Debt in the Context of Decanting: The Surprising Impact of Section 27 of The Uniform Trust Decanting Act

The UTDA revises previous law on the liability of a receiving trust for the debts of the decanting trust—it is worth considering this liability when making changes to trust structure.

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As a general rule, a beneficiary who receives a distribution from an irrevocable trust is not liable for the debts and liabilities of the trust. Exceptions exist where a beneficiary is obligated under the law of contracts, torts, or unjust enrichment, and also in situations where the trustee has made a fraudulent conveyance of trust property to a beneficiary. In contrast, when a trustee distributes property in further trust for a beneficiary (i.e., a trust decanting), rather than outright, the recipient trust may be obligated for the debts and liabilities of the distributing trust. In what appears to be a drastic departure from the law that applies to outright trust distributions, Section 27 of the Uniform Trust Decanting Act ("UTDA") imposes a perpetual liability on the recipient trust for the debts and liabilities of the distributing trust, even when those debts and liabilities could not be enforced against a beneficiary who receives the same assets in an outright distribution. Trustees should carefully consider the impact of UTDA section 27 when choosing between a trust decanting, a trust combination or division, and a non-judicial or judicial trust modification as the preferred method to tweak or modify a trust to meet the settlor's objectives in light of changing circumstances.

Liability Of A Trust Beneficiary Receiving An Outright Distribution For The Debts And Liabilities Of The Distributing Trust

The genesis of a trustee's authority to distribute assets in further trust for a beneficiary, commonly referred to as decanting, is the trustee's power to distribute assets outright to a beneficiary.[1] Therefore, the law governing the liability of a beneficiary, who receives an outright distribution of trust property, to a creditor of the distributing trust will first be examined.

General rule – trust beneficiary not liable for trust debts. In general, a beneficiary is not personally liable for obligations incurred by the trustee in the normal course of the trust's administration. The Restatement (Second) of Trusts provides that in the normal course of administration of a trust, a beneficiary is not liable for trust debts to third parties, is not liable under contracts made by the trustee, is not liable to third parties for torts committed by the trustee, and is not subject to third-party liabilities imposed upon the holder of the title to trust property.[2] Section 103 of the Restatement (Third) of Trusts reaffirms these general rules, stating, "[a] benefi-

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ciary is not personally liable to a third party for an obligation incurred by the trustee in the administration of the trust. . ."[3]

Exceptions to the general rule. Exceptions can exist, of course, in circumstances where it would be inequitable for a beneficiary to escape liability for debts and obligations of the trust. Restatement (Third) of Trusts section 103 leaves open the possibility that a beneficiary can be held personally liable for a trust's obligations to a third party to the extent a beneficiary would bear personal liability to the trust under section 104, or "as provided by other law, such as the law of contract, tort, or unjust enrichment." Comment c(2) to section 103 provides that a beneficiary will be liable to a third party under "other law" if the beneficiary agrees to indemnify a third party in the event of the trustee's nonperformance, and where a beneficiary induces a third party to do business with the trust through fraudulent representations.

A beneficiary's liability to a third-party creditor of the trust can also be based on the beneficiary's liability to the trust itself. Under Restatement (Third) of Trusts section 104, a beneficiary is personally liable to a trust to the extent:

1. of a loan or advance to the beneficiary from the trust;
2. of the beneficiary's debt to the settlor that has been placed in the trust, unless the settlor manifested a contrary intention;
3. the trust suffered a loss resulting from a breach of trust in which the beneficiary participated; or
4. provided by other law, such as the law of contract, tort, or unjust enrichment.

As a general rule, a beneficiary who receives a distribution from an irrevocable trust is not liable for the debts and liabilities of the trust.

Other situations where a beneficiary can become liable to the trust include the following:

Trustee acting as agent of the beneficiary. Where the trustee is also the agent of the beneficiary, the trustee can bind the beneficiary for trust liabilities.[4] This can occur where the beneficiary has named the trustee as the beneficiary's agent under a valid power of attorney and, pursuant to this power of attorney, the trustee acting as the beneficiary's agent, and not as trustee, agrees to guarantee a trust liability on behalf of the beneficiary.

Beneficiary as joint tortfeasor. If the beneficiary participates in a tort committed by the trustee, the beneficiary can be held liable for the trust's debts and obligations resulting from the joint tortious behavior.[5] This can occur, for example, where the beneficiary assisted the trustee in the theft of property from a third party.

Beneficiary's contracts. The beneficiary will be held liable on the beneficiary's agreement to indemnify the trustee for any loss related to a risky investment or other course of action.[6] A beneficiary may similarly be held liable for any indebtedness of a trust personally guaranteed by the beneficiary.

Beneficiary participation in breach of trust. A beneficiary of a trust has a duty to the other beneficiaries not to participate in a breach of trust,[7] and is liable for participation in a breach of trust just as any non-beneficiary would be.[8] This liability could occur where the beneficiary persuades the trustee to improperly lend or distribute trust assets to the beneficiary or a third party.[9]

Tort by beneficiary. A beneficiary can become liable to a trust under general principles of tort law.[10] A commonly cited example is where a beneficiary misappropriates trust property.[11]

Unjust enrichment. If a trust beneficiary receives a distribution of trust property to which the beneficiary is not entitled, regardless of whether the distribution resulted from a breach of trust or whether the beneficiary knew the distribution was

1 The trustee's authority to decant assets from one trust to another trust can be based on the specific powers contained in the trust agreement, state statute, or common law.

2 Restatement (Second) of Trusts sections 274, 275, 276, and 277 (1959).

3 Restatement (Third) of Trusts section 103. Comments to section 103 further state:

Thus, a beneficiary ordinarily is not personally liable on a contract entered into, or for a tort committed by, the trustee or an agent of the trustee. Similarly, if a third party has a claim against the trustee based on the trustee's ownership of trust property, the third party ordinarily is not entitled to enforce the claim against a beneficiary personally.

4 Restatement (Second) of Trusts section 274 (1959).

5 See comment d. to Restatement (Second) of Trusts section 276 (1959).

6 See comment g(1) to Restatement (Third) of Trusts section 104 (2012).

7 See comment f to Restatement (Third) of Trusts section 104 (2012).

8 *Loring and Rounds: A Trustee's Handbook*, section 5.6 (2012), citing Bogert, *Trusts and Trustees* section 256; 4 *Scott & Ascher* sections 25.2 (Liability of Beneficiary to Trust Estate), 25.2.6 (Beneficiary Who Consents to or Participates in Breach of Trust), and 25.2.6.3 (Participation by Beneficiary in Breach of Trust).

9 Id.

10 See comment g(2) to Restatement (Third) of Trusts section 104 (2012).

11 Id.

12 Id. at comment g(3).

improper, the beneficiary can be held liable to the trust.[12] This could occur where the beneficiary receives an overpayment or misdelivery of trust property.[13]

Fraudulent conveyance of trust property. If the trustee makes a fraudulent conveyance of trust property to a beneficiary to avoid paying trust obligations, the beneficiary can be held liable to the trust. Section 279 of the Restatement (Second) of Trusts provides as follows:

> If a creditor is entitled by a proceeding in equity to reach trust property and apply it to the satisfaction of his claim, and the trustee conveys the trust property to the beneficiary before the claim has been paid, the creditor can by a proceeding in equity hold the beneficiary personally liable for the claim to the extent of the value of the trust property so conveyed, unless the beneficiary is a bona fide purchaser or has so changed his position that it is inequitable hold him personally liable.[14]

In *Wendell Corp. Trustee v. Thurston*, the Supreme Court of Connecticut cited this authority in imposing a constructive trust on property of a beneficiary following a distribution to the beneficiary that left the trust with only $100 of assets and a note payable of over $500,000.[15] The facts of Wendell illustrate why the court viewed this as a fraudulent conveyance case, and not simply an ordinary trust distribution. Within the span of less than eleven months:

1. the trustee signed a promissory note for $509,049 secured by a mortgage on trust property,
2. the plaintiff (Wendell Corp.) purchased the note and mortgage from the original obligee,
3. the trust stopped making payments on the note five months after the note sale to Wendell Corp.,
4. three months after the note payments ceased, the trustee distributed several parcels of real estate to the beneficiary, leaving the trust with assets of approximately $100, and
5. the beneficiary signed a note payable to the trustee's accounting firm for $230,275 secured by a mortgage on one of the real estate parcels simultaneously distributed by the trustee to the beneficiary.

A trustee of an irrevocable trust is subject to the same fraudulent conveyance rules as an individual.

The beneficiary's promissory note to the trustee's accounting firm indicated that it was for past accounting services provided by the trustee's accounting firm to the trust and other business entities with which the beneficiary was involved, as well as for future accounting services to those same entities. Specifically citing Connecticut fraudulent conveyance law, the court found that imposing a constructive trust on the distributed property was an appropriate remedy for the aggrieved creditor because, the court reasoned, the beneficiary benefitted from the debt that gave rise to the promissory note and mortgage owned by Wendell Corp., and

> having received a distribution without consideration from the trustee that left the trust effectively without funds, it is only fair that [the beneficiary's] ownership of an asset so distributed not be shielded from satisfaction of the debt that produced those funds in the first place.[16]

Application of fraudulent conveyance rules. Trustees and beneficiaries of irrevocable trusts are subject to the same fraudulent conveyance rules as individuals. The Uniform Voidable Transactions Act (UVTA), named the Uniform Fraudulent Transfer Act (UFTA) before it was renamed in 2014, provides the rules for fraudulent transfers. The UVTA provides remedies to creditors with respect to certain debtor transactions that are unfair to the debtor's creditors. Section 4 of the UVTA provides, in part, as follows:

> (1) A transfer made or obligation incurred by a debtor is voidable as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation: (a) With actual intent to hinder, delay, or defraud any creditor of the debtor; or (b) Without receiving reasonably equivalent value in exchange for the transfer or obligation, and the debtor: 1. Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or 2. Intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due.[17]Where a trustee decants assets from one trust to another which results in the first trust being unable to pay its debts as they become due, the decanting may be treated by the courts as a fraudulent conveyance.[18]

In *Lazare*, the court relied on the Nevada Uniform Fraudulent Transfer Act to rule that a trustee's decanting of trust assets was a fraudulent conveyance against the federal government, which at the time of the trust decanting had a tax collection claim against assets of the first trust that were under a court-mandated constructive trust,

had petitioned the court for a preliminary injunction enjoining the trustee from transferring assets of the first trust, and received a favorable recommendation from the judge at the hearing on the preliminary injunction that the trustee be enjoined from transferring the first trust's assets.[19] The trust beneficiary in *Lazare* was a tax-dodger who owed the federal government $334.8 million and previously transferred assets to the first trust from another trust that the court determined was the beneficiary's alter ego, which prompted the court to impose a constructive trust on those assets in favor of the federal government's claim. While the trustee's objections to the judge's recommendation on the preliminary injunction were pending, the trustee of the first trust decanted substantial trust assets to a second trust located in another state. The court concluded that the decanting of assets from the first trust to the second trust was constructively fraudulent and made by an insolvent debtor.

Myriad situations exist of course where trustees can make distributions to beneficiaries that do not violate the UVTA, either because there is no actual intent to hinder, delay, or defraud a creditor, or because the trust distribution is comparatively small when considering the trust assets and liabilities.[20] For example, a trustee's ordinary cash distribution of $10,000 to or for the benefit of a beneficiary from a trust having $1 million of liabilities and a net asset value of $10 million should not run afoul of the UVTA.

Liability Of A Recipient Trust For The Debts And Liabilities Of A Distributing Trust After A Decanting Of Distributing Trust's Assets

Section 27 of the UTDA upends the settled law with respect to the liability of a distributee for the debts and obligations of a distributing trust where the trust distribution is not made outright to a beneficiary, but is instead made in further trust for the beneficiary pursuant to a trust decanting. UTDA section 27 provides as follows

> A debt, liability, or other obligation enforceable against property of a first trust is enforceable to the same extent against the property when held by the second trust after exercise of the decanting power.

It appears that the purpose of UTDA section 27 is to prevent the type of liability avoidance techniques attempted by the trustee in the *Lazare* case through a decanting of encumbered property from Trust One to Trust Two. The official comments state as follows:

> It would be inequitable to permit a second trust to evade liabilities incurred by the trustee of the first trust to the extent the creditor would have been entitled to satisfaction out of the trust property. Section 27 provides that a debt, liability or other obligation of the first trust against property of a first trust is enforceable to the same extent against such property when held by the second trust (emphasis added).

The intent and meaning of the phrase "debt, liability or other obligation of the first trust against property of a first trust" is not clear. As a prerequisite to the application of section 27, does this phrase mean the property of the first trust must be specifically encumbered by the liability of the first trust, for example by a mortgage or lien? If so, then it is reasonable for such specifically encumbered property to remain liable for the first trust's "debt, liability or other obligation" even after the specifically encumbered property is decanted to a second trust because the mortgage or lien is specific to the assets which are subject to it. However, UTDA section 27 seems unnecessary to reach this result, since under general creditor/debtor law the encumbrance follows the distributed property. Alternatively, if the liability of the first trust "against" property of the first trust refers to a general unsecured liability without a specific lien or encumbrance on any particular trust property, then the justification for allowing a creditor of the first trust to reach the former assets of the first trust after they have been decanted to the second trust is tenuous. Absent one of the previously discussed exceptions to the general rule that the recipient of a trust distribution is not liable for the debts of the distributing trust, a creditor of the first trust should be unable to reach the decanted assets of the second trust without a specific lien or encumbrance.

The comments to UTDA section 27 contain two examples intended to illustrate the scope of this provision.

Example 1: Chicago Bank makes a loan to First Trust secured by Fuchsia Corp. stock owned by First Trust, and the trustee subsequently decants all of First Trust's assets to Second Trust (including the Fuchsia Corp. stock serving as security for the bank debt). The comments conclude that

> Chicago Bank may enforce the loan against the property of Second Trust, including the Fuchsia

13 Loring and Rounds at section 5.6.

14 Restatement (Second) of Trusts section 279 (1959).

15 *Wendell Corp. Trustee v. Thurston*, 680 A.2d 1314 (Conn. 1996).

16 Id. at 119.

17 See UVTA section 4.

18 See UVTA section 4; for a complete discussion of the fraudulent conveyance risks involved in trust decantings, see Culp & Bennett, 871 T.M., *Trust Decanting* at p. 201.

19 *Lazare*, 117 A.F.T.R. 2d 2016-917 (2016).

20 UTDA, comments to section 27.

Corp. stock, to the same extent it could have enforced the loan against the property of First Trust. If Second Trust also owns property not attributed to the decanting, Section 27 does not expose such property to Chicago Bank's claim.

This result is unsurprising and consistent with settled law. The stock owned by First Trust served as security for the bank debt and a transfer of the stock to a new trust should not prevent the bank from enforcing its lien against such stock if the debt is not repaid. To conclude otherwise would be contrary to the law regarding rights of secured creditors.

Example 2: First Trust decants all of the Fuchsia Corp. stock securing the bank debt to Second Trust and decants all of First Trust's other assets to Third Trust. The comments conclude that Third Trust's assets are liable for the bank loan to First Trust if, prior to the decanting, the bank could have enforced the loan against the property of First Trust other than the Fuchsia Corp. stock. In both of these examples, the debt was known and quantifiable at the time of the decanting. The result of this second example is surprising because it produces a different result than if the First Trust's assets other than the Fuchsia Corp. stock were simply distributed outright to the proposed beneficiary of the Third Trust. Absent the existence of one of the exceptions to the general rule described above, a trust beneficiary is not liable for the trust's debts and obligations. Adding some additional facts to the second example helps illustrate the distortion that UTDA section 27 causes. Assume that the beneficiaries of First Trust are the settlor's child (age 60) and grandchild (age 30), and that the decanting was being implemented to provide one trust to benefit only the child (the Second Trust), and one trust to benefit only the grandchild (the Third Trust). Further, assume that at the time of the decanting First Trust's debt to Chicago Bank is $500,000, the Fuchsia Corp. stock which secures this debt is worth $1 million, and the other assets of First Trust which are decanted to Third Trust consist of cash of $100,000. Had the trustee of First Trust distributed the $100,000 of cash outright to the grandchild, rather than to Third Trust for the benefit of the grandchild, the distribution would not have been a fraudulent transfer and the distributed assets would not have remained liable for the debt to Chicago Bank.

There is no corollary to UTDA section 27 applicable to trust divisions or non-judicial trust modifications under the UTC.

Although UTDA section 27 only applies to obligations of the first trust that were "in existence and enforceable against the property of the first trust at the time of the decanting," this Section appears to provide a creditor with additional rights to reach property of a second trust that are not available to the creditor if the property was distributed outright to the beneficiary of the first trust. Further, section 27 provides no statute of limitations after which the second trust would be free from any claims for liability for the debts of the first trust. In contrast, UVTA section 9 provides for a statute of limitations of not later than four years after the transfer was made or the obligation was incurred, or one year after the transfer or obligation could reasonably have been discovered. Even without a specific statute governing the statute of limitations applicable to a decanting of assets from one trust to another, many states have a catchall statute of limitations which should apply to cut off the liability of a second trust for the debts of the first trust. For example, North Carolina has a ten year statute of limitations which should apply in this situation.[21]

But what about a more difficult situation where the trustee of a large trust decants trust assets along family lines, and because of an event that was unforeseen at the time of the decanting the first trust becomes unable to pay its debts?

For example, assume that in Year One a parent creates a trust ("Trust One") for the benefit of two children, A and B, and funds Trust One with $10 million of assets consisting of $5 million of cash and marketable securities, and a $10 million office building subject to $5 million of bank debt. As the years go by, A and B begin to have differing needs and desires with respect to trust investments and trust distributions, and they live in different states with inconsistent state income tax statutes. For these reasons, the beneficiaries and the trustee desire to divide Trust One into two separate trusts to allow the trustee to invest the trust assets to meet each beneficiary's differing income and principal needs, and to accommodate differing state governing laws to mini-

21 See, for example, NCGS Section 1-56.

22 Uniform Trust Code section 417.

mize state income taxation. In Year 5, the Trustee decants $5 million of cash and marketable securities to Trust Two for the benefit of B. At the same time as the decanting, Trust One is modified to remove B as a beneficiary, leaving A as the sole beneficiary of Trust One. which continues to hold the $10 million office building secured by $5 million of bank debt. Consider the impact of two alternative events that could occur in Year 10, and that were unforeseen in Year 5:

1. A significant economic recession occurs, the tenant defaults on the building lease, Trust One is unable to find a new tenant for the building, and Trust One defaults on its bank loan after exhausting its remaining assets to make note payments.
2. Asbestos is discovered in the building after a water leak, the tenant moves out and stops paying rent, and the combination of the debt to the bank and the asbestos remediation costs exceed the fair market value of the property.

Is Trust Two liable for Trust One's bank debt? Under these facts, there is no fraudulent conveyance. The decanting in Year Five did not render Trust One insolvent, nor was it done with any intent to hinder, delay or defraud any creditor. However, the answer under UTDA section 27 appears to be yes. As long as the debt was in existence and enforceable against the property of Trust One at the time of the decanting, then by its terms, UTDA section 27 subjects the property of Trust Two to the bank debt, regardless of the motivations of the trustee and beneficiary, and the solvency of both trusts at the time of the decanting. In contrast, had the decanted assets instead been distributed outright to B, the decanted assets would not have been liable on the Trust One bank debt.

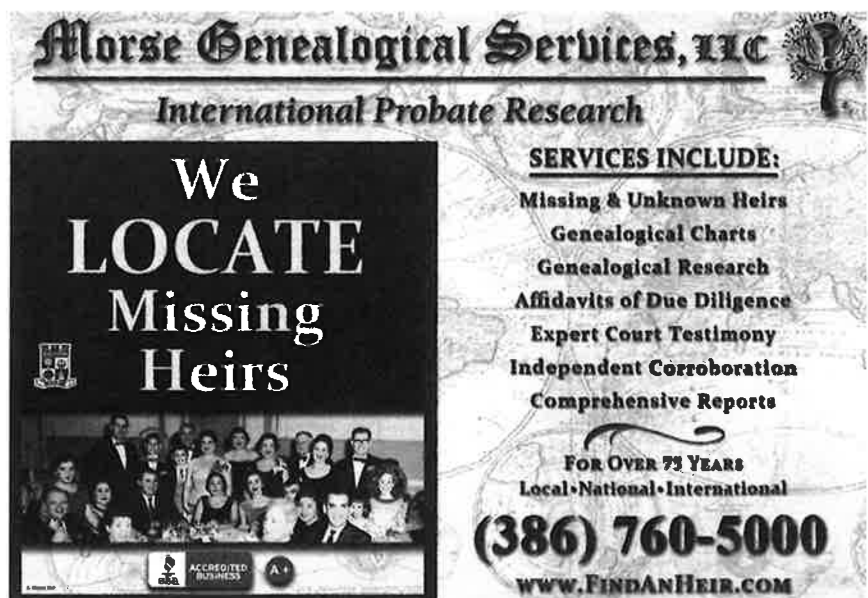
Comparison to Trust Divisions and Trust Modifications under the Uniform Trust Code

There is no corollary to UTDA section 27 applicable to trust divisions or non-judicial trust modifications under the Uniform Trust Code ("UTC"). Therefore, it appears that trust divisions and non-judicial trust modifications may be a preferable method to trust decantings where the trustee is planning for the restructure of an irrevocable trust to meet the varied needs of the trust beneficiaries.

Trust divisions. Trust divisions are a routine aspect of trust administration. Many irrevocable inter-vivos trusts provide that upon the death of the settlor the trust shall divide into equal separate shares for each of the settlor's children. Similarly, many testamentary trusts provide for a division into separate shares for children upon the death of one of the beneficiaries (i.e., the surviving spouse). Trust divisions are also routinely used to segregate GST exempt assets from GST non-exempt assets.

Under UTC section 417 a trustee is granted the power to divide a trust into multiple separate trusts "if the result does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trust."[22] Therefore, under the UTC it is permissible for a trustee to divide a pot trust (Trust One) that provides for discretionary distributions of income and principal among two children into two separate trusts, one for each child (Trust Two and Trust Three) and fund each separate trust with assets of equivalent value. The UTC contains no provision which would make the assets of Trust Two liable for the debt of Trust Three in the event the assets of Trust Three proved to be insufficient to pay off Trust Three debt that was incurred prior to the division and was distributed to Trust Three as part of the division of Trust One into two separate trusts of equal value.

Trust modifications. Non-judicial trust modifications have also become a useful technique to divide trust assets into separate



trusts for beneficiaries where the operation of a single pot trust for the benefit of multiple beneficiaries has become problematic. For example, a single pot trust that benefits the grantor's two children could be nonjudicially modified to create two separate trusts, one for each child, so that the trustee could separately invest the trust assets based on the differing needs of each child.

Under UTC section 411 "[a] noncharitable irrevocable trust may be modified or terminated upon consent of the settlor and all beneficiaries, even if the modification or termination is inconsistent with a material purpose of the trust."[23] Utilizing this provision, the settlor and all trust beneficiaries could modify a single trust that benefits two children, to provide for separate trusts for each child, and fund each separate trust with assets of an equivalent value. The UTC contains no provision which would make the assets of one trust resulting from a non-judicial modification liable for the assets of another trust that was created as part of the same non-judicial modification.

Conclusion

Despite the best efforts of the grantor and the grantor's drafting attorney, irrevocable trusts invariably, and quite often with remarkable rapidity, require a change or tweak to deal with unforeseen circumstances. Three of the most common tools for altering an irrevocable trust are a decanting, a non-judicial modification, and a trust division. While all three may achieve the desired end result, UTDA section 27 imposes a significant added liability risk for a trust decanting, when compared to a trust division or non-judicial trust modification. For trusts governed by the law of states that have included section 27 as part of their UTDA,[24] a trustee should carefully consider whether a decanting of trust property to a second trust is preferable to an outright distribution, a trust division, or a trust modification, where a trust decanting subjects the transferee trust to a perpetual liability for the distributing trust's debt and where the other options do not. ■

[23] Uniform Trust Code section 411(a).

[24] As of the date of publication of this article the following states have adopted the UTDA: Alabama, California, Colorado, Illinois, New Mexico, North Carolina, Virginia, and Washington. Of the seven states that have adopted the UTDA, two (North Carolina and Virginia) have omitted section 27 from their respective versions of the UTDA.