusts, it is not surprising that litigation over the interests in such trusts has found its way into divorce proceedings at an alarming rate.[2]

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[1] *See* Sitkoff, Robert H. and Dukeminier, Jesse, *Wills, Trusts And Estates*, 702 (11th ed. 2022).

[2] *See* Poppe, Emily S. Taylor, *Surprised by the Inevitable: A National Survey of Estate Planning Utilization,* 53 U.C. Davis L. Rev. 2511, 2545-46 (2020) (addressing an increase in trust usage). *See* also *In the Matter of the Living Tr. of Davies*, 138 Nev. Adv. Op 89, 522 P.3d 427 (2022) (addressing the use of trusts increasing in even simple planning).

This material will explore the impact of divorce on irrevocable trusts, and particularly on spendthrift trusts, including identifying areas of vulnerability for both the attacking spouse and defending spouse, as well as considering best practices for drafting such trusts to survive divorce.

I.
UNDERSTANDING IRREVOCABLE DISCRETIONARY TRUSTS VS. SPENDTHRIFT TRUSTS

Before exploring the impact of marital dissolution on discretionary trusts and spendthrift trusts, it is important to first understand what they are and are not.

A "discretionary trust" is typically a trust that provides the trustee with some type of discretion in the exercise of a distribution power to determine whether a distribution should be made, when a distribution should be made, and/or the amount of the distribution.[3] There are a variety of types of discretionary trusts including those that provide the trustee with the complete and unfettered discretion over distributions known as a "purely discretionary trust", and those that provide for certain distributions (often for support) if certain conditions are met as determined in the discretion of the trustee ("support trust"). In some cases, the nature and extent of the discretion create a hybrid trust that may have some resemblance to a support interest, but that subject the support interest to certain discretionary authority by the trustee ("hybrid support trust").[4]

Drafters of purely discretionary trusts will often use words such as "the trustee *may*, in the trustee's sole and absolute discretion, distribute as much or as little as the trustee determines" without reference to a standard of distribution. Purely discretionary trusts have long been touted as beneficial for asset protection since the beneficiary holds no authority to compel a trustee to make a distribution.[5] However, this representation is not always accurate. The extent of discretion may significantly depend on the law and policy of the applicable jurisdiction. For example, in the recent New York case of *Bildner v. Bildner*, the New York Superior Court held that "sole and absolute discretion" did not really mean that the trustee could repeatedly deny the beneficiary's requests for a distribution for educational expenses as the trustee had a duty of good faith and an absolute duty of loyalty to the beneficiary to consider the beneficiary's financial circumstances.[6] However, in other states like Nevada, both the Nevada Supreme Court and the Nevada legislature have determined that discretion really does mean discretion, making it difficult for a beneficiary to compel a distribution absent a finding that the trustee was dishonest, acted in bad faith, or committed willful misconduct.[7] In fact, Nevada law provides that "[a] trustee given discretion in a trust instrument that is described as sole, absolute, uncontrolled, unrestricted or unfettered discretion, or with similar words, has no duty to act reasonably in the exercise of that discretion" evidencing that failure to act reasonably does not evidence bad faith

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[3] Nevada Revised Statutes ("Nev. Rev. Stat.") § 163.4185.

[4] Nev. Rev. Stat. §163.4185(2).

[5] RESTATEMENT (SECOND) OF TRUSTS § 155 cmt. B (Am. Law Inst. 1959).

[6] *See Bildner v. Bildner,* 2023 WL 6162011, No. 160493/2019 (N.Y. Sup. Ct Sept. 21, 2023.

[7] *See* Nev. Rev. Stat. § 163.419(1). *See also In the Matter of the Linda Lee Ward Revocable Tr. Agreement dated July 7, 2004*, 137 Nev. 926 499 P.3d 1217 (2022) and *In Re Matter of William J. Raggio Family Tr.*, 136 Nev. 172 460 P.3d 969 (2020).

or willful neglect.[8] The above difference raises the quintessential question of how a New York family court judge in a divorce proceeding with New York residents might evaluate the discretionary distribution authority of a trustee of an irrevocable discretionary Nevada trust. Would the *Bildner* decision control a New York action by the beneficiary to compel a distribution for support from a Nevada trust despite the contrary provisions of the governing law? This is the burden facing many of our courts.

Even where a purely discretionary trust permits a beneficiary to overcome a discretionary standard under a duty of good faith as in *Bildner*, a separate issue is whether a creditor of the beneficiary (which might include a divorcing spouse or minor child) can compel a distribution in the same manner. The answer rests on the policy of the jurisdictions at issue. By way of example, in *Scanlan v. Eisenberg*, the court held that an unrelated creditor could not reach the trust assets due to a spendthrift clause in the beneficiary's trust despite the fact that such limitation did not negate the potential ability of a beneficiary to pursue a breach of trust to compel a distribution, finding that the beneficiary and trustee have a fiduciary relationship that does not exist for the creditor.[9] In other jurisdictions, courts have held that while the trustee's discretionary decision to withhold distributions from a beneficiary will be upheld, it may be possible to get an order forcing the trustee, when and if a distribution is made, to make that distribution to the creditor first until the judgment is satisfied.[10] This is known as a "Hamilton Order"[11] which is designed to respect the discretion but prevent the beneficiary from benefiting while the creditor is left unpaid. States like Nevada, Alaska, and Wyoming however have legislated to prohibit the same under their policy that discretion means discretion, and as a result, such states have made nearly all discretionary trusts spendthrift trusts in those jurisdictions.[12]

A "support trust" is a trust that often has some discretion but requires the trustee to make a distribution to the beneficiary pursuant to a support standard, often in the form of an ascertainable standard of health, education, support and maintenance within the meaning of Section 2041(b)(1)(A) or 2514(c)(1) of the Internal Revenue Code, 26 U.S.C. 2041(b)(1)(A) or 2514(c)(1).[13] These support trusts, which are often hybrid discretionary trusts, will contain language such as "the trustee <u>shall</u> distribute as much of the trust income as the trustee determines is necessary for the proper health, education, support, and maintenance of the beneficiary. While it is often stated that support and hybrid styled trusts do not have asset protection features, that is not correct. Ordinary creditors are not generally permitted to compel a trustee to make a distribution from a support trust to pay all unrelated creditors.[14] However, such trusts are at risk as to those creditors who have provided support to the beneficiary, and further may be subject to risk from actions by special types of creditors such as spouses and children of

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[8] Nev. Rev. Stat. § 163.419(2).

[9] *Scanlan v. Eisenberg,* 669 F.3d 838 (7th Cir. 2012)

[10] *Berlinger vs. Casselberry*, Fla ed DCA Case No. 2D12-6470, (Nov. 27, 2013).

[11] *Hamilton v. Drogo*, 150 N.E. 496 (N.Y. 1926)

[12] Nev. Rev. Stat. §163.417(3) (2009), Alaska Stat. § 34.40.113 (2020); Wyo. Stat. Ann. § 4-10-504(b)(2020).

[13] *See* Nev. Rev. Stat. §163.4185(1)(b), and (2)-(3) for an example of a support interest and a hybrid interest that contains some support and some discretionary authority for the trustee.

[14] *Young v. McCoy*, 54 Cal. Rptr. 3d 847 (Cal. Ct. App. 2007).

the beneficiary discussed below.[15] Those seeking to maximize asset protection, including as against a spouse, will generally wish to steer clear of such hybrid standards. However, doing so may necessitate use of an independent trustee to avoid transfer tax related issues that may arise with an otherwise purely discretionary distribution power. Clients considering and using hybrid type discretionary trusts may be those that are uncomfortable with granting a trustee absolute discretion and desire for the trustee to act reasonably in making support distributions for the beneficiary's benefit under stated circumstances. Some states, like Nevada, have lumped these hybrid trusts into the discretionary trust section, protecting the beneficiaries and these trusts from all creditors, even against those specialty creditors like spouses in divorce.[16] However, that does not always mean that the Nevada trust is going to be interpreted in Nevada by a Nevada court. Therefore, even in Nevada, there is a concern that support trusts may be vulnerable to creditors. Accordingly, in this area it is important to review the applicable authority and understand the treatment of such standards within the appliable jurisdictions, coupled with the concerns of the grantor who is establishing the trust.

A separate, but related type of trust is a "spendthrift trust." A spendthrift trust is often defined as "a trust in which by the terms thereof a valid restraint on the voluntary and involuntary transfer of the interest of the beneficiary is imposed."[17] A spendthrift trust prevents the beneficiary from assigning his or her beneficial interest in the trust to another. Further, a creditor cannot attach the beneficiary's interest directly or force an involuntary transfer to the creditor. While this might at first seem to be the same as a discretionary trust, that is not the case in all jurisdictions. If a discretionary trust does not contain a spendthrift clause, the beneficiary could in fact assign the beneficiary's interest absent a state prohibition to the contrary (such as exists in Nevada, South Dakota and Wyoming). As noted above, states that have strong asset protection policies tend to define all discretionary trusts as spendthrift trusts. Further, some states such as Delaware have adopted policies that provide that all trusts are presumptively spendthrift even where not stated in the trust instrument.

Spendthrift trusts, while well settled law today, were not recognized under English law and in fact were initially highly criticized under U.S. law. It was deemed against public policy to allow a beneficiary to enjoy his or her property, but restrict the rights of creditors from reaching it to satisfy the person's obligations.[18] Nevertheless, the 1882 Massachusetts case of *Nichols v. Eato*n set the stage for what is well settled law today on the basis that it is the right of the settlor (also known as the grantor) to determine who may or may not enjoy the fruits of such settlor's labors.[19] Spendthrift trusts have historically been settled by a settlor for the benefit of another person, and by its very name, a spendthrift trust suggests that the beneficiary is someone who is a spendthrift in need of protection from himself or herself, as well as from creditors. But establishment of such a trust for oneself was prohibited until the introduction of the "asset protection trust" or "APT." For a long time, APTs were not welcome in the U.S. and were

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[15] *See* RESTATEMENT (SECOND) OF TRUSTS § 157 (Am. Law Inst. 1959).
[16] *See* fn. 2, *supra*.
[17] Nev. Rev. Stat. § 166.020.
[18] *See Vanderbilt Credit Corp. v Chase Manhattan Bank*, 473 N.Y.S.2d 242 (N.Y. App. Div. 1984).
[19] *Nichols v. Eato*n, 133 Mass. 170 (1882).

available only by going offshore to remote jurisdictions that specialized in such trusts. Such offshore trusts were often difficult to navigate as they often involved countries with potentially volatile governments and uncertainty in the safety and security of the resources placed in such offshore trusts. It was also difficult to guarantee access and ability to recover such offshore assets in the event of the settlor's death. Locations such as the Cook Islands and Cayman Islands established themselves as beacons for offshore APTs. However, in 1997, Alaska became the first state to adopt legislation recognizing a domestic APT, now known commonly as a DAPT, or "self-settled spendthrift trust".

While there were, and still are, many nay-sayers who question the use of DAPTs, and who further question the validity of DAPTs under the basis that U.S. Courts will not support the same, such negativity has not proven itself true in all cases. In fact, approximately 20 states have now adopted DAPT legislation of one variety or another.[20] But not all DAPTs are created equal, and the laws from one jurisdiction to another do vary depending on public policy concerns.[21] Notwithstanding the broadening acceptance of spendthrift trusts in the U.S. and the broadening acceptance of the self-settled DAPT, there are a number of recognized exceptions to the enforcement of such trusts. These exceptions are often referred to as "exception creditors" and permit those who fall within the exception to break the spendthrift protection. Typical categories of exception creditors include (i) the beneficiary's spouse and former spouse as to support and alimony; (2) a beneficiary's child (often limited to a minor child); (3) a judgment creditor who has provided services for the protection of a beneficiary's interest in the trust; (4) a claim by a state or federal body, such as for taxes; and (5) a judgment creditor who is the victim of certain types of crimes or intentional torts by the beneficiary. These exceptions vary widely by state and are typically indicative of the public policy of the applicable jurisdiction.[22] For a detailed discussion of the public policy behind exception creditors, see the 2017 Nevada DAPT case of *Klabacka v. Nelson* wherein the Nevada Supreme Court evaluated whether to adopt exception creditors (i.e., a spouse in divorce) against a self-settled spendthrift trust, and concluded that such a decision was a policy decision that was best left to the Nevada legislature who had affirmatively not adopted exception creditors.[23] In fact, very few states, namely Nevada, Utah and West Virginia, have elected to forego exception.[24]

While a review of the exception creditor status of each state is beyond the scope of this material, it is important to review the applicable state laws at issue when addressing DAPTs, exception creditor standards, and evaluating the likely outcomes in such jurisdictions.

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[20] *See* David G. Shaftel, Twelfth ACTEC Comparison of Domestic Asset Protection Trust Statutes (August 2019), available at https://perma.cc/6R96-S58N . See also Oshins & Associates, LLC, Domestic Asset Protection Trust State Rankings Chart, available at https://www.oshins.com/_files/ugd/b211fb_e159190aa9c04112af068c994dc2c144.pdf.

[21] For a state by state comparison, see Bove, Alexander A., Jr., *Domestic Asset Protection Trusts – A Practice And Resource Manual*, American Bar Association (2021).

[22] *See* fn. 2, *supra.*

[23] *Klabacka v. Nelson*, 133 Nev. 164, 394 P.3d 940 (2017).

[24] *See* fn. 2, *supra.*

II.

GENERAL LEGAL CONCEPTS SURROUNDING MARITAL RIGHTS

Understanding the general rules applicable to discretionary and spendthrift trusts, ’'ts appropriate to have a basic understanding of marital rights in the context of marriage, divorce, and death. This section is not intended to be a comprehensive guide to marital rights and does not intend to provide an overview of jurisdictional differences on a state by state basis. Rather, the section provides a general overview of important concepts that may arise in the context of enforcement of marital rights against irrevocable discretionary and spendthrift trusts.

A. Community Property Jurisdictions. Community property concepts originate from France, Spain and Mexico, rather than the English law systems that are generally the basis for much of U.S. law.[25] Community property jurisdictions view the married couple as a “community” and strive to recognize that the efforts of one spouse are for the good of the community. Property acquired prior to the marriage may remain as the separate property of the owner spouse, but property acquired during the marriage is presumed to be property of the community regardless of which spouse was the earner.[26] There are a variety of rules pertaining to the determination of what property will be characterized as separate property versus community property, and even within the community property states, the rules vary. For example, some community property states, like California, have adopted a third property characterization known as “quasi-community property” consisting of property that was separate property but has become quasi-community property during the course of the marriage in California.[27] Given the lack of uniformity within community property states, it is important to review the specific statutory provisions and case law of the state or states at issue without assuming that all community property states will rule the same. A few typical tenets of community property are as follows:

1. Typical Presumptions. There are several presumptions surrounding community property which provides that property acquired during marriage is presumed to be community property and property acquired prior to marriage will be separate property.[28] However, it is more nuanced than that simple statement. For example, Nevada law provides that if any property is purchased during the marriage with one spouse’s separate property funds, the presumption will be that it is community property unless it can be clearly shown that the property was purchased with separate property funds, and no community funds have been utilized to

[25] *See*, Bowen, Angela, You can have the car, just not the DAPT: Domestic Asset Protector Trusts and the Distribution of Property Upon Divorce, ACTEC Foundation (Oct. 11, 2020), available at https://actecfoundation.org/wp-content/uploads/You-Can-Have-the-Car-Just-Not-the-DAPT-Domestic-Asset-Protection-Trusts-and-the-Distribution-of-Property-Upon-Di.pdf.

[26] *See* Nev. Rev. Stat. Chapter 123. *See also,* Willick, Marshal S., *A Summary of Nevada Community Property Law*, available at https://www.willicklawgroup.com/wp-content/uploads/2012/04/Summary-Primer-on-Nevada-Community-Property-Law.pdf

[27] Cal. Fam. Code § 125.

[28] Nev. Rev. Stat. § 123.130 and Nev. Rev. Stat. § 123.220.

maintain the property during the marriage.[29] Further, gifts and inheritance received by one spouse, as well as personal injury awards are often characterized as separate property when received, even if during marriage. But those initial presumptions can quickly change when such property is comingled with community property following receipt.

2. Protecting Separate Property Status. Despite the presumption of community property, it is possible to overcome that presumption and even nullify the presumption through a number of techniques, both pre-marriage and after marriage, as follows:

a. Maintain Records for Tracing. A spouse claiming separate property should keep meticulous records of separate property including (i) a description of the asset(s) considered to be separate property and why (i.e. pre-marriage asset; gift from a parent, etc.); (ii) the value of the property; (iii) how the asset is titled; and (iv) who has access to the account (if held in an account). In many cases, it is the lack of records and cost of tracing that result in otherwise separate property being treated as community property.

b. Keep Separate Property Separate. It is inconvenient, but advisable that the separate property owner (i) keep separate property separate; (ii) maintain separate accounts; (iii) keep title of separate property only in the name of the spouse claiming the separate property; (iv) avoid any comingling of separate property accounts/monies with community property accounts, and (v) be consistent.

c. Understand risk of "creeping community interests" in separate property. Even if the separate property holder successfully keeps all separate property separate and maintains separate title to the property, it is still possible for that property to gain some community property characterization over the course of the marriage, depending on specific facts and circumstances. For example, the holder may have purchased a home prior to marriage that is titled only in the holder's name. If, however, the holder pays a mortgage on the home, and uses community property funds, the holder's spouse could claim a community interest in the asset upon divorce.[30] To avoid any community interest from accruing, the mortgage and all expenses related to the house should be paid only with clearly documented separate property funds. Note that all employment earnings during marriage are community property, absent a prenuptial agreement, so payment of any expenses of this hypothetical house with income earned from employment during the marriage creates a community property interest in the house.[31]

3. Prohibitions on Unilateral Transfers of Community Property. Community property is based on an undivided interest of each spouse in the whole of the asset. In many states, neither spouse can effectuate a transfer of the property, including their one-half (1/2)

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[29] *Kelly v. Kelly*, 86 Nev. 301, 468 P.2d 359 (1970), *Johnson v. Johnson*, 89 Nev. 244, 510 P.2d 625 (1973), *Cord v. Neuhoff*, 94 Nev. 21, 573 P.2d 1170 (1978), and *Malmquist v. Malmquist*, 106 Nev. 231, 792 P.2d 372 (1990).

[30] *Id.*

[31] *Id.*

interest in the whole without the consent of the other spouse during life.[32] This prevents unilateral transfers by one spouse without the consent of the other.[33] This is different than a disposition on death since the "community" is severed by death and allows the deceased spouse to be able bequeath his or her one-half interest to someone else under a Will or other qualified testamentary disposition.[34]

B. Common Law States/Equitable Division. Many states and particularly states in the Mid-West and East Coast have not adopted community property laws, and instead are referred to as common law states. Common law states base marital rights in English law where title to the property often controls.[35] Many common law states have adopted a dual classification system as well that designate property as either marital or separate.[36] Clients in those states may be able to maintain ownership of assets without risk of the community gaining ownership. Most common law states use "equitable distribution" to divide the assets of the married couple on divorce, whereas community property states typically divide community assets equally between the couple, and assign separate property to the separate property owner. Nevertheless, despite the allocation of separate property to the separate property owner, separate awards of alimony can be imposed on the separate property owner.[37]

C. Benefits of Using a Prenuptial Agreement. A valid and binding prenuptial agreement can be a way to protect separate property status. Many states have adopted the Uniform Premarital Act which provides for the establishment and enforcement of such agreements between the parties if properly executed prior to marriage.[38] However, it must be completed not only prior to marriage but also with sufficient time to allow for the agreement to be valid. A prenuptial agreement is only helpful if it is enforceable. Careful attention to the negotiation and execution is important. But it is also important that the parties actually comply with the agreement during marriage. Useful tips toward best practices (even if not legally required) are (i) make sure both parties are represented by independent legal counsel; (ii) prenuptial agreement finalized and fully executed at least 30 days[39] (longer in some jurisdictions) prior to marriage; (iii) make sure the parties are providing a full and complete financial disclosure which may require assistance of counsel to identify (including all assets and liabilities (at a minimum and including beneficial interests)); disclosure of prior tax returns; disclosure of business financial statements; disclosure of personal financial statement; and explore whether there may be any cohabitation rights that need to be waived in the agreement.

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[32] Nev. Rev. Stat. §123.230.
[33] *Id.*
[34] Nev. Rev. Stat.§ 123.230 (1).
[35] *See* Bowen, *supra* at fn. 19.
[36] *Id.*
[37] *See* fn. 2, *supra.*
[38] Nev. Rev. Stat. Chapter 123A (Premarital Agreements – Uniform Act).
[39] Some states have specific time for consideration of a premarital agreement and mandatory rights to revoke such agreements prior to effective date. *See* Cal. Fam. Code § 1615. This author prefers to have 3-6 months prior to marriage to address premarital planning. While there is no specific time in Nevada under which the premarital agreement must be executed prior to the wedding, best practice guidelines indicate that last minute signing on the church steps should be avoided.

There are many arguments that can cut against enforcement including evidence of duress or coercion. Lack of sufficient business acumen or understanding can lead to determinations that the agreement was unconscionable and/or unfair. Further other attacks under contract law may apply.

D. Benefits of using a postnuptial agreement. Postnuptial agreements can also be helpful in clarifying marital rights once married. Postnuptial agreements can alter or clarify property status between married persons as to some or all of the assets of both spouses. Postnuptial agreements generally cannot be used to address, waive or limit the rights of spouses to alimony in case of divorce due to the fact that once married, a confidential relationship exists between spouses that cannot generally be waived after marriage.[40] Although it is not always required, best practice is for both parties to be represented by independent legal counsel. Postnuptial agreements can be challenged on many of the same bases as prenuptial agreements. In some states, there may be requirements for recording the agreement or notice of such agreement to place others on notice of the agreement, and nullification arguments may exist for not only a spouse challenging its validity but also a third party creditor challenging the same.[41]

E. Transmutation Agreements. Transmutation agreements are agreements after marriage that seek to alter the character of one or more assets. Transmutation agreements are really just a form of a postnuptial agreement but are often used to address a specific asset rather than a broader class of issues. Nevertheless, transmutation agreements can be subject to challenge under the same contractual challenges attributable to challenges to postnuptial agreements, and careful attention should be paid to the negotiation and process. Just as for postnuptial agreements, in some states, there may be requirements for recording the agreement or notice of such agreement.

III.

SPOUSAL RIGHTS ON DIVORCE

When divorce proceedings are instituted, there are a variety of claims that spouses may make in the process, and these materials are not intended to address all such claims.

A. Challenges to Ownership & Character of Property. Typically the spouses will face the reality of the division of their assets, depending on the characterization and jurisdictional rules where the divorce proceedings are occurring. To the extent that the spouses disagree on the characterization of property, the family court will be left to resolve these disagreements.

B. Challenges to Applicable Law and Jurisdiction of Court. Given that the laws of various states differ greatly, challenges often arise over the interpretation of the ownership and

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[40] *Williams v. Waldman*, 108 Nev. 466, 472, 836 P.2d 614, 618 (Nev. 1992) ("A fiduciary relationship also arises from the existence of the marriage itself, thus precipitating a duty to disclose pertinent assets and factors relating to those assets.").

[41] *See* Nev. Rev. Stat. §§ 123.270-310.

character of property under different states and different courts who may have jurisdictional authority over the assets, the trust, the parties and the persons in control of such assets and trusts. The courts may be relying on applicable law which may be based on the law where the marriage occurred, where the couple resided during the marriage, where the divorce is occurring, or the law that is applicable to agreements between the spouses, or the law applicable to various assets like business interests, real property and trusts that may be located or have situs in other jurisdictions.[42] This process is difficult enough when all assets are within the jurisdiction of the family court. But this process becomes exceedingly more difficult when the divorcing couple has interests not only in the state at issue, but in other jurisdictions.[43] In fact, in some cases, the family court may determine that it is not able to resolve a disagreement where the court does not have jurisdiction over the asset at issue such as an irrevocable trust being administered in another state wherein one of the spouses holds a beneficial interest. Further, even where a court has determined it has authority to decide an issue, it may not have actual authority to compel a non-resident trustee of a non-resident trust to comply.

C. Challenges to Identifying Assets Subject to Divorce (including nullification of lifetime gifts). Spouses may seek to challenge ownership of the assets that are obviously included in the divorce, in addition to seeking to include other assets that are not so obvious. Prior gifts by one or more of the spouses to other third parties during the marriage may be questioned, including gifts in trust. Further, gifts made to one of the spouses (i.e., a gift from a parent or inheritance in trust) may be the focus of claims that such beneficial interests are included in the divorce for consideration of the division of "property." Because a beneficial interest can, in some cases, potentially be "property," the effort to pull such beneficial interest into the divorce proceedings can be complicated.

D. Challenges to Contractual Obligations of Spouses. Spouses may also have contractual obligations to each other under business agreements, prenuptial or postnuptial agreement, or even under existing estate planning instruments that may be the source of conflict on dissolution.

E. Challenges to Alimony. In addition to determining which assets will ultimately pass to which spouse, the family court may also (and in some jurisdictions must) award alimony or support payments to one of the spouses, and further may impose child support. Unlike the division of ownership of assets, alimony and child support obligations are often based on the value of the assets and resources available to the spouse at issue. For example, under Nevada law:

[42] Streisand, Adam, *Claims Against Irrevocable Trusts in Divorce Proceedings: Select Topics from A Litigator's Perspective*, Estate Planning Course Materials Journal, pp. 14-37 (Jan. 2022).

[43] *See* discussion of *Dahl v. Dahl*, *supra*.

> In addition to any other factors the court considers relevant in determining whether to award alimony and the amount of such an award, the court *shall* consider . . .[t]he nature and value of the respective property of each spouse.[44]

Therefore, the separate property of each spouse is one factor the court will consider when determining alimony and child support. Further, alimony and child support, since based on available resources, can be revisited following divorce and increase or decrease during the applicable period. Hence, settlement of these issues is not always "final" on divorce.

F. <u>Other Challenges</u>. The above is by no means the extent of potential claims in divorce and creative counsel, and parties may determine other causes of action including personal injury, physical or mental abuse, or even an abuse of process to name a few.

IV.

<u>TREATMENT OF INTERESTS IN DISCRETIONARY TRUSTS AND SPENDTHRIFT TRUSTS IN DIVORCE</u>

Addressing irrevocable trusts in divorce is an exceptionally large and complex issue. Divorce itself is emotionally charged, and adding to that emotion is the fact that each spouse is attempting to provide for himself or herself for the future, and desiring to protect what he or she perceives as his or her wealth for the future. Divorcing individuals can go to extensive lengths to protect what they perceive as "theirs," whether such perception is accurate or not. Making this difficult, the laws in different jurisdictions are not uniform, and therefore, what may be "theirs" in one state may only belong to the other in another state. One asset class that is at the heart of these differences of opinions of ownership are the interests held in irrevocable trusts. These interests may be interests in property that one or both spouses transferred or gifted in trust for the benefit of others (generally gifts in trust to children); it may be a beneficial interest of one or both spouses in an irrevocable trust established by a third party by way of a gift (i.e., a gift in trust from a parent to child who is then involved in a divorce); or it may be assets that one or both spouses transferred in trust for their own benefit (i.e., transfers to a self-settled DAPT). This section will explore these three categories of trusts and their treatment in divorce.

A. <u>Transfers in Trust for the Benefit of Third Parties</u>.

It is not uncommon for individuals, married or not, to wish to provide for the benefit of others such as children in the form of a lifetime gift in trust. This is often done not only to provide for the benefit of beneficiaries of the trust (generally children or grandchildren) for their education and for other support purposes, but it is also done by those with wealth for gift and estate tax purposes. In some cases, it has been inferred that the gift or transfer to third parties was done not out of a gratuitous intent, but rather for the purpose of evading a spouse's interest (or rights of a creditor of the donor) in such property. Regardless of the purpose, when gifts are made by an individual prior to marriage with property that is not subject to marital claims, the

[44] Nev. Rev. Stat.125.150(9)(b).

gifts should be free from later spousal claims so long as the records can reflect the timing of these gifts and no additional marital assets are funded to the gift trust at a later date. That is often fairly easy to determine where the gifts all occurred pre-marriage and the trust was formed pre-marriage without additions following the marriage. But occasionally, this gets convoluted where the gifting spouse engages in a series of ongoing additions to such trust during the marriage. This can be even further complicated where the trust is for the benefit of certain children who may not be the children of the subsequent marriage.

Accordingly, a first step in evaluating the enforceability of gifts in trust to third parties is determining (1) the timing of the gift or gifts in trust, (2) the character of the property transferred, and (3) the purpose of that transfer.

Several cases have addressed these factors in considering whether to unwind the "gift trust" established by one spouse for the benefit others. In *Brooks v. Brooks*[45], the Alaska court considered whether the wife's intervivos gifts of marital property to her four sons during marriage was proper, or should be voided entirely (or at least as to one-half) attributed to the non-consenting spouse. The Alaska court referenced the Uniform Marital Property Act (1983) and held that when both spouses make a gift, the gift is valid, but if both did not consent, the gift is voidable at the option of the non-consenting spouse.[46] The case was remanded to the family court to consider whether the property characterized as marital property had been gifted with the consent of both spouses. While consent was the issue, the court did not define what was required for a finding of consent. Some jurisdictions, such as community property jurisdictions, may require a written consent to a gift of marital property during marriage, and this case may have had a different result in different jurisdictions without need for remand.

Consent may be statutorily defined in some jurisdictions or it may be inferred from conduct (or even by way of knowledge and failure to object). For example, attending the meeting with the gifting spouse's lawyer or being present at the bank during the transfer of funds may infer knowledge on behalf of the non-gifting spouse after which failure to object may be a deemed consent. But even in jurisdictions where a written consent is required, there may be a number of writings that could potentially satisfy a strict writing requirement including (1) a gift tax return reporting the gift or consenting to gift-split for gift tax purposes, (2) emails or communications in writing such as a gift letter that evidences consent by both spouses, (3) a signature on a check or transfer instrument. In jurisdictions where consent is not required to be in writing.

Another important factor is the purpose of the gift. In *Anderson v. Anderson,*[47] the Kentucky Court considered this issue but on death, rather than during life, questioning the husband's ability to redirect assets away from his spouse on death for the specific purpose of circumventing her marital rights. The Kentucky Court did not agree with such purpose and upheld the rights of the objecting spouse to unwind the same due to the improper purpose of the transfer. Of course, this ruling may not apply in a community property state where spouses are

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[45] *Brooks v. Brooks*, 733 P.2d 1044 (Alaska 1987).

[46] *Id*. at 1055.

[47] Anderson v. Anderson, 583 S.W. 2d 504 (Ky. 1979)

free to transfer their one-half interest in community property on death. But in states where the purpose of the transfer can be used to violate the public policy of supporting a spouse, such a purpose may be sufficient to void a transfer.

To the contrary, in *Windsor v. Leonard*, the wife transferred funds during her life to an irrevocable trust for the benefit of friends and charities, and not for her husband.[48] Instead, the wife left a more modest bequest of her residuary estate on death to her husband. On the wife's death, the husband exercised his applicable elective share rights under Maryland law, and asserted that his elective share should also include those assets that were gifted in trust by wife, arguing she had circumvented his marital rights. In consideration, the Maryland Court acknowledged several factors that are the same or remarkably similar to those factors considered by courts in the analysis of transfers to DAPTs. Specifically, the *Windsor* Court considered (1) completeness of the transfer, (2) motive (or purpose) for the transfer, (3) participation in the alleged fraud, (4) amount of time between transfer and death, (5) the fairness of the result to the surviving spouse.[49] While these factors, known as the "Windsor Balancing Test" address a deathtime challenge rather than divorce, the factors were applied to an intervivos gift and are therefore also applicable to intervivos transfers to DAPTs.[50] In *Windsor*, after application of the factors, the Court found no basis to unwind the intervivos gift.[51]

Several themes are relevant to courts in considering the validity of a lifetime transfer in trust by one spouse when later attacked by the other spouse in death or divorce:

- **Timing**. Gifts made prior to marriage are difficult to challenge because not only is such transfer outside the marital scope, but it is difficult to defraud a spouse that does not yet exist as to marital rights that do not exist. Therefore, timing of the gift is important. However, this timing issue can be muddied if there are additions to the trust later on during the marriage. Timing can also matter from a statute of limitations perspective as to the validity of the transfers and the length of time an objecting spouse had to object.

- **Source of funds for gifting/character of gifted property**. Certainly if the gifts are made from separate property in community property states and can be traced or from non-marital property in common law states, these circumstances are ideal for upholding the gift. But when community property or marital source assets are at issue, the vulnerability of the gift increases.

- **Purpose of the Transfer**. It is important to note that several of the cases in this area focus on the "purpose" of the transfer and whether it was intended to thwart marital rights. This is the equitable arm of the court and goes to the public policy that addresses the importance of marital rights. This also brings into consideration the

48 *Windsor v. Leonard*, 475 F.2d 932 (D.C. Cir. 1973).
49 *Id*.
50 *Id*. *See also*, Bowen, *supra* at fn 19.
51 *Windsor*, at 934, *supra* at fn. 36.

Uniform Fraudulent Transfer Act ("UFTA") or Uniform Voidable Transactions Act ("UVTA") which recognize the ability to overturn transfers not only for actual fraudulent activity but also for other transfers that fall within in the purview of the UFTA/UVTA even when there is not an actual fraudulent intent.

- **Consent of the non-gifting spouse**. Consent to the gift is an important factor. Consent may be direct consent or indirect consent based on knowledge without challenge. Consent does not always require an affirmative written consent, but of course, some written acknowledgment is helpful to enforcement and can have the effect of transferring the burden of proof as to the invalidity of such consent to the objecting spouse. While ideally an affirmative written consent is helpful, there are other less direct forms of consent that may also be sufficient such as (1) signing a gift tax return that reports the gift, or consents to gift splitting in relation to the gift, (2) signing transfer instruments such as a deed, authorizing a wire or signing a negotiable instrument, (3) verbally consenting and accepting a thank you from the recipient, and (4) having knowledge of the gift with a failure to object until time of divorce.

- **Jurisdiction over the Trust and assets gifted**. While a discussion of the importance of the divorce court's jurisdiction over the Trust and assets therein is an important factor, there are not a significant number of historical cases dealing with this issue, and this is certainly of a more recent vintage of litigation. The divorce court addressing the issue of the transfer may be able to opine on the same, but without jurisdiction over the asset, the persons in control of the trust, or the trust itself, it may be difficult for the divorce or family court to effectively force a return of the trust resources. However, this does not mean that divorcing parties can ignore the power of the divorce or family court to equitably address such issues as to those assets within the court's jurisdictional purview.

B. Transfers by one or both spouses in a DAPT.

Transfers by one or both spouses to a DAPT, also known as a self-settled spendthrift trust, are the subject of many ongoing disputes, and with the increase in the use of DAPTs, there is an increase in the number of cases addressing such DAPTs in the dissolution of a marriage. The cases in this area tend to consistently address similar themes related to the timing, purpose, character of the source funds, knowledge and consent, as well as the fairness and equity of the impact on the dissenting spouse at the time of divorce. But these cases also involve a few different issues, namely (1) whether the rights of the grantor/beneficiary in the DAPT can be attached in divorce to benefit the non-grantor/non-beneficiary spouse, (2) whether the court can consider the grantor/beneficiary spouse's interest in the trust in considering support and alimony for the benefit of the non-grantor/non-beneficiary spouse; and (3) whether the court can take jurisdiction of the Trustee, the trust, and any assets in the trust. Several cases have considered these issues which provide insight.

In the pivotal case of *Klabacka v. Nelson*[52], 133 Nev. 164 (2017), the Nevada Supreme Court considered whether or not the wife could recover assets in divorce from husband's DAPT. Several important facts were (1) the husband and wife were residents of Nevada, (2) community property law applied, (3) husband and wife each set up a separate DAPT at or around the same time working with the same estate planning counsel, (4) each DAPT was subject to Nevada law, and (5) each spouse converted community property to their respective separate property before funding their respective DAPTs with the assistance of separate qualified independent legal counsel during the transmutation process. Accordingly, the *Klabacka* Court did not address jurisdiction of another state over the DAPTs and further did not face the issue of "consent" since both spouses were aware of what the other was doing and participated in the same. However, wife's position was that during the drafting process, the drafting attorney had promised them that the DAPTs would not be used to restrict each other, and were only intended to protect them from outside creditors. Further, wife asserted that the drafting attorney promised that there would be an equalization clause in the trusts that would allow adjustments if the value of the separate trusts were different. Unfortunately for the wife, those provisions were not actually set forth in the instruments, and the Court found the terms of the Trust unambiguous. Husband's trust had of course grown substantially in value as compared to wife's DAPT by the time of divorce.[53]

The Nevada Supreme Court found that the spouses had entered into valid transmutation agreements, and that the agreements and trusts were clear and unambiguous, thereby excluding extraneous and parole evidence from consideration. The trusts were therefore deemed valid and enforceable spendthrift trusts, protecting the assets thereof from each other in divorce.[54] Of significance, the *Klabacka* Court held that although spousal rights were important, public policy was within the authority of the Nevada legislature, and the Nevada legislature had not chosen to provide for exception creditors to be excluded from the spendthrift protections.[55] Therefore, the Court declined to do so.[56] The Court did however remand the case to family court to confirm whether any community assets (rather than separate property) had been used to fund the trust of which wife would have an interest.[57]

Accordingly, in Nevada, DAPTs are protected against the court-ordered spousal support obligations (and also child support). There is however still some room for consideration of whether any community property interests in the DAPT would be subject to spousal claims which was directed to be addressed on remand. Additionally, it does not appear that a transfer to a DAPT established after issuance of an award of spousal support or child support would survive a challenge as such claims would presumably place such claimants into the category of an existing creditor at time of such post-divorce formation. [58] At a minimum, such claims would

[52] *Klabacka, supra*.
[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Id.*
[57] *Id.*
[58] Nev. Rev. Stat. 166.170.

not be extinguished without reference to the extended statute of limitations for existing creditors at time of a DAPT's formation.

Despite the strength of the *Klabacka* decision for Nevada DAPTs, it is important to acknowledge the issues that the Court was not required to address in the case, namely whether the public policy issue would be the same for non-Nevada spouses or even as to a Nevada spouse who lacked any knowledge of the DAPT's formation. These issues were considered in *Dahl v. Dahl* just prior to *Klabacka*.[59] In *Dahl*, which predated *Klabacka* by two years, the wife sought to recover assets from husband's DAPT, claiming it had been funded with and remained part of the marital estate to be divided (or at least considered) in the divorce. The Trust at issue specifically provided that it was governed by Nevada law. Further, the Trust had a Nevada Trustee and was not otherwise being administered in Utah where the divorce was proceeding and where the couple resided. Considering whether to apply Utah or Nevada law to the issues at hand, the Utah court stated that Utah had a "strong public policy interest in the equitable division of marital assets, [and] will not enforce the choice-of-law provision contained in the Trust."[60] The Utah Court proceeded to construe the DAPT in accordance with Utah law, stating that because Utah is the forum state for the divorce, Utah choice-of-law provisions applied. This was actually a notable variation from Utah law because Utah's choice-of-law rules generally enforce a choice-of-law provision contained in a trust document. But here, the Court found that doing so would undermine a strong public policy of the state of Utah.[61]

Of further interest, the Utah Court never had to reach the most interesting of decisions about the validity of a DAPT that the husband had secretly established without the wife's knowledge in Nevada where they did not reside. Due to what most certainly must have been a drafting error in the document, Section 5.5 of Trust agreement had two conflicting provisions which stated:

> Trust Irrevocable. The Trust hereby established is irrevocable. ***Settlor reserves any power whatsoever to alter or amend any of the terms or provisions hereof***."[62]

Emphasis added. Not only did the Trust instrument say it was irrevocable, but it was also titled as "The Dahl Family Irrevocable Trust." But rather than interpreting the conflicting sentences in Section 5.5 of the DAPT as a scrivener's error, the Court interpreted the Trust strictly as unambiguous, and found that the Trust was irrevocable as to others, but that the husband had reserved a power to amend the Trust to himself, causing the trust to fail to be a true DAPT and resulting in a revocable trust as to the settlor. Since the Trust was deemed a revocable trust as to the settlor under Utah law, the Court asserted it could address wife's claims. The Court found marital property had been transferred to the Trust, and therefore held that the wife was actually a

[59] *Dahl v. Dahl*, 459 P.3d 276 (2015).
[60] *Id.*
[61] *Id.*
[62] *Id.*

"settlor" with the power to amend the trust, at least as to her share of the marital property she was deemed to have contributed.[63]

Of importance in this case were the findings (1) of secrecy surrounding the establishment of the DAPT, (2) the fact she was never given a copy of the trust agreement, (3) the fact that she was unaware of its terms, (4) the fact that she was unaware that she was not a named settlor, and (5) the fact that she was not aware that her status as a trust beneficiary was dependent on her status as Dr. Dahl's spouse which would terminate on divorce.[64] The Utah Court stated that if they had decided that Ms. Dahl had no enforceable interest in the trust, despite having contributed marital property to it, the result would be to allow a spouse to shield marital property from equitable division in the event of a divorce contrary to the policy of Utah.[65] Accordingly, at least in this case, it is evident that the public policy of a non-DAPT state was used to override the actions of the husband to circumvent the laws of Utah through trust planning.

Does this mean that non-residents of the DAPT state cannot establish an enforceable DAPT outside of their state of residence? That was not the ruling in *Dahl*. In fact, based on the Utah Court's finding of revocability, it was actually not a qualified Nevada DAPT. Not answered by the decision is whether the results would have been any different if (1) the wife had known and consented affirmatively to the trust and its terms, (2) the DAPT had been funded entirely with separate assets in which wife had no marital interest, and (3) the trust had not contained a revocation power for the husband. Accordingly, while *Dahl* initially was touted as the death of asset protection trusts in marital disputes across state lines, it has not ultimately been read so broadly. The power of revocation issue provided the Utah Court a relatively straightforward route to enforce jurisdiction over the trust despite the choice of law provisions in the Trust. But without that loophole, the analysis may have been different. For example, if the DAPT was being administered in Nevada, with a Nevada Trustee, without any retained rights of husband, with a proper funding of non-marital property, and with wife's knowledge, the Utah court may have reached a different conclusion.

In another case involving a DAPT, bad acts by one spouse again appear to be the source of concern in a Florida decision, more so than the trust itself. In *Berlinger vs. Casselberry,*[66] Mr. Berlinger transferred assets to an irrevocable trust for the benefit of himself. However, Mr. Berlinger did so during a time he was subject to an order for alimony, and following denial that he had done so in a deposition under oath.[67] Citing Sir Walter Scott, the Court stated "Oh what a tangled web we weave when we first practice to deceive", and thereafter held Mr. Berlinger in contempt of court, finding the trust to be an improper circumvention of alimony by deception. Although the Court acknowledged the important protections afforded spendthrift trusts in Florida, the court found that Mr. Berlinger was supporting himself from the Trust through a

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[63] *Id.*
[64] *Id.*
[65] *Id.*
[66] *Berlinger vs. Casselberry*, 133 So.3d 961, (Fla. Ct. App., 2013).
[67] *Id.*

variety of means, including having a credit card for cash advances and living expenses paid for his benefit by the Trust.[68] While the Trustee attempted to claim that the Trust was not making discretionary distributions directly to Mr. Berlinger, and was only making distributions for his benefit, the court saw no distinction. Reviewing Florida's spendthrift statute, the Court upheld the exception to such spendthrift protections where there is an outstanding order for support or maintenance afforded to a child, spouse or former spouse. While the Court noted that a creditor cannot compel a trustee to make a distribution from the trust,[69] the action at issue was not designed to compel a distribution but rather was a garnishment against Mr. Berlinger's beneficial interest.[70] Therefore, the court upheld the garnishment, effectively restricting Mr. Berlinger's ability to benefit from the trust without the Trustee satisfying the garnishment.[71]

While two of the above three cases are not favorable for the settlor who established the DAPT (or who attempted to do so), there is a striking difference between the facts in *Klabacka* and *Dahl/Casselberry*. DAPTs themselves were not the "bad actor", but involved bad acts by the settlor that the Courts took action to set aside. In other words, equity overruled. *Dahl* and *Casselberry* are strong indicators that courts sitting in equity dislike bad actors. *Klabacka* on the other hand was quite different with a series of facts that evidenced a well-structured plan without secrecy or unclean hands.

C. Divorce Challenges to Beneficiary's Beneficial Interest in a Spendthrift Trusts.

The above cases address challenges to the grantor's transfer of property to a spendthrift trust and/or to the grantor's beneficial interest in a spendthrift trust. But the third category of challenges are by a spouse of a beneficiary of a third party spendthrift trust, which is generally a trust established by the parents or grandparents of the beneficiary which trust provides the beneficiary with certain beneficial interests that are often subject to discretion of the trustee, and subject to spendthrift protections. Allowing a challenge to a beneficiary's interest in a third party spendthrift trust is contrary to the interests of the non-debtor settlor who transferred his or her assets to a trust for the benefit of a beneficiary, not the beneficiary's creditors, and often specifically not for the intent of benefiting a beneficiary's spouse or former spouse. But that has not stopped these trusts from being brought into divorce proceedings.

Generally, these types of challenges are premised on the idea that the beneficiary's interest in the trust is "property" and that therefore such property is subject to equitable division in the divorce, or consideration by the court in determination of alimony.[72] The legal question is whether the present interest of a beneficiary in a discretionary trust is subject to division. Where the beneficiary does not control the distribution decision, the distribution interest is speculative

[68] *Id.*
[69] *Id*
[70] *Id*
[71] *Id*
[72] *See* Sitkoff, Robert H. and Dukeminier, Jesse, *Wills, Trusts And Estates*, 706, 866 (11th ed. 2022).

and therefore difficult for a court to determine value in divorce. This situation gets even more difficult when the beneficiary is not the only beneficiary of the trust, there have been inconsistent distributions that evidence no pattern or reliance by the beneficiary on a steady distribution steam, and where the Trustee is independent from the beneficiary. There does appear to be a trend toward finding an indefeasibly vested remainder interest in a trust is "property" that can be valued. But where that interest is subject to divestment, is contingent, or is a sprinkle power among many potential beneficiaries, it is difficult to value due to its uncertain nature.[73] The above analysis is evidenced in *Harrison v. Harrison,* 88 N.E.3d 232 (Ind. 2017) wherein the divorcing beneficiary's interest in a discretionary trust was deemed too remote to have pecuniary value for inclusion as property subject to the marital dissolution proceedings.[74] Of note, the discretionary trust was a pot trust in which the beneficiary at issue was not the sole beneficiary, could not compel a distribution and whose interest was subject to defeasance if she died.[75] In contrast to *Harrison*, the same Indiana court took a contrary view where the assets in the trust granted the beneficiary a withdrawal right of pension benefits from the trust, which were determined to be vested for life and of a nature that could be valued.[76] It must be noted that when these courts are deciding whether to consider the asset in the marital division, the courts are not necessarily suggesting that the court can order or compel the trustee in all cases to distribute something to the opposing party spouse. But the court can consider the fact that the beneficiary spouse has access to such resources in the ultimate calculation, thereby allotting a larger portion of the marital estate to the opposing party spouse than would occur if the trust property were not considered in the calculation.

D. Divorce Challenges to Beneficiary's Transfer of Assets in Sale to a Spendthrift Trust.

Another type of challenge to a beneficiary's interest in an irrevocable trust is based on challenges to transactions entered into between the beneficiary and the trustee of the beneficiary's trust. One such case is the *IMO Daniel Kloiber Dynasty Tr.*[77] out of Kentucky. In the *Kloiber* decision*,* the grantor of the trust was the father of the beneficiary. The father initially funded the trust with $15,000 as a minimal funding in what appears to have been a BDIT structure. The significant value of the trust ultimately came about by a sales transaction between the trust and its beneficiary, the grantor's son. Not only was the grantor's son the beneficiary but he was also the Special Trustee of the Trust and further was the Manager of three LLCs which were the property of the Trust estate. The beneficiary-son sold 99.45% of his shares in a company known as Exstream Software, Inc. to the Trust in exchange for an unsecured promissory note with a face amount of $6,000,000.[78] The Trust later sold 80% of the shares of stock in the company for $250,000,000 and then sold the remaining shares for $60,000,000, which assuming the same was successful was an exceptional result from a transfer tax

[73] *Id.*
[74] *Harrison v. Harrison,* 88 N.E.3d 232 (Ind. 2017).
[75] *Id.*
[76] *Bock v. Bock*, 116 N.E.3d 1124 (2018).
[77] *IMO Daniel Kloiber Dynasty Tr.*, 98 A.3d 924 (Ky. 2014).
[78] *Id.*

perspective. Despite the excellent tax result (assuming that it was successful), the best laid plan went awry not due to audit, but due to divorce. The beneficiary-son was married at the time he sold the Exstream shares to the trust, and evidence at trial indicated that the wife was not aware of the transfer, did not consent to the transfer, and was not a party to the Trust similar to the *Dahl* case. Beneficiary-son's wife was named as a discretionary beneficiary under the Trust Agreement so long as she remained married to son, but such beneficial rights terminated on divorce leaving that property interest of no real value. During divorce, she challenged the sale of stock by beneficiary-son to the trust, claiming the same to be marital property and therefore an invalid transfer.[79] She was not only seeking to have the assets considered in the marital property, but also to recovery assets from the transfer.

The Trust was a dynasty trust, and appears to have been a directed trust with the beneficiary-son in charge of that direction. In addition, the beneficiary-son had a withdrawal power of up to five percent (5%) of the trust estate. The beneficiary-son's children, as well as his wife (so long as married) were also permissible beneficiaries. The Trust, while a discretionary trust, was of a hybrid nature, providing that the trustee "shall pay" the beneficiary-son as much as necessary pursuant to an ascertainable standard, including a residence. These same provisions were also provided for the wife of the beneficiary-son. After a heated jurisdictional battle between the jurisdiction of Kentucky and Delaware, the property interests were ultimately decided Kentucky as between the spouses.

It should be noted that the "property" interests in this case did place the beneficiary-son in the position of control over assets in his Special Trustee capacity, he had certain withdrawal rights and powers, and the Kentucky court found that these were property interests. Of course, the main attack however was not on the trust itself but on the transfer by the beneficiary-son to the trust via a sale.

E. <u>Jurisdictional & Conflict of Law Challenges</u>.

As can be seen in many of the above cases, when the divorce is in one state and the trust is governed by the law and administered in another state, jurisdictional battles ensue. In *Dahl* and in *Kloiber*, the courts at issue had to consider a variety of challenges in the recognition and application of laws governing the trust, laws governing the divorce, and varying public policies in the different jurisdictions.

In *Dahl,* the Court resolved the matter by attaching the husband's retained revocation power which allowed the Court to treat the trust as revocable under Utah law, ignoring the laws governing the trust had it been irrevocable. Accordingly, the analysis, while interesting, did not provide us with insight on how the same court would have navigated applicable law issues where the attempted DAPT had been validly formed. In *Kloiber*, the Delaware and Kentucky courts navigated both applicable law and jurisdiction, resulting in both having jurisdiction over similar and different aspects of the case. In a detailed jurisdictional analysis, the Delaware Court determined that both courts could have jurisdiction to hear legal matters related to the Trust.

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[79] *Id*.

Further, unless those issues resulted in one court interfering unreasonably with the jurisdiction of the other, the same was permissible, citing the "Doctrine of Primary Jurisdiction" stating:

> When a particular court could be expected to establish a continuing relationship with a trust, it was logical that once a trustee qualified in a particular court, that court would exercise primary supervision in the form of "continuing jurisdiction over the administration of the trust.[80]

The process of resolving jurisdiction, as the Delaware Court confirmed, citing *Bogert* and the Restatement (Second), requires balancing the nature and extent of the various contacts which the states have with the trust. On review, the Delaware Court stated that under Delaware law, reference to "exclusive jurisdiction" was applicable to address the differences in Delaware between its Chancery Court of equity and other Courts.

Unless the Delaware Court found a basis for a claim of interference by the non-primary court with the primary court, which it did not find in *Kloiber*, it was not inclined to interfere with the Kentucky Court's competition jurisdiction.[81] The jurisdictional issue in *Kloiber* related to beneficiary-son's wife's success in obtaining a protective order in Kentucky that prevented the son from moving the trust funds during the pendency of the divorce in his capacity as "Special Trustee." However, in an apparent effort to find a way to work around the protective order, the beneficiary-son resigned as Special Trustee and as Manager of the LLCs, and exercised his power to appoint another person who was a resident of Delaware who petitioned for the Delaware Court to take exclusive jurisdiction, and did not notice the Kentucky Court of these changes, which point the Delaware Court noted. The Delaware Court found that it did have the permissive authority to assert primary jurisdiction over the *administrative* issues raised by the petitions.[82] But did not find sufficient evidence that Kentucky's jurisdiction would not constitute undue interference with supervision of the Delaware court in the primary jurisdiction.[83] It's unclear if the actions of the beneficiary-son caused the Delaware court to lean toward denial of his requests. The Delaware Court did ultimately find that the dispute over the property interests transferred into the trust under the sale was properly litigated in family court in Kentucky where the sale occurred, while the administrative issues of the Trust were governed by Delaware law and were to be decided by the Delaware Court.[84] Of note, the Delaware Court did not discuss the *Princess Lyda Doctrine* discussed below which restricts "in rem" jurisdiction to one court at a time, but it is unclear whether the Court was asked to opine on the same.

V

LESSONS FROM THE REPORTED CHALLENGES

Regardless of the public policy of a specific jurisdiction or personal perspectives of clients, counsel and courts in regard to spendthrift trust protections, these trusts are here to stay

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[80] *Id.* at 943-44.
[81] *Id.*
[82] *Id.*
[83] *Id.*
[84] *Id.*

with nearly half the states within the U.S. having some form of the DAPT, and many more supporting third party spendthrift trusts. In review of the above cases, several lessons can be gleaned when preparing such interests in relation to divorce challenges.

A. **<u>Formalities matter at time of formation</u>**.

Even more so than unrelated creditor claims, it is evident in divorce proceedings that the courts are considering not only state public policy, but also the facts, circumstances, and details surrounding the formation of spendthrift trusts. Accordingly, for drafters, this signals the importance of proper formation from the start. For a detailed discussion of formation issues, please see "Domestic Asset Protection Trusts – a Practical Resource Guide," by editor Alexander A. Bove, with chapters for states with DAPT statutes.[85] This author contributed the Nevada chapter, which in summary provides the following:

1. <u>Valid Trust</u>. The Trust Agreement must be validly formed, meeting all the criteria of a valid trust on formation. While formation of a valid trust is often fairly easy to accomplish, if the Trust is to be a spendthrift trust, the settlor must also comply with the additional and specific requirements of each state. In Nevada, those provisions are set forth in NRS 166.010–166.050. In summary, the trust must (1) be in writing; (2) be duly executed by the settlor who is competent at time of execution; (3) be funded with a property interest; and (4) to qualify as a DAPT, the trust must (a) be irrevocable; (b) not require mandatory distributions to the settlor; and (c) not be formed with intent to hinder, delay, or defraud known creditors. In addition to these requirements, the trustee of the DAPT must be qualified under NRS 166.015, which requires at least one trustee of a Nevada DAPT to be a natural person who is a resident of Nevada or who is a bank or trust company with offices in Nevada. While the settlor may be the Nevada resident trustee, the settlor may not be the only trustee nor hold the discretion to make distributions to himself or herself.[86]

2. <u>Fund the Trust Carefully and Correctly</u>. Dry trusts may not be permitted in all states. Nevada law requires that spendthrift trusts be funded with property, real or personal. While there are no minimum dollar requirements, satisfaction of this requirement is important to confirm the effective date of the trust since a dry trust is not effective.

3. <u>The Trust must be irrevocable</u>. To qualify as a DAPT, a trust must be "irrevocable." NRS 163.556 provides that a trust is irrevocable unless it states otherwise. Accordingly, all trusts in Nevada default to irrevocable status unless the trust terms provide for revocation. While Nevada law allows a spendthrift trust to be modified under a nonjudicial settlement or a judicial modification, the Nevada Supreme Court recently held that the ability to so modify does not, in and of itself, render a trust revocable or negatively impact the enforceability of a spendthrift clause.[87] To avoid uncertainty, it is recommended that the trust

[85] Bove, Alexander A., Jr., *Domestic Asset Protection Trusts – A Practice And Resource Manual*, American Bar Association (2021).

[86] Nev. Rev. Stat. § 166.040(3).

[87] *In re Frei*, 133 Nev.50, 54, 390 P.3d 646, 650 (2017).

instrument affirmatively state the trust shall be irrevocable and avoid conflicting statements as were present in *Dahl.*

4. Limitation on Distributions to the Settlor/Beneficiary. As was noted in the *Dahl* case discussed above, retained interests in the settlor should be scrutinized. For a DAPT, the trust instrument must not mandate a requirement for the trustee to make a distribution to the settlor, including from income or principal of the trust estate.[88] While this may appear overly restrictive, there is no limitation on the ability of the non-settlor trustee to hold discretionary authority to make distributions to the settlor. There are also broad statutory exceptions to the general rule: (1) the settlor may hold a veto power to prevent a distribution from being made from the trust; (2) the settlor may hold a lifetime or testamentary limited power of appointment over the assets of the trust that cannot be exercised in favor of the settlor (or the settlors estate or creditors); (3) the settlor may be entitled to a payment as the beneficiary of the trust if it is qualified as a charitable remainder trust; (4) the settlor may be authorized or entitled to a percentage of the trust each year not exceeding a qualified retirement plan minimum distribution requirement; (5) the settlor may be entitled to an annuity or unitrust payment under the trust if it is qualified as a grantor-retained annuity trust or a grantor-retained unitrust trust; (6) the settlor may be authorized to receive income or principal of the trust by direction of another person (including but not limited to another trustee); and (7) the settlor may be authorized to use the real or personal property owned by the trust.[89] In other words, the limitation on mandatory disbursements to the settlor does not necessarily prevent the settlor from benefitting from distributions from the trust estate.

A beneficiary may also have interests that make it more vulnerable to being treated as property for inclusion in the marital estate. Withdrawal rights and powers or control features, even if permissible for tax purposes, may provide a negative optic to a court that evidence a property right that can be valued and therefore included for equitable division of a marital estate, or consideration for alimony purposes.

5. Discretionary Pot Trust Features May be More Protective in Third Party Spendthrift Trusts. When preparing a third party spendthrift trust, those trusts that provide a beneficial interest to a single beneficiary who is the subject of a divorce may find such trusts are easier to challenge simply because the beneficial interests are more likely than not to benefit the single beneficiary. Pot trusts and trusts with inconsistent distribution patterns may be more likely to represent speculative interests that are difficult to value, and therefore excluded by the court for equitable division purposes.

6. Trustee Other than the Settlor/Beneficiary. If the trust is a DAPT, there must be a qualified trustee acting other than the settlor.[90] Although a settlor can be a co-trustee, the settlor cannot hold the authority to make distributions to himself or herself, even if such distributions are not required. Nevertheless, if the settlor genuinely wants to avoid another state exercising jurisdiction over the trust by virtue of the settlor's state of residence, cautious drafters

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88 Nev. Rev. Stat. § 166.040(1)(b).
89 Nev. Rev. Stat. § 166.040(2).
90 Nev. Rev. Stat. § 166.180.

will advise settlors to consider avoiding serving as the co-trustee.[91] It is common for settlors to seek to name individuals as trustees of DAPT instead of professional trust companies or banks. This decision is often driven by attempts to minimize trustee fees. However, do not be penny wise and pound foolish. Individuals who reside elsewhere can trigger jurisdiction over the trust in other states.

The same applies to the beneficiary. Consideration of the role that the beneficiary will play can have an impact on the perspective of the beneficiary's control. While there may not be a tax reason to avoid naming the beneficiary, there may be other reasons such as avoiding jurisdictional issues for the trust in the state where the beneficiary resides or a negative perspective in divorce.

7. <u>Proper Purpose – No intent to hinder, delay or defraud at time of formation</u>. Different states have different rules regarding purpose on formation. For example, the Nevada DAPT must not have been established with intent to hinder, delay, or defraud known creditors at the time of its formation.[92] While this is not applicable to a third party spendthrift trust, this requirement should be considered even as to a third party spendthrift trust for public policy purposes. The requirement relates to the settlor's intent on formation, as opposed to the later discussion of intent to defraud a creditor on a transfer of assets to the trust. This factor was recognized by the *Klabacka* court, which summarily concluded that there was no intent to hinder, delay, or defraud known creditors on formation.[93] Extrinsic evidence is only admissible to resolve ambiguity in Nevada trusts.[94] For this reason, it is recommended that drafters of Nevada DAPTs include language in the trust instrument that sets forth the intent of the settlor on formation and affirmatively states that the settlor is not intending to hinder, delay, or defraud a known creditor in forming the trust.

8. <u>Bad Facts Cause Bad Results</u>. Consistent with the proper purpose, bad facts or nefarious or secret conduct can lead to a result-oriented decisions.[95] Such a scenario may prompt a court to consider the factors set forth in the Uniform Fraudulent Conveyance Act (i.e., NRS 112.180(2) in Nevada) in determining whether the transfer was made with actual intent to hinder, delay, or defraud "any creditor" under NUFTA. Such factors include whether "the transfer was of substantially all the debtor's assets" and the debtor "became insolvent shortly after the transfer was made."[96]

9. <u>Find a Nexus to the State of Formation</u>. For a spendthrift trust to be governed by Nevada law, there must be nexus to Nevada, which can easily be accomplished by (1) the existence of real or personal property in Nevada; (2) the declared domicile of the creator (not necessarily the settlor) of the trust affecting personal property in Nevada; or (3) a Nevada

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[91] Nev. Rev. Stat. § 166.015(2).

[92] Nev. Rev. Stat. § 166.040(1)(b).

[93] *Klabacka*, 133 Nev. at 172, 394 P.3d at 947.

[94] *Jones*, 72 Nev. at 123, 296 P.2d at 296; *see also* Nev. Rev. Stat... § 137.005 (referencing permissible use of extrinsic evidence in a no-contest clause where the words used are ambiguous).

[95] See *U.S. v. Lazare*, 117 A.F.T.R.2d 2016–17, for evidence of a "bad facts" case involving a Nevada DAPT disregarded by the federal court in a tax lien case brought well within the two-year period and therefore not barred by Nevada's statute of limitations. *See also Kilker v. Stillman*, 2012 WL 5902348 (Cal. Ct. App. Nov. 26, 2012) (unpublished), involving a California appellate court ignoring the Nevada spendthrift trust provisions when the settlor testified the transfer was made to defraud his creditors.

[96] Nev. Rev. Stat. § 112.180(2)(e), (i).

trustee.[97] The mere appointment of the Nevada trustee, which is mandatory for a DAPT, will satisfy the nexus requirement even though no actual property is located in Nevada but is that really going to be enough in a divorce? This author, however, recommends that nexus consist of more than a Nevada trustee alone, and it is therefore advisable to encourage locating at least some of the assets of the DAPT in Nevada This can be easily accomplished by establishing a bank account in Nevada, and/or forming a Nevada entity owned by the DAPT.

10. Affidavits of Solvency. Some states require such Affidavits of Solvency at the time of trust formation. Others like Nevada, do not. But it might be helpful in a challenge as to the purpose to reflect on intent and purpose.

11. Notice of Formation. While settlors do not generally like to announce they have formed a DAPT, notice may be advisable at least as to a spouse for the simple purpose of avoiding the negative appearance of a secret formation in divorce proceedings. As is evident in the case law, secrecy in formation of a DAPT by one spouse is not generally viewed positively. Notice and consent by a spouse is often a critical concern and reason for overturning the trusts as between spouses. If that argument can be short circuited by a notice up front when the relationship is friendly, that may entirely avoid this source of challenge at a later stage.

12. Review Timing and Form of Funding. The most common form of challenge to a Nevada spendthrift trust is to the settlor's (or contributor's) act of funding assets into the trust under NRS Chapter 166 or under NUFTA. This can also apply to a beneficiary who is exchanging or selling assets to a trust. This can be avoided by understanding the assets used in funding, understanding the character of that property and what is required if it is marital property, obtaining consents where necessary, and understanding which state's laws will govern the transfer of the property.

13. Evaluate if Transmutations are Needed and Requirements for a Valid Transmutation in the Applicable Jursidictions. The *Klabacka* decision discussed above evidenced proper transmutation of the transferred assets and was a fact considered by the Court in its analysis upholding the trust as valid. Separately, while not a divorce case, a challenge to a domestic asset protection trust in Nevada came in the form of certified questions from the federal U.S. District Court, District of Nevada, regarding the application of the alter ego theory to a number of different causes, claims, and entities, including Nevada DAPTs.[98] In *Magliarditi v. Transfirst Grp., Inc.*, a judgment was issued outside of Nevada against the debtor and the creditors sought collection against a number of entities, including several Nevada trusts.[99] Specifically, in addition to pursing the debtor, the creditors also pursued the debtor's wife, individually, and as Trustee of her Nevada DAPT. The creditor asserted that the debtor had transferred all of his assets to his wife, and that the wife had thereafter transferred those same assets to her Nevada trusts, which rendered the debtor husband judgment proof.[100] The debtor husband had no role or interest in the wife's DAPT, was not a transferor, settlor nor beneficiary. The debtor-husband had transmuted his community property interest in certain property to his wife's separate property. Thereafter, the debtor's wife formed at least one Nevada DAPT and transferred the same property (formally community property) to that trust. The question of

[97] Nev. Rev. Stat.§ 166.015(1).
[98] *Magliarditi v. Transfirst Grp., Inc.*, No. 73889, 2019 WL 5390470, 450 P.3d 911 (Nev. Oct. 21, 2019).
[99] *Id.*
[100] *Id.*

whether the transmutation agreements were technically in compliance with applicable law was raised in the lower court versions of the case, and gave rise to opportunities for challenge.

14. Nevada Family Court Subject Matter Jurisdiction over Nevada DAPTs. Despite argument by the husband that jurisdiction over the DAPTs was improper in family court and limited to the probate court, in *Klabacka*, the Nevada Supreme Court upheld the family court's assertion of subject matter jurisdiction for purposes of the divorce.[101] While the family court could not rule on issues relating to trust administration such as a trustee's alleged breach of a fiduciary duty, the validity of the transmutation agreements and character of the property transferred to the trusts were subject to the family court's review, and the assets therein were also available for the family court's consideration in determining equitable division of the divorcing couple's other assets held outside the DAPTs. Since the trusts in the case were Nevada DAPTs and the divorce proceedings were in Nevada, the decision did not address whether the family court's subject matter jurisdiction would still have existed to the same extent if the DAPTs at issue had been established and maintained in a jurisdiction other than the same location of the divorce action. But the *Kloiber* Court in Delaware recognized that different courts could have jurisdiction on issues under some circumstances.

15. Tracing Assets Transferred to a DAPT to Characterize Property. The *Klabacka* court confirmed the well-settled Nevada law prohibiting one spouse from unilaterally transferring community property without the consent of the other spouse.[102] Although NRS 123.125 allows the transfer of a settlor's share of community property to a trust, it can only be done with the consent of both spouses. Therefore, a spouse can attempt to unwind a transfer by the settlor of community property (including the settlor's one-half of that community property) if made without consent of both spouses. Further, as stated in *Klabacka*, the family court retained jurisdiction to decide whether property in the husband's DAPT was community property or separate property through tracing. If a family court determines that community property was transferred to the DAPT without the consent of one or both spouses, the family court might not only order the return of the non-consenting spouse's one-half interest from the trust, but also declare the entire transfer void, effectively unwinding estate and tax planning, and further opening the door to increased claims of support, alimony, and child support against such property. Accordingly, even though Nevada does not judicially recognize exception creditors to DAPTs, settlors should take steps to confirm that transfers of community property to such trusts are made with consent. Consents, joint planning, tax returns reflecting the gifts are some evidences of consent and knowledge of the gifting. But better yet, limiting funding to the settlor's separate property assets would eliminate this risk.

16. Admitting Trust to Court Jurisdiction. In many states, the idea of going to court for a probate or trust matter is dreadful. Court proceedings can be time consuming, provide inconsistent results, and be extremely expensive. However, some states have streamlined its court proceedings for trust matters and made the process as desirable as in can be, and in some cases more desirable than nonjudicial settlements, modifications, and actions taken under a

[101] *Klabacka v. Nelson*, 133 Nev. 164, 169, 394 P.3d 940, 945 (2017).
[102] *Id.* at 179, 394 P.3d at 952.

notice of proposed action. Courts can assume in rem jurisdiction over trusts and grant instructions to the trustee for a variety of actions, including formation of DAPTs, transfers to such trusts, modifications and actions by the trustees, and even approval of actions by the trustee, trust protector, or other advisors. Subjecting a DAPT to the jurisdiction of a court may be advantageous for several reasons, including (1) creating a record of intent on formation, (2) creating a record of intent on transfer of assets, (3) providing notice of a public hearing or record of transfer to creditors, (4) validating the character of property transferred to the trust, and (5) instructing the trustee on a variety of actions including addressing claims of creditors.[103] Such action may also provide protection against other courts' attempting to claim in rem jurisdiction over the trust estate.[104] Courts may also grant declaratory relief in a manner that validates and insulates trustees and trust instruments from post-death contests and challenges.

VI

LESSONS FROM THE REPORTED CHALLENGES

More so than in any other type of creditor challenge, divorce challenges to spendthrift protections in trusts involve related party marital rights that go to the heart of public policy concerns. The support of the family and the exclusion of assets from that support are not granted without scrutiny. Therefore, careful planning and documentation of the process can go a long way in supporting the validity of the transfers, as well as minimizing the litigation in the unfortunate event of divorce. It is important in these settings to also explore the impact not only of tax matters in estate planning, but also to evaluate the areas of vulnerability if asset protection planning is a primary or important aspect of estate planning for the settlor. Additionally, educating clients and beneficiaries as to the legal and jurisdictional challenges that can arise in this area can assist in setting reasonable expectations as to what asset protection planning can, and cannot, do.

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[103] Nev. Rev. Stat. §§ 164.025; 164.030; 153.031.

[104] *Princess Lida of Thurn & Taxis v. Thompson*, 305 U.S. 456, 59 S. Ct. 275 (1939).