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Powers of Withdrawal, Claims for Set-Off, and Spendthrift Protection

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If a beneficiary of a spendthrift trust has a right to withdraw property from the trust, may the beneficiary's creditors reach the assets subject to the withdrawal power? That was the principle question recently addressed by the 1st District Court of Appeals in *Great American Insurance Company v. Thompson Trust*.¹ Also of interest: the case may have involved an offset by the trustee of amounts distributable to the beneficiary to repay amounts owed by the beneficiary to the trust.

Background.

When she died, Patricia Smith Thompson's will created a testamentary spendthrift trust (the "Trust") for the benefit of her husband, Morley.² The terms of the Trust gave Mr. Thompson the annual right to withdraw from principal the greater of \$5,000 or 5% of the value of the trust assets.³

As executor for Mrs. Thompson's estate, Mr. Thompson improperly disposed of trust assets. The resulting litigation was settled, but Mr. Thompson did not pay more than \$1.3 million that he was obligated to pay to the Trust under the settlement agreement. His default led the probate court to issue an order that while his debt to the Trust was unpaid, no further distributions were to be made to Mr. Thompson from the Trust. Rather, any amounts he otherwise would have been entitled to receive from the Trust were to be applied against his debt to the Trust.⁴

A year and a half later, Great American Life Insurance Company (“GALIC”) obtained a default judgment against Mr. Thompson for nearly \$5.8 million in connection with obligations he had guaranteed. Shortly thereafter, GALIC filed a creditor’s bill and complaint under R.C. §2333.01 against Mr. Thompson and the Trust. (Under §2333.01, judgment creditors may reach, among other things, any interest of the debtor in “a money contract, claim, or chose in action, due or to become due to him, or in a judgment or order, or money, goods, or effects which he has in the possession of any person or body politic or corporate.”) The Trust defended the action on three grounds: (1) that the spendthrift provision prohibited GALIC from reaching Mr. Thompson’s interest in the Trust; (2) that the probate court’s order prevented GALIC’s lien from attaching to Mr. Thompson’s interest in the Trust; and (3) that if and to the extent GALIC could secure a lien against Mr. Thompson’s interest in the Trust, it was junior to the Trust’s claim.

Although Mr. Thompson did not respond and had another default judgment issued against him, GALIC’s claim against the Trust was tried. The trial court rejected each of the Trust’s defenses. As summarized in the appellate court’s opinion: “The trial court concluded that the spendthrift provision did not prohibit Great American from asserting an equitable lien on the nondiscretionary trust distributions⁵ to Thompson, and that Great American had a priority lien on that money in preference to the . . . Trust, despite the probate court’s order directing the trustees to retain any money due to Thompson in order to pay off Thompson’s debt to the trust.”⁶ The court of appeals affirmed.

Spendthrift Protection.

In 1991, in *Scott v. Bank One Trust Co.*, the Ohio Supreme Court broadly upheld the validity of spendthrift provisions.⁷ The appellate court in *Great American*, however, distinguished Mr. Thompson’s withdrawal power from a beneficial interest in a trust that is protected by a spendthrift provision. A power of withdrawal is a presently exercisable general power of appointment.⁸ The question was thus whether GALIC, as a creditor of the holder of a presently exercisable general power (over assets in a spendthrift trust of

which the holder is a beneficiary), could reach the assets subject to the power. In holding that it could, the court characterized the rule to that effect under the Restatement (Third) of Trusts as “black-letter trust law.”⁹ While the Restatement’s rule the court relied on may well be the right one from a policy perspective – given that the holder of an unconditional presently exercisable power has unrestricted, unilateral access to the property subject to the power for the holder’s own benefit – it is an overstatement to describe it as black letter law.

According to the Restatement (Second) of Property, the rule – that creditors of a holder of an unexercised, presently exercisable general power of appointment may reach the property subject to the power – is inconsistent with the law of most states, and is not the law except to the extent a statute so provides.¹⁰ Statutes in a number of states do so provide,¹¹ although in most, creditors may reach the appointive assets only if other property available for payment of their claims is insufficient.¹² Similarly, the rule under federal bankruptcy law is that the power holder’s creditors may reach property subject to a presently exercisable general power of appointment,¹³ and federal tax law also treats the holder of such a power as the owner of the property subject to the power.¹⁴ Case law in several states does not allow creditors of an unexercised, but presently exercisable general power to reach property subject to the power, however.¹⁵ Similarly, statutes in Alaska and Rhode Island do not allow a power holder’s creditors to reach the property subject to the power unless it not only is a general power, but also is exercised in favor of the holder, the holder’s estate, or the creditors of either.¹⁶

Consistent with the Uniform Trust Code (UTC), the pending Ohio Trust Code (OTC) reaches the same result as does the Restatement (Third) of Trusts by treating a power of withdrawal as equivalent to the power of a settlor to revoke a revocable trust,¹⁷ thus allowing creditors of the power holder to reach the assets subject to the power.¹⁸ (Note, however, that under the OTC and the UTC, that result applies only “during the period the power may be exercised.”¹⁹ Further, if the holder allows the power to lapse, the holder will be treated as the settlor of the trust only to the extent the value of the property affected by the lapse exceeds the greater of the 5 x 5 amount or the annual

exclusion amount, which under the OTC is doubled if the donor of the gift to the trust is married at the time of the transfer.²⁰) The rationale for the OTC and UTC treatment is that a presently exercisable general power and the power of a settlor to revoke a revocable trust are “functionally equivalent.”²¹ Thus, the result in *Great American* – that GALIC could reach the property subject to Mr. Thompson’s right of withdrawal despite the spendthrift provision – would also be reached under the OTC.

Prior Probate Court Order.

As mentioned above, before GALIC filed its creditor’s bill and complaint, the probate court issued an order directing that any amounts otherwise distributable to Mr. Thompson from the Trust instead be retained in the Trust to reduce his \$1.3 million obligation to the Trust. In its appeal, the Trustee argued that the trial court erred in granting GALIC a secured priority interest in amounts Mr. Thompson could withdraw under the 5 x 5 power in preference to the Trust’s interest in those amounts. The appellate court disagreed, finding that the probate court’s order did not amount to a lien on Mr. Thompson’s interest. Citing 51 American Jurisprudence 2d of Liens (2004), §11, the court stated that “[l]iens may only be created by agreement or by a fixed rule of law, but not by courts.”²² Further, while characterizing the Trust as a creditor of Mr. Thompson, the court noted that the Trustee “never sought to obtain a lien or to secure its interest in Thompson’s right to withdraw money at the end of each year.”²³ Accordingly, the Trust was an unsecured creditor “whose interest in Thompson’s right to withdraw was subordinate to Great American’s secured interest.”²⁴

Mr. Thompson’s Income Interest?

According to the appellate court’s opinion, Mr. Thompson not only had a 5 x 5 power to withdraw principal from the Trust, he also was entitled to receive its income.²⁵ The appeal, however, did not involve Mr. Thompson’s interest in the Trust’s income. Rather, the parties’ briefs, and the appellate court’s opinion, address only the question whether GALIC could reach amounts Mr. Thompson could withdraw by exercising his 5

x 5 power. Because the probate court ruled that “no further distributions be made to Morley Thompson regardless of any circumstance or entitlement,” with any distributions he otherwise would be entitled to receive to be applied to his debt to the Trust, the implication is that income distributions otherwise to be made to him instead were to be offset against his debt to the Trust despite its spendthrift nature. Curiously, however, there is no mention in either party’s brief of Mr. Thompson being entitled to receive distributions of Trust income.

If in fact Mr. Thompson was entitled to receive distributions of Trust income, in addition to having the right to withdraw principal under the 5 x 5 power, the question whether the Trustee could offset the Trust’s income against Mr. Thompson’s debt to the Trust, despite the spendthrift provision, would be raised. Because of the breadth of the Ohio Supreme Court’s opinion in *Scott* upholding spendthrift provisions,²⁶ in my view it is doubtful that an offset spendthrift exception would be created by an Ohio court under existing law.²⁷ Further, the pending Ohio Trust Code lists only two spendthrift exceptions²⁸ and expressly states that they and three others are the only exceptions to the effectiveness of a spendthrift provision.²⁹ Because a trustee’s claim against a spendthrift trust beneficiary is not among those exceptions, presumably such a claim could not be successfully asserted under the OTC.

¹ 2006 WL 199751, 2006-Ohio-304.

² The facts recited in this article are taken not only from the court’s opinion, but also from the parties’ briefs. The spendthrift provision in the trust instrument explicitly prohibited the voluntary or involuntary alienation of Mr. Thompson’s interest in the trust.

³ The court’s opinion states that Mr. Thompson could withdraw “\$5,000, plus 5% of the fair market value of the trust,” but the withdrawal provision, reproduced in the appellee’s brief, provides that the 5% Mr. Thompson could withdraw at the end of the year was to be reduced by any amounts he had previously withdrawn during the year (i.e., any of the \$5,000 that he had withdrawn during the year).

⁴ The appellee’s brief states that Mr. Thompson exercised the withdrawal power for the year 2001 and withdrew nearly \$490,000, indicating the trust had a value at that time of nearly \$10,000,000, and that he

withdrew nearly \$377,000 more for 2002. In both cases, the withdrawals were not actually made to him, but were applied against his debt to the Trust.

⁵ It is clear from the court's opinion that its reference to "nondiscretionary trust distributions" refers to amounts Mr. Thompson could withdraw from the Trust by exercising his 5 x 5 power.

⁶ *Supra* note 1, at paragraph 5.

⁷ 62 Ohio St.3d 39, 577 N.E.2d 1077 (1991). The Court's syllabus in *Scott* states that: "2. A trust beneficiary has no greater interest in the trust property than that given by the trust agreement. 3. The beneficiary of a spendthrift trust has no interest that is liable to the execution of a judgment. 4. Spendthrift trusts will be enforced in Ohio."

⁸ See RESTATEMENT (SECOND) PROPERTY: DONATIVE TRANSFERS, §§11.4, cmt. a, and 11.5 (1986).

⁹ *Supra* note 1, at paragraph 9. Under the Third Restatement: "An intended spendthrift restraint is ... invalid with respect to a nonsettlor's interest in trust property over which the beneficiary has the equivalent of ownership, entitling the beneficiary to demand immediate distribution of the property. Thus, if an income beneficiary also holds a presently exercisable general power of appointment (that is, a power currently to compel distribution of trust property to the power holder), a spendthrift restraint will not prevent the beneficiary's creditors ... from reaching the property that is subject to the power."

RESTATEMENT (THIRD) TRUSTS § 58, cmt. b(1) (2003).

¹⁰ RESTATEMENT (SECOND) OF PROPERTY: DONATIVE TRANSFERS § 13.2 and Reporter's Note 1 to §13.2 (1986). The rationale for the traditional rule "is that the donee of a general power has no property interest in the appointive property unless the donee exercises that power, and that the right to do so is personal to the donee. As Lord Justice Fry once said: 'The power of a person to appoint an estate to himself is, in my judgment, no more his 'property' than the power to write a book or to sing a song.' In re Armstrong, 17 Q.B.D. 521, 536 (1886)." JESSE DUKEMINIER ET. AL., WILLS, TRUSTS, AND ESTATES 594 (7th ed. 2005).

¹¹ See, e.g., N.Y. EST. POWERS & TRUSTS LAW §§ 10-7.2 and 10-7.4 (McKinney 1998).

¹² See CAL. PROB. CODE § 682(a) (West 1992); MICH. COMP. LAWS § 556.123 (1979); MINN. STAT. § 502.70 (1982); OKLA. STAT. tit. 60, § 299.9 (1981); WIS. STAT. § 702.17 (1980).

¹³ 11 U.S.C.A. § 541 (1994).

¹⁴ See, e.g., I.R.C. §2041.

¹⁵ See, e.g., Univ. Nat'l Bank v. Rhoadarmer, 827 P.2d. 561 (Colo. Ct. App. 1991); Irwin Union Bank & Trust Co. v. Long, 312 N.E.2d 908 (Ind. Ct. App. 1974).

¹⁶ See ALASKA STAT. § 34.40.115 (Michie 2005); R.I. GEN. LAWS § 34-22-13 (1969).

¹⁷ See UNIF. TRUST CODE § 505(b)(1) (2005); Ohio Trust Code §5805.06(B)(1).

¹⁸ See UNIF. TRUST CODE § 505(a)(1) (2005); Ohio Trust Code §5805.06(A)(1).

¹⁹ See UNIF. TRUST CODE § 505(a)(1) (2005); Ohio Trust Code §5805.06(A)(1).

²⁰ See Ohio Trust Code §5805.06(B)(2).

²¹ UNIF. TRUST CODE § 505 cmt. (2005). For criticisms of the traditional rule under which creditors of the holder of a presently exercisable general power of appointment may not reach property subject to the

power, *see* 5 AMERICAN LAW OF PROPERTY § 23.17 (A.J. Casner ed. 1952); LEWIS SIMES & ALLEN F. SMITH, FUTURE INTERESTS § 944 (2d ed., 1956); Olin L. Browder, Jr., *Future Interest Reform*, 35 N.Y.U. L. REV. 1255, 1272 (1960); Berger, *The General Power of Appointment as an Interest in Property*, 40 NEB. L. REV. 104, 119-20 (1960); and Roy Lee Steers, Jr. Note, *Creditors' Ability to Reach Assets Under a General Power of Appointment*, 24 VAND. L. REV. 367 (1971).

²² *See supra* note 1, at paragraph 13.

²³ *See supra* note 1, at paragraph 14.

²⁴ *Id.*

²⁵ *See supra* note 1, at paragraph 4.

²⁶ *See supra* note 7.

²⁷ Arguably, a spendthrift provision should not be effective against a claim by the trustee, however, because the trustee is the owner of the trust property. Thus, a spendthrift provision prohibiting the voluntary or involuntary transfer of the beneficiary's interest would not apply to the trustee with an offset claim, because the trustee would be retaining property, rather than transferring it. However, trust beneficiaries have an equitable, or beneficial, interest in the assets of the trust. Allowing a trustee to offset property that otherwise is distributable to the beneficiary against amounts owed by the beneficiary to the trust would be involuntarily – from the beneficiary's perspective – alienating the beneficiary's equitable interest in the trust. For more on the offset exception to spendthrift protection, see RESTATEMENT (THIRD) TRUSTS § 59, cmt. a(2) and Rptr. Notes (2003).

²⁸ *See* Ohio Trust Code §5805.02(B). These two exceptions relate to (i) support claims of a child or current spouse and (ii) the United States or the State of Ohio, to the extent federal law or the Revised Code so provide.

²⁹ *See* Ohio Trust Code §5805.02(E). The other three exceptions are under (i) §5805.05(B), which permits a creditor to reach mandatory distributions owed to a beneficiary if they are not made within a reasonable time, even if the trust's terms include a spendthrift provision; (ii) §5805.06, which permits creditors of a settlor/beneficiary to reach his or her interest, even if the trust's terms include a spendthrift provision; and (iii) §5810.04, which permits the court to award costs, expenses, and reasonable attorney fees to any party, to be paid by another party, from the trust, of from a party's interest in the trust, even if the trust's terms include a spendthrift provision.