ASSET PROTECTION:
AN OVERVIEW FOR MARYLAND ESTATE & TRUST LAWYERS

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1. Introduction.

Asset protection planning, once considered an exotic – perhaps fringe – area of the practice of law, is recognized increasingly as a fundamental part of estate planning:

> "Asset protection in some respects has been a part of estate planning for as long as an estate planning discipline has existed. After all, people create trusts for family members in most instances to preserve and protect property for the future use and benefit of the family members. From this perspective, asset protection is really just an integral part of the primary goal of the estate planner – to provide a structure to pass property, either during life or at death, to a client's designated beneficiaries, while reducing transfer taxes and avoiding other costs and delays.
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> In today's increasingly litigious environment, however, asset protection planning is becoming increasingly significant as a separate area of focus within the field of estate planning. The essence of asset protection planning is the use of advanced planning techniques to place assets beyond the reach of future potential creditors. In this way, the client can preserve the assets to pass to family members or other beneficiaries through traditional estate planning techniques."

Fox & Huft, Asset Protection and Dynasty Trusts, 37 Real Prop. Prob. & Tr. J. 2987, 291 (Summer 2002).

2. Potential Risk to the Lawyer.

2.1 The Maryland Rule of Professional Conduct.

For the practitioner, asset protection planning and implementation raises ethical issues irrevocably tied to the substantive law. A creditor seeking to set aside a transaction that otherwise might place assets beyond the creditor's reach uses the fraudulent conveyance or fraudulent transfer act applicable to the debtor. The ABA model rules governing a lawyer's conduct and the Maryland Rules of Professional Conduct ("MRPC") 1.2(d) state: "A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law." (Emphasis added.) ABA model rule and MRPC 4.4(a) state: "In representing a client, a lawyer shall not use means that have no substantive purpose other than to embarrass, delay, or burden a third person…" Also MRPC 8.4(c) provides that a lawyer shall not "engage in conduct involving dishonesty, fraud, deceit or misrepresentation." These rules reflect directly the language used under the Uniform Fraudulent Conveyance and Transfer Acts.

In *Attorney Grievance Comm'n v. Pak*, 400 Md. 567, 929 A.2d 546 (2007), a Maryland lawyer was disbarred for executing a series of actions designed to prevent a judgment from attaching to property of her client (who were her parents): "Using her knowledge of the law, respondent aided and advised her parents in creating shell corporations to transfer title in order to avoid a judgment lien." The Court upheld the circuit court finding that the creation of "shell" business entities and other actions violated the Fraudulent Conveyance Act and therefore violated MRPC 8.4(c):

> "Judge Martin concluded that respondent undertook fraudulent actions in order to protect her parents and their assets and thus violated MRPC 8.4(c). He found that her actions to create shell business entities (H&K, L.L.C. and CACHA, L.L.P.) had no legitimate business purposes and were used to transfer title to the Pak's properties, without consideration. The evidence before the hearing court was sufficient for Judge Martin's conclusions. The hearing court also noted that respondent advised her parents when to send the funds to Korea and orchestrated the purchase of the Autumn Frost property in her husband's name only. Lastly, the hearing court found that the Respondent's actions were within the definition of fraud, as outlined in Maryland Code (1975, 2005 Repl. Vol.), § 15-207 of the Commercial Law Article."

The Court of Appeals agreed: "We accept Judge Martin's findings and conclusions on the issue and hold that the respondent did violate MRPC 8.4(c), because there is clear and convincing evidence that her actions were an effort to delay, hinder, or defraud her parents' creditors."

In *Pak*, there was ample evidence that the attorney instituted the series of questionable transactions for the specific purpose of frustrating the creditor's collection of a judgment. Indeed, part of the transaction involved a transfer to the lawyer's husband. Additionally, the attorney became a defendant in the collection suit and as a party (as well as in her representative capacity) she made misleading statements in depositions, in pleadings and in open court. The *Pak* case involved unique facts arising, no doubt, from her love of her parents and her desire to protect them. The case, however, demonstrates the willingness of the Court to wed the language of the Rules of Professional Conduct with that of the Fraudulent Conveyance Act.

2.2 <u>Civil Conspiracy and Other Cases.</u>

The creditor in *Pak* filed suit against the attorney alleging conspiracy for her involvement in the fraudulent transfers. Because of the family relationship between the lawyer and clients, and the deep involvement by the attorney, it was reasonably clear that the lawyer crossed the line from permissible advocacy to active participant.

The lawyer acting as active participant was the basis of the complaint in *Morganroth & Morganroth v. Norris, McLaughlin & Marcus P.C.*, 331 F.3d 406 (3d Cir. 2003). The Plaintiff, Morganroth & Morganroth, was a Michigan law firm that sought to collect a judgment it had against its former client, John DeLorean. The Defendant was a New Jersey law firm representing Mr. DeLorean. The complaint alleged that the New Jersey firm actively, knowingly and intentionally participated in Mr. DeLorean's unlawful efforts to shield his farm from execution. According to the complaint, the New Jersey lawyers prepared a memorandum of lease after the Michigan judgment was rendered purporting to set out the terms of a pre-existing life lease on the property running in favor of Mr. DeLorean's children. These allegations were sufficient to return the case to the federal district court for a trial on civil conspiracy and aiding and abetting a fraud on creditors. See *Miller Avenue Professional & Promotional Services, Inc. v. Koss*, 2005 WL 2787455 (Cal. App. 2005) (Unreported) ("An attorney may not, with impunity, engage in intentionally tortious conduct towards third persons, or conspire with a client to defraud or injure a third person."). Maryland recognizes a civil cause of action for aiding and abetting as being culpable as principals. *Alleco, Inc. v. Harry & Jeanette Weinberg Foundation, Inc.*, 340 Md. 176, 199, 665 A.2d 1038, 1049 (1995).

In Florida, no cause of action exists for aiding and abetting a fraudulent transfer. *Freeman v. First Union Bank*, 865 So. 2d 1272 (Fla. 2004). Essentially, this holding is based on the view that the Uniform Fraudulent Transfer Act "is not a source of liability; rather it only allows creditors to set aside fraudulent transfers made to transferees under a theory of cancellation." [This is how the issue was framed in the federal suit which referred the issue to the Florida Supreme Court. See *Freeman*, 329 F.3d 1231 (11th Cir. 2003).] See also *Nastro v. D'Onofrio*, 263 F. Supp. 2d 446, 459 (D. Conn. 2003) (The lawyer creating the offshore trust is not liable "in light of the strong public policy in the State of Connecticut against imposing liability upon a lawyer to third parties for the performance of legal services to a client.")

The *Freeman* case, of course, addressed the narrow issue of whether the UFTA creates tort liability or whether it is merely a remedial statute. Not addressed are the other theories of liability that may involve others, beyond that of the debtor – including liability of the lawyer. See generally Siegel, <u>Attorney Liability: Is This the New Twilight Zone?</u>, 27 U. Mem. L. Rev. 13 (1996); Richmond, Lamberth and LeLawalla, <u>Lawyer Liability and the Vortex of Deepening Insolvency</u>, 51 St. Louis U. L.J. 127 (2006); Schiltz, <u>Civil Liability for Aiding and Abetting: Should Lawyers be 'Privileged' to Assist Their Clients' Wrongdoing?</u>, 29 Pace L. Rev. 75 (2008).

2.3 "Respectable" Asset Protection Planning.

The line between participating in a fraudulent transfer and engaging in asset protection planning will be determined by a "facts and circumstances" test: "As a general proposition, attorneys who assist clients with transfers of property in good faith and without actual or deemed knowledge that the transfers are fraudulent conveyances should not be liable to the clients' creditors or in violation of any ethical obligations that the attorneys may have under state law." Culp and Perrin, The Case for Caution: Fraudulent Conveyance Risks in Estate Planning, 24 Real Prop. Prob. & Tr. J. 41, 44 (Jan./Feb. 2010).

Accordingly, it is essential that the practitioner document that the plan was not designed to prejudice known or reasonably anticipated creditors:

> "Under what circumstances will transfers to APTs [asset protection trusts] be deemed fraudulent under the fraudulent transfer laws? More particularly, if a settlor transfers assets to an APT not with a specific creditor in mind, but rather with the general goal of shielding assets from potential future creditors, will the transfer be deemed fraudulent and thus voidable under the UFTA or similar laws? Although the answer to this question is not without doubt, it appears that most courts are unwilling to void transfers whose purpose and effect is to shelter assets from creditors that were unknown at the time of the transfer. Furthermore, the more remote in time the claim of a future creditor, the less likely a court will be to find that an earlier transfer was fraudulent with respect to that creditor. Thus, as long as a person creating an APT does so well in advance of a creditor's claim, and especially if the creditor was unknown and unforeseeable at the time of the transfer to the trust, it is likely that the transfer will not be deemed fraudulent.
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> In an action brought under UFTA section 4(a)(1) -- in which the creditor must prove "actual intent to … defraud" -- a future creditor must typically establish that, as of the time of the transfer, the creditor held 'contingent, unliquidated, or unmatured claims,' or that the creditor held 'a claim that [could] reasonable [be] foreseen by the transferor.' Professor Peter A. Alces states that, in an action based on actual intent to defraud, a future creditor must 'establish a causal link between the fraudulent disposition and the injury suffered.' Regarding this same question Professor Alces further states that '[the] focus on causality provides a means to distinguish between the actions that operate directly to prejudice a particular creditor and those actions that in some remote, not foreseeable way, have after the passage of considerable time or the occurrence of an intervening cause, compromised a creditor's financial interest.'

> Concerning a similar issue, in an often-cited passage the court in Oberst v. Oberst stated: 'While the Court finds it very difficult to locate the exact line between bankruptcy planning and hindering creditors, Congress has decided that the key is the intent of the debtor. If the debtor has a particular creditor or series of creditors in mind and is trying to remove his assets from their reach, this could be grounds to deny the discharge. If the debtor is merely looking to his future wellbeing, the discharge will be granted. This is an uncomfortable test and does not seem equitable; but it is the law. Thus, the concept of 'reasonable foreseeability,' the requirement that future creditors establish a 'causal link' between the transfer and their claims, and the notion that one may permissibly plan for one's general 'future wellbeing' all serve to limit those future creditors who can successfully claim that a transfer was intended to defraud them."

Danforth, Rethinking the Law of Creditors' Rights in Trusts, 53 Hastings L.J. 287, 330 (2002).

Practitioners should be careful to document: (i) the reasons for any asset protection plan, (ii) the extent of the client's debt (including foreseeable creditors), and (iii) that, at the time of the plan, the client has sufficient other assets to meet his or her obligations as those obligations come due. A careful solvency analysis will identify those assets that are not available to creditors under state law, identify assets available for a client's known and anticipated creditors, and then focus the asset protection planning on the remaining assets. This process should be documented in the file. This process has been called a "creditor protection plan." Osborne and Terrill, Fundamental of Asset Protection Planning, 31 ACTEC J. 319, 324 (Spring 2006):

> "The proper approach to effective, careful asset protection planning begins with a solvency analysis of the client.
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> In an accurate solvency analysis, the lawyer should make a complete list of all of the client's assets and then make three subtractions from the total value. The first subtraction should be the value of all current debts. Reserves must be established to satisfy these obligations. This action protects present creditors.
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> The second subtraction should include all liabilities, claims, contingent liabilities, threats, guarantees, contingent claims, pending lawsuits, and potential claims faced by the client. The lawyer should aggressively identify, document and quantify all of these liabilities. To assist in this exercise, it may be appropriate to conduct independent internet database research of the client's financial/legal situation. In some cases, an audited financial statement is very helpful and should be

secured. Furthermore, the attorney should inquire about the client's business and professional reputation. For example, does the physician client have a history of malpractice claims? Does the business client have a history of disputes with creditors, associates, etc.? After all liabilities are evaluated and summed, reserves must be set aside to satisfy them. This action protects potential subsequent creditors.

The third subtraction in the solvency analysis involves all client assets already protected from creditors under the law (*e.g.*, homestead, insurance, and retirement plans). Such exemptions and protections vary tremendously from state to state, of course. In some cases, it may be advisable to join an attorney from another state (if that is where some assets are located) and/or join an attorney with creditor's rights expertise (if there are pending claims against the client) as co-counsel.

Finally, at the end of the solvency analysis, the lawyer must devise a methodology to protect creditors. Indeed, that 'creditor protection plan' is the entire purpose of the solvency analysis and is, in fact, the linchpin of prudent, careful asset protection planning."

3. <u>Fraudulent Conveyance Act.</u>

3.1 <u>Background.</u>

There are two uniform acts governing fraudulent conveyances: the Uniform Fraudulent Conveyance Act (1918) (The "UFCA") and the Uniform Fraudulent Transfer Act (1984) (the "UFTA"). Maryland continues to use the older act which is rooted in the Statute of 13 Elizabeth (1571):

> "Fraudulent conveyance law has its origins in the Statute of 13 Elizabeth, ch. 5 (1571). See 5 Collier on Bankruptcy ¶ 548.01 (15th Ed. Revised). The purpose of the fraudulent conveyance doctrine is to prevent assets from being transferred away from a debtor in exchange for less than fair value, leaving a lack of funds to compensate the creditors. Id. In the foundational fraudulent conveyance case, In re Twyne's Case, 3 Co. Rep. 806, 76 Eng. Rep. 809 (Star Chamber 1601), the Star Chamber examined the facts surrounding such transfers to determine whether they had "signs and marks" of a fraudulent or malicious intent, such a secret transfers, continued ownership or possession of property after its alleged transfer, self-serving representations in transfer documents that the transfer was not intended to defraud creditors, transfers of substantially all assets, or transfer made while action was pending against the transferor. See also Collier's, supra. In short, fraudulent conveyance law is aimed at preventing debtors from making collusive transfers to other – often friendly recipients – in an attempt to avoid their creditors. See Fraudulent Conveyance Law & Its Proper Domain, Douglas G. Baird & Thomas H. Jackson, 38 Vand. L. Rev. 829, 830 (1985) ("A debtor cannot manipulate his affairs

in order to shortchange his creditors and pocket the difference. Those who collude with a debtor in these transactions are not protected either.")

* * *

In the United States, § 67(e) of the 1898 Bankruptcy Act directly copied much of the Statute of 13 Elizabeth. Most states followed suit, either recognizing 13 Elizabeth through common law, or expressly adopting or reenacting it. See Fick v. Perpetual Title Co., 694 A.2d 138, 143 (Md. Ct. Spec. App. 1997) (citing 37 C.J.S. Fraudulent Conveyances § 2, at 852 (1943)). Maryland adopted the English statute, 1 Alexander's British Statutes 499 (cod's ed. 1912), which remained in effect until 1920, when the MUFCA was adopted. See Fick, 694 A.2d at 143; see also Clinton Petroleum Serv., Inc. v. Norris, 319 A.2d 304, 307 (Md. 1974) (stating that the MUFCA 'replaced in virtually identical terms the statute of 13 Elizabeth'). The Maryland Court of Appeals remarked of the statute, '[t]he Uniform Act is declaratory of the common law and is practically a restatement of the Statute of 13 Elizabeth.' Westminster Sav. Bank v. Sauble, 39 A.2d 862, 864 (Md. 1944) (citations omitted); see also Damazo v. Wahby, 305 A.2d 138, 141-142 (Md. 1973) (reiterating that the MUFCA is declaratory of common law and did not restrict the legal or equitable remedies already available to a creditor)."

In re Abatement Environmental Resources, Inc., No. 03-1771 (4th Cir. 6/15/04) (unpublished). The Maryland version of the UFCA is located in Title 15 of the Commercial Law Article (hereinafter "MUFCA").

Despite declarations that the MUFCA had "virtually identical terms" with the Statute of 13 Elizabeth, MUFCA was actually a refinement of its antecedent: "The Uniform Act (of 1918) was a codification of the 'better' decisions applying the Statute of 13 Elizabeth." Prefatory Note, Comments, "Uniform Fraudulent Transfer Act" (1984) NCCUSL. These "better decisions" expanded the original requirement of showing subjective intent to defraud to a more objective standard:

"The Statute of Elizabeth required that a creditor prove actual, subjective intent to hinder, delay, or defraud to avoid a conveyance. Because subjective intent to defraud was difficult to prove, courts focused on objective factors to establish the wrongful intent. Decisions under the Statute soon turned on 'circumstances, so frequently attending sales, conveyances and transfers, intended to hinder, delay and defraud creditors, that they [were] known and denominated *badges of fraud*.' The court in *Twyne's Case* (an English Star Chamber case of 1601) cataloged several factors having particular probative force: (1) the debtor made a general transfer of all property; (2) the debtor retained possession and use of the property; (3) the transfer was clandestine; (4) the transfer was made 'pending the writ': (5) the parties created a trust to govern use of the property; or (6) the deed explicitly vouched for its own validity and the parties' honesty and good faith.

American jurisdictions enacted legislation similar to the Statute of Elizabeth or adopted the Statute as part of the common law. The American courts similarly adopted the English decisions that expanded the Statute through the use of objective indicia of fraud; later American decisions also increased the list of 'badges.' Although a strict construction of the Statute required proof of fraudulent intent, many courts permitted creditors to avoid a transfer on the basis of objective factors alone."

Alces and Dorr, A Critical Analysis of the New Uniform Fraudulent Transfer Act, 1985 U. Ill. L. Rev. 527, (1985).

3.2 The Maryland Law.

The MUFCA provides that any conveyance made "with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud present or future creditors, is fraudulent as to both present and future creditors." MUFCA § 15-207. The MUFCA also provides that conveyance without "fair consideration" is fraudulent if (i) the conveyance is made by a person who is insolvent or becomes insolvent because of the transfer (MUFCA § 15-204), (ii) by a person engaged or about to be engaged in a transaction for which the conveyance leaves him or her with "unreasonably small capital" for that transaction (MUFCA § 15-205), or (iii) by a person who intends or believes that he or she will incur debts beyond his or her ability to pay as they mature (MUFCA § 15-206). The MUFCA also provides similar rules governing the conduct of partners and partnerships. MUFCA § 15-208.

MUFCA § 15-202 defines insolvency:

"(a) A person is insolvent if the present fair market value of his assets is less than the amount required to pay his probable liability on his existing debts as they become absolute and matured.

(b) In determining if a partnership is insolvent, there shall be added to the partnership property:

> (1) The present fair market value of the separate assets of each general partner in excess of the amount probably sufficient to meet the claims of his separate creditors; and
>
> (2) The amount of any unpaid subscription to the partnership of each limited partner, if the present fair market value of the assets of the limited partner is probably sufficient to pay his debts, including the unpaid subscription."

The 1918 Uniform Act uses "fair salable value" instead of "present fair market value" in its definition of insolvency. The UFTA uses "fair valuation" as it standard. When applying this balance sheet test, assets do not include unreachable assets (such as Tenants by the Entirety property or trust assets subject to a valid spendthrift clause). MUFCA § 15-201(b).

The handling of contingent obligations, such as guarantees, presents some difficulty. *In re Merry-Go-Round Enterprises, Inc.*, 229 B.R. 337 (Bankr. D. Md. 1999), the Court held that contingent debts are not determined under standard accounting rules (GAAP) which only lists debts that are probable and can be reasonably estimated. Instead, "the amount of a contingent claim, however, is determined in accordance with the probability that the contingency will occur and that this valuation after such discounting is made from the debtor's perspective." In other words, the debtor must measure, and adjust for, the likelihood of needing to cover all contingent debt. All of it should be scheduled and dealt with in the planning process using a reasonable judgment as to the probability such guaranty will be called.

As noted, fair consideration given for property or an obligation will defeat a constructive fraudulent conveyance claim. It is defined by MUFCA § 15-203:

> "Fair consideration is given for property or an obligation, if:
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> (1) In exchange for the property or obligation, as a fair equivalent for it and in good faith, property is conveyed or an antecedent debt is satisfied; or
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> (2) The property or obligation is received in good faith to secure a present

> advance or antecedent debt in an amount not disproportionately small as compared to the value of the property or obligation obtained."

3.3 Badges of Fraud.

The Court of Appeals in *Berger v. Hi-Gear Tire and Auto Supply, Inc.*, 257 Md. 470, 476-77, 263 A.2d 507, 510 (1970) adopted the traditional "badges of fraud" indicia as the test in Maryland:

> "Relative to indicia or badges of fraud 37 Am.Jur.2d, Fraudulent Conveyances, § 10 (1968) states:
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> 'The facts which are recognized indicia of fraud are numerous, and no court could pretend to anticipate or catalog them all. Among the general recognized badges of fraud are the insolvency or indebtedness of the transferor, lack of consideration of the conveyance, relationship between the transferor and the transferee, the pendency or threat of litigation, secrecy or concealment, departure from the usual method of business, the transfer of the debtor's entire estate, the reservation of benefit to the transferor, and the retention by the debtor of possession of the property.
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> Although it has been said that a single badge of fraud may stamp a transaction as fraudulent, it is more generally held that while one circumstance recognized as a badge of fraud may not alone prove fraud, where there is a concurrence of several such badges of fraud an inference of fraud may be warranted.'"

3.3.1 Family Relationship.

Several cases examine the importance of a family relationship as an indicium of fraud, concluding that it is not necessarily, of itself, conclusive. In *Oles Envelope Corp. v. Oles*, 193 Md. 79, 65 A.2d 899 (1949), a husband sold closely held family stock to his father immediately preceding his divorce. The Court reviewed extensive evidence concerning the family dynamics (the father was displeased about his son's mid-life crisis) and looked at the consideration paid for the stock. The father paid a premium over book value: "[I]t is argued that the stock was worth considerably more than book value. But it must be appreciated that it might have taken some time to find someone who would invest more than a quarter of a million dollars in an unlisted stock, and that Oles (the son) wanted to sell promptly…. [W]e … hold here that there is not such a glaring inadequacy of consideration as of itself to stamp the transaction with fraud by shocking the common sense of honesty and thereby to render the transaction void." (At 89-90).

Cases involving transfers between near relatives shift the burden of proof. In those situations, the relative receiving the property must prove sufficient consideration <u>and</u> the lack of fraudulent intent:

> "Though he who alleges fraud must prove it, facts and circumstance of a conveyance, especially one between near relatives, may be such as to shift to one who claims to be a bona fide purchaser for value the burden of proving that he is. Freedman v. Yoe, 141 Md. 482, 487, 119 A. 260; Commonwealth Bank v. Kearns, 100 Md. 202, 209, 210, 59 A. 1010; Kennard v. Elkton Bank and Trust Company, 176 Md. 497, 500-501, 6 A.2d 258. It is necessary to establish both a sufficient consideration and also bona fides. If a conveyance is made and accepted with intent to hinder, delay or defraud creditors, it matters not that a full consideration has been paid. McCauley v. Shockey, 105 Md. 641, 649-650, 66 A. 625."

Kline v. Inland Rubber Corp., 194 Md. 122, 137-8, 69 A.2d 774, 780 (1949).

3.3.2 <u>Constructive Notice of Fraud.</u>

Under MUFCA § 15-209, a transaction may be set aside "as against any person except a purchaser for fair consideration without knowledge of the fraud at the time of the purchase or one who has derived title immediately or immediately from such a purchaser." Thus, either lack of "fair consideration" or knowledge of the fraud will defeat the transfer. In *Fick v. Perpetual Title Co.*, 115 Md. App. 524, 694 A.2d 138 (1997), the Court held that constructive knowledge is sufficient:

> "Must the grantees have actual, as opposed to constructive, knowledge of the fraudulent nature of the conveyance in order to set aside a conveyance as fraudulent under section 15-209? Most courts that have considered the question have held that constructive notice is sufficient.
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> While there is authority to the contrary in some jurisdictions, the general rule is that if a purchaser had knowledge of facts and circumstances naturally and justly calculated to excite suspicion in the mind of a person of ordinary prudence, and

> which would naturally prompt him to pause and inquire before consummating the transaction, and such inquiry would have necessarily led to a discovery of the fact with notice of which he is sought to be charged, he will be considered to be affected with such notice, whether or not he made the inquiry. Under these circumstances it is immaterial that the purchaser did not have actual knowledge of the fraudulent intent of the seller or did not participate therein."

Although the general principle is stated in sweeping language, its application has been narrowly interpreted. Indeed, in *Fick* the transferee knew of unsatisfied judgments and of a transfer to the debtor's daughter for no consideration and the Court refused to find imputed knowledge.

Likewise, in the cases involving inter-spousal transfers, the focus is not on imputed knowledge presumably because of the high degree of proof required. *Cruickshank-Wallace v. County Banking and Trust Co.*, 165 Md. App. 300, 885 A.2d 403 (2005), for example, focused on whether a transfer by a husband to a wife for "family support" could constitute fair consideration. In Maryland, the "ancient necessities doctrine" requiring a husband to be liable for his wife's necessities was abolished as a consequence of ERA. Now each spouse has an affirmative duty to support each other and his or her family. In *Cruickshank-Wallace,* the transfer did not qualify as fair consideration as a matter of law because of the repeal of the necessities doctrine. The issue of imputed knowledge of insolvency and of the fraud was sidestepped (although the Court reviewed testimony that the wife did not involve herself in her husband's business affairs).

Cruickshank-Wallace may not have adequately described the implications of the supposed abolishment of the ancient necessities doctrine. In *Wal Mart Stores, Inc.*, 187 Md. App. 690, 979 A.2d 744 (2009), the Court effectively held that the doctrine merely meant that both spouses owe the other a duty to provide necessities. Satisfying that duty would seem to constitute "consideration."

3.4 <u>Disclaimer as Transfer.</u>

For most purposes, a disclaimer should not be a transfer for fraudulent conveyance purposes under Maryland law. Given the asset protection benefits afforded married couples by tenancy by the entireties, if a disclaimer is not a transfer a planning opportunity exists. A couple could hold most of their assets by the entities then rely on a "disclaimer trust" with a spendthrift clause at the first death. If the debtor spouse dies first, the asset is received (in general, see below) free of the debts. If the debtor spouse survives <u>and</u> a disclaimer is not a transfer, then at least part of the entireties property could be "directed" to a spendthrift trust for the benefit of the survivor. Obviously, the key issue to this planning is whether a disclaimer is a transfer for fraudulent conveyance purposes.

Maryland has adopted the 2002 version of the Uniform Disclaimer of Property Interest Act. It states that "a disclaimer made under this subtitle is not a transfer, assignment, or release." Est. & Trusts § 9-202(f). This language is meant to continue the "relation back" effect of prior law:

> "Subsection (f) restates the long standing rule that a disclaimer is a true refusal to accept and not an act by which the disclaimant transfers, assigns, or releases the disclaimed interest. This subsection states the effect and meaning of the traditional "relation back" doctrine of prior Acts. It also makes is clear that the disclaimed interest passes without direction by the disclaimant, a requirement of tax qualification."

Comment, Section 6, UDPIA (2002).

Effective October 1, 2007, Est. & Trusts § 9-202(f)(2) was added to provide: "Creditors of the disclaimant have no interest in the property disclaimed." This should preclude most (but as discussed below, perhaps not all) creditors from reaching disclaimed assets.

The declaration that a disclaimer is not a transfer is not absolute. In *Troy v. Hart*, 116 Md. App. 468, 697 A.2d 113 (1997); cert. denied 347 Md. 255, 700 A.2d 1215 (1997) the court held under the prior law that an inheritance disclaimed is subject to a constructive trust in order to disgorge the disclaimant's Medicaid benefits. This decision was grounded in public policy:

> "What this Court is more broadly faced with is the propriety of the disclaimer in light of societal interest and overall policy considerations. What is ludicrous, if not repugnant, to public policy is that one who is able to regain the ability to be financially self-sufficient, albeit for a temporary or even brief period of time, may voluntarily relinquish his windfall.
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> While we are mindful that social agencies are 'skewered through and through with office pens, and bound hand and foot with red tape,' this acknowledgment does not vitiate legal obligation to report a recipient's change in financial status. Lettich had a legal obligation to 'pay his own way' (by means of the inheritance) until such time as his resources were exhausted. Had the disclaimed funds actually been acquired and exhausted, Lettich most certainly would have been eligible to resume his receipt of Medicaid benefits.
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> In Molloy v. Bank, 214 A.D.2d 171, 631 N.Y.S.2d 910 (1995), the Supreme Court of New York, Appellate Division, confronted the same issue now before this Court. Molloy, a resident of a nursing home, was a recipient of medical assistance. Upon the death of her daughter, Molloy, pursuant to intestacy law, was entitled to her statutory share of the estate. Prior to disposition of the estate, Molloy renounced her interest in it. Acknowledging that the right to renounce a intestate is irreconcilable with the principle that public aid is of a limited nature and should only be afforded to those who demonstrate legitimate need, 631 N.Y.S.2d at 911, the court found that '[Molloy]'s renunciation of a potentially available asset was the functional equivalent of a transfer of an asset since by refusing to accept it herself, she effectively funneled it to other familial distributes.' Id. at 913.
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> Applying this analysis to the case sub judice, we adopt the reasoning of the New York court. The result of such a transfer prior to application for benefits is that the transferee enjoys a 'windfall' for which the applicant/transferor is penalized against the inception of his eligibility. So too should this penalty result in a circumstance in which a Medicaid recipient disclaims or otherwise transfers an inheritance that if accepted would result in a loss of eligibility."

Although the *Troy* Court adopts the New York approach that a disclaimer is "the functional equivalent of a transfer," it appears to adopt this position only for the purposes of determining whether an applicant has an "available resource" for benefit qualification purposes. That determination is worlds away from treating a disclaimer as a transfer, fraudulent or otherwise. For a discussion of the different treatment afforded in various jurisdictions of whether a disclaimer can be a fraudulent conveyance, see generally Fred Franke, Asset Protection and Tenancy by the Entirety, 34 ACTEC J. 210, 219-21 (2009).

Under federal law, a disclaimer will not defeat a federal tax lien. This decision turned (like *Craft*, discussed below) on a federal definition of whether property interests constitute "property" or "rights to property" under IRC § 6321. *Drye v. United States*, 528 U.S. 49, 120 S.Ct. 474 (1999):

> "In sum, in determining whether a federal taxpayer's state-law rights constitute 'property' or 'rights to property,' '[t]he important consideration is the breadth of the control the [taxpayer] could exercise over the property.' Morgan, 309 U.S., at 83. Drye had the unqualified right to receive the entire value of his mother's estate (less administrative expenses), see National Bank of Commerce, 472 U.S., at 725 (confirming that unqualified 'right to receive property is itself a property right' subject to the tax collector's levy), or to channel that value to his daughter. The control rein he held under state law, we hold, rendered the inheritance 'property' or 'rights to property' belonging to him within the meaning of § 6321, and hence subject to the federal tax liens that sparked this controversy."

Whether disclaimers work beyond the *Troy* and *Drye* situations is not fully decided in Maryland. The literal language of Est. & Trusts § 9-202(f), of course, may define the state of the law. This provision flatly denies a creditor's claim to disclaimed property. Est. & Trusts § 9-210(e), however, states that disclaimers are barred or limited if "so provided by law other than this subtitle." As discussed in the Comment to the Uniform Act (at Section 13), ultimately the issue is left to the legislature or to the courts:

> "Subsection (e), unlike the 1978 Act, specifies that 'other law' may bar the right to disclaim. Some States, including Minnesota (M.S.A. § 525.532 (c)(6)), Massachusetts (Mass. Gen. Law c. 191A,§ 8), and Florida (Fla. Stat. § 732.801(6)), bar a disclaimer by an insolvent disclaimant. In others a disclaimer by an insolvent debtor is treated as a fraudulent 'transfer'. *See Stein v. Brown*, 18 Ohio St.3d 305 (1985); *Pennington v. Bigham*, 512 So.2d 1344 (Ala. 1987). A number of States refuse to recognize a disclaimer used to qualify the disclaimant for Medicaid or other public assistance. These decisions often rely on the definition of 'transfer' in the federal Medical Assistance Handbook which includes a 'waiver' of the right to receive an inheritance (*see* 42 U.S.C.A. § 1396p(e)(1)). *See Hinschberger v. Griggs County Social Services*, 499 N.W.2d 876 (N.D. 1993); *Department of Income Maintenance v. Watts*, 211 Conn. 323 (1989), *Matter of Keuning*, 190 A.D.2d 1033, 593 N.Y.S.2d 653 (4th Dept. 1993), and *Matter of Molloy*, 214 A.D.2d 171, 631 N.Y.S.2d 910 (2nd Dept. 1995), *Troy v. Hart*, 116 Md. App. 468, 697 A.2d 113 (1997), *Tannler v. Wisconsin Dept. of Health & Social Services*, 211 Wis. 2d 179,

> 564 N.W.2d 735 (1997); *but see, Estate of Kirk*, 591 N.W.2d 630 (Iowa, 1999) (valid disclaimer by executor of surviving spouse who as Medicaid beneficiary prevents recovery by Medicaid authorities). It is also likely that state policies will begin to address the question of disclaimers of real property on which an environmental hazard is located in order to avoid saddling the State, as title holder of last resort, with the resulting liability, although the need for fiduciaries to disclaim property subject to environmental liability has probably been diminished by the 1996 amendments to CERCLA by the asset Conservation Act of 1996 (PL 104-208). These larger policy issues are not addressed in this Act and must, therefore, continue to be addressed by the States. On the federal level, the United States Supreme Court has held that a valid disclaimer does not defeat a federal tax lien levied under IRC § 6321, *Drye, Jr. v. United States*, 528 U.S. 49, 120 S.Crt. 474 (1999)."

Under current law, the only exceptions to the "no-transfer" rule impacting Marylanders are those of the *Troy* and *Drye* situations. Thus, a disclaimer trust should work in other circumstances.

4. Bankruptcy Reform.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "New Bankruptcy Act") was signed by President Bush on April 20, 2005. The impact of the New Bankruptcy Act, as with most new legislation, will not be fully known until digested and interpreted by courts handling specific cases. What follows is a broad outline of some of the statutory changes affecting estate or asset protection planning for Marylanders.

4.1 Fraudulent Conveyance Look-Back Period.

The general fraudulent conveyance look-back period has been extended from one year to two years from the date a bankruptcy case is filed. A new ten (10) year look-back rule, however, applies to "a self-settled trust or similar devise":

> "In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if-(A) such transfer was made to a self-settled trust or similar device; (B) such transfer was by the debtor; (C) the debtor is a beneficiary of such trust or similar device; *and* (D) *the debtor made such transfer with actual intent to hinder, delay, or defraud* any entity to which the debtor was or became, on or after the date that such transfer was made, indebted."

New Bankruptcy Act 11 U.S.C. § 548(e)(1).

Literally, this new look-back provision applies where it can be established by the bankruptcy trustee that the transfer was made with the actual intent to avoid a specific debt. One can easily imagine, however, courts assuming that such an intent exists especially if the transfer is to an asset protection trust under U.S. or foreign law. This puts a premium on documenting the non-fraudulent reasons for the establishment of the trust <u>and</u> the importance of never funding an asset protection trust without first documenting that sufficient assets are "left on the table" to satisfy existing creditors.

"A self-settled trust or similar device," of course, is broader than an asset protection trust. The exact parameters will evolve as cases are decided. Presumably, it would include grantor retained annuity trust (GRATs); grantor retained income trusts (GRITs); qualified personal residence trusts (QPRTs); and other common arrangements. With these arrangements, a non-fraudulent purpose may be easier to document. If, however, such interests are exposed to the ten (10) year look-back, what is the extent of the exposure – the grantor's retained interest, or the whole asset or fund? These arrangements are, after all, supposedly irrevocable. Should a charitable remainder trust be entirely set aside or only the grantor's retained interest? How would a QPRT be treated – differently from a CRT? Does the QPRT qualify for a homestead exemption in jurisdictions recognizing such exemptions?

4.2 <u>Forum Shopping.</u>

The Bankruptcy Code, in general, gives debtors the choice of using either the 11 U.S.C. § 522(d) exemptions or the exemptions available under state law. Many states, however, have "opted out" of the federal exemption by forcing use of the state exemption. Maryland (unlike Florida or Texas) has opted out of the federal exemptions. (Cts. & Jud. Proc. Art. § 11-504(g)). Thus, a Maryland debtor will be limited to preserving the existing general dollar caps. [These general exemptions are not lavish: $11,000 per Cts. & Jud. Proc. Art. § 11-504(b)(5) and (f).]

Before the New Bankruptcy Act, debtors could relocate to jurisdictions with extensive state homestead exemptions. Florida, for example, permitted an unlimited homestead exemption even when the acquisition of the property was with actual intent to defraud a creditor! *Havoco of America, Ltd. v. Hill*, 790 So. 2d 1018 (Fla. 2001) (debtor relocating from Tennessee.)

The New Bankruptcy Act targets debtors moving to jurisdictions to enhance their homestead exemptions. Now, if a debtor moves domicile from one state to another within two (2) years of filing the petition, domicile for the purpose of available state exemptions shall be the state of domicile for the six (6) months immediately prior to the two (2) year window. New Bankruptcy Act 11 U.S.C. § 522(b)(3). Prior law looked to domicile within 180 days of filing.

4.3 Limits on Homestead Exemption.

The new federal law also limits the extent of a state homestead exemption. The homestead exemption is reduced to the extent of any additions to the value of the property within ten (10) years of filing if the additions were made with the intent to defraud creditors. New Bankruptcy Act 11 U.S.C. § 522(o). Also any additions over $125,000 of value to the homestead within three (3) years and four (4) months of filing are reachable. New Bankruptcy Act 11 U.S.C. § 522(p). For debtors owing certain debts (security fraud penalties, intentional torts, etc. within the preceding five (5) years), an overall limit of $125,000 is put on the homestead exemption except if reasonably necessary for the support of the debtor and dependents. New Bankruptcy Act 11 U.S.C. § 522(q). These new homestead caps apply to states opting out of the federal exemptions. As noted, however, Maryland does not have a homestead exemption.

4.4 IRAs; Insurance.

Cts. & Jud. Proc. § 11-504(h) exempts IRAs and Roth IRAs regardless of value. In

In Re: Neil Solomon, M.D., 67 F.3d 1128 (4th Cir. 1995), the federal Court of Appeals held that an IRA was exempt and the debtor was not forced to consider non-mandatory withdrawals as potential income for Chapter 13 purposes. In that case, Dr. Solomon was facing $160 Million in potential tort liability – much of it non-dischargeable under Chapter 7 because it arose from "willful and malicious injury by the debtor." The bankruptcy court denied a Chapter 13 plan, holding that the debtor needed to include as "disposable income" some part of his IRAs. The Court of Appeals reversed.

Rousey v. Jacoway, 544 U.S. 320, 125 S.Ct. 1561 (2005), held that IRAs were covered under the federal exemptions of § 522(d)(10)(E) of the Bankruptcy Code. Before *Rousey* there was an issue because IRAs are not ERISA plans. The New Bankruptcy Act makes the federal IRA exemption explicit and adds a limit of $1 Million for IRAs (but no limit for 401(k)s; rollovers from 401(k)s, SEPs and SIMPLE-IRAs). The $1 Million may cover IRAs under state exemptions when the state opted out of the federal exemptions (Maryland). New Bankruptcy Act § 522(n). There is ambiguity on this point.

Inherited IRAs, on the other hand, may be characterized as a self-settled trust and consequently not be protected under the general provisions of the exemption statute but regarded as reachable by the creditors of the beneficiary. Although there is no case on point in Maryland, this is the trend from bankruptcy cases nationally. See, for example, *In re Kirchen*, 344 B.R. 908 (Bankr. E.D. Wis. 2006) (holding that an inherited IRA was not an exempt asset under the state exemption statute because it was not a fund created by the debtor for his retirement) for a string citation of the jurisdictions not treating inherited IRAs as exempt assets under the applicable state law. For planning purposes, of course, it will be the law of the domicile of the beneficiary, not the original owner, that will control the result. One solution may be to make a "conduit" spendthrift trust that qualifies as a designated beneficiary under Treasury Regulation §1.401(a)(9)-4, A-5 the beneficiary rather than an individual.

The Maryland exemptions also include life insurance proceeds or proceeds from a annuity contract "on the life of an individual made for the benefit of or assigned to the spouse, child, or dependent relative of the individual … whether or not the right to change the named beneficiary is reserved or allowed to the individual." Ins. § 16-111 ("Proceeds Exempt from Creditors"). "Proceeds" include death benefits, cash surrender value, loan value and dividends except if the debtor receives cash for these items. Ins. § 16.111.

4.5 529 Plans.

New Bankruptcy Act 11 U.S.C. § 541 excludes 529 plans and education IRAs from the bankruptcy estate. Certain limits apply. The Maryland statute establishing529 plans states:

> "A person may not attach, execute, garnish, or otherwise seize any current or future benefit under an investment account or any asset of the Plan."

Education § 18-19A-06.1 "Person" does not include the State.

5. Tenants by the Entirety.

5.1 General Rule.

One of the most dramatic examples of the respect afforded tenants by the entirety property in Maryland is *Watterson v. Edgerly*, 40 Md. App. 230, 388 A.2d 934 (1978), a case cited most often for the operation of spendthrift trusts. In *Watterson*, a husband had a judgment lien filed against him. His wife, however, was not a creditor on the original debt or as a result of the judgment. The husband transferred his interest in tenants by the entirety property to his wife for no consideration. Thereupon, the wife executed a Will containing a testamentary spendthrift trust for the benefit of her husband. She died 61 days after the conveyance to her of the real estate. The Court of Special Appeals upheld the conveyance of the real estate despite the existence of a judgment lien operating against the husband: "When, as here, a husband and wife hold title as tenants by the entirety, the judgment creditor of the husband or of the wife has no lien against the property held as entireties, and has no standing to complain of a conveyance which prevents the property from falling into his grasp." (At 238). This holding was not a fluke: "Upon this appeal, appellant, Richard Spitz, Jr., asks us to examine an issue which was settled by the court in *Watterson*. That issue is: 'whether a husband may convey his interest in real estate, owned by the husband and wife as tenants by the entirety, to his wife … so as to shield the husband from his judgment creditors…' Our answer remains the same; yes." *Spitz v. Williams*, 69 Md. App. 694, 519 A.2d 775 (1987).

Except for federal tax liens, the rule articulated in *Watterson* is still good law. As seen below, however, a new rule applies for federal tax liens. Also, *Watterson*-like transfers within the bankruptcy set –aside period will effectively defeat the technique. For an in-depth discussion of tenancy by the entirety and asset protection in Maryland and elsewhere, see Fred Franke, Asset Protection and Tenancy by the Entirety, 34 ACTEC J. 210 (2009).

5.2 Nature of the Tenancy.

Tenants by the entirety is most often thought as a way of holding real estate by a married couple. Indeed, although there is a statutory presumption against property held by more than one person creating a joint tenancy (R.P. § 2-117), there is a common law presumption in favor of entireties if title is in husband and wife. *Columbian Carbon Co. v. Kight*, 207 Md. 203, 114 A.2d 28 (1955).

Maryland has long recognized tenancy by the entireties in bank accounts and other personal property: "It is well established that this Court recognized that a tenancy by the entireties may be created in personal property … A number of our sister states are in agreement with this view." *Diamond v. Diamond*, 298 Md. 24, 29, 467 A.2d 510, 513 (1983) (citations omitted).

As with joint tenancies, a tenancy by the entirety requires the "four unities:"

> "A tenancy by the entireties is essentially a joint tenancy, modified by the common law theory that the husband and wife are one person." *Schilback v. Schilback*, 171 Md. 405, 407, 189 A. 432 (1937); *see also Schlossberg, supra*, 380 F.3d at 178. Thus, just as the creation of a joint tenancy requires the four essential common law unities of interest, title, time and possession, so does the creation of a tenancy the entirety."

Cruickshank-Wallace v. Co. Banking & Trust Co., 165 Md. App. 300, 312, 885 A.2d 403, 410 (2005). In *Cruickshank-Wallace*, the husband and wife executed an agreement years before the husband incurred the debt declaring their intent that all of husband's future wages would be held as tenants by the entirety. After the husband incurred the debt, a tax refund check was sent payable to the couple and diverted into the wife's account. The Court held that the intent of the couple alone does not create a tenants by the entirety account in the absence of the four unities. A refund check in the names of a husband and wife is not presumed to be held as tenants by the entirety regardless of whether a joint return was filed. *McClelland v. Massinga*, 786 F.2d 1205 (4th Cir. 1986). Therefore, even if the couple intended to create a tenants by the entirety in the refund check, they had to take steps to create the tenancy after receipt of the check. By the time of such receipt, of course, the judgment lien attached to the husband's interest in the refund. The four unities did not exist at the time they received the refund.

5.3 <u>Joint Action Necessary.</u>

Once the conditions for the creation are satisfied, the tenancy becomes more than the sum of its parts:

> "Maryland retains the estate of tenancy by the entirety in its traditional form. Columbian Carbon Co. v. Kight, supra. By common law, a conveyance to husband and wife does not make them joint tenants, nor are they tenants in common; they are in the contemplation of the law but one person, and hence they take, not by moieties, but by the entirety. Neither can alienate without the

> consent of the other, and the survivor takes the whole … Tenancy by the entirety may not be severed by the consent of one of the parties or by their individual judgment creditors during their joint lives; except in the case of absolute divorce, during the lifetime of both tenants their estate may be terminated only by the joint action of both and a conveyance to a third person."

Beall v. Beall, 291 Md. 224, 234, 434 A.2d 1015, 1021 (1981) (citations omitted).

Beall involved a bare offer executed by a husband and wife to sell real estate held by the entireties. The husband died before the offeree accepted the offer to purchase the land. The issue was whether the offer survived the husband's death. The rule governing such offers (not supported by consideration) is that it is revoked by the death of the offeror. The Court held that the offer was by a separate entity (the entirety estate) and that this estate terminates by the death of one spouse. The surviving spouse is not obligated to uphold the offer.

In *Arbesman v. Winer*, 298 Md. 282, 468 A.2d 633 (1983) the issue was whether one spouse may unilaterally terminate a lease of the tenants by the entirety property. In *Arbesman*, the wife's sister lived in part of the marital home, taking care of the wife. The husband attempted to terminate the tenancy of his wife's sister. The Court held that such a lease could only be terminated by both husband and wife:

> "In summary, the tenancy by the entireties estate as it currently exists in Maryland has the following pertinent incidents: the husband and wife take the tenancy by the entireties property not by moieties but by the entirety; each spouse has an equal right to income derived from the tenancy by the entireties property but no right to compel an accounting during marriage … and neither spouse may lease, dispose of or encumber land held as tenants by the entireties without the consent of the other."

Arbesman, at 290 (citation omitted).

It is the separateness of the tenancy from its individual constituents that creates the asset protection attribute of the tenancy. Entireties property is not subject to the claims against only one spouse: "[P]roperty held by the entireties is watertight as to claims against one spouse only." *In re Carroll*, 237 B.R. 872, 874 (Bankr. D. Md. 1999).

5.4 Creating or Adding to Entity Property.

Once a claim arises, of course, the creation of a tenancy by the entirety could be a fraudulent conveyance if the Fraudulent Conveyance Act is tripped. Under Com. Law § 15-204, "[e]very conveyance made and every obligation incurred by a person who is or will be rendered insolvent by it is fraudulent as to creditors without regard to his actual intent, if the conveyance is made or the obligation is incurred without fair consideration." Thus, in *Cruickshank-Wallace*, the defending spouse claimed that the transfer of the refund check to her was, if not already held tenants by the entirety, for "fair consideration." The fair consideration asserted was satisfaction of the husband's duty of family support. The court rejected this argument, repudiating part of its earlier (by 20 years) opinion in *Pearce v. Micka*, 62 Md. App. 265, 489 A.2d 48 (1985). In *Pearce*, the court permitted transfers to the extent of interest payments on the mortgage on the family home under the support doctrine but held that payments of mortgage principal were fraudulent. The *Cruickshank-Wallace* court looked to the statutory exemptions permitted a debtor (tools of trade; personal allowance, etc.) and limitations on garnishment as legislative expressions of adequate protection for family dependents. The court also pointed to the duty of the wife equally to provide family support. In the post-ERA world, family support no longer constitutes an automatic exception under the fair consideration provisions.

5.5 Maryland Tenants by the Entirety Trusts.

Effective October 1, 2010, property held by the entirety may be transferred to a trust or trusts and the "same immunity from the claims of (each spouse's) separate creditors" shall continue to protect the property as if the husband and wife had continued to hold the property or its proceeds as tenants by the entirety" as long as (i) they remain married, (ii) the property or its proceeds remain in the trust or trusts, and (iii) "both the husband and the wife are beneficiaries of the trust." Est. & Trusts § 14-113 (b).

By its terms, Est. & Trusts § 14-113 (b) purports to permit self-settled asset protection trusts for married couples. Unlike domestic asset protection trusts (DAPTs) elsewhere, the settlor may be sole trustee, the trust need not be irrevocable, and the settlor may retain a non-testamentary general power of appointment. See generally, Richard W. Nenno, Planning with Domestic Asset-Protection Trusts: Part II, 40 Real Prop. Prob. & Tr. J. 477, 512-520 (Fall 2005) for a (slightly out-of-date) summary of DAPTs in the various states where permitted by statute, none of which permit such sweeping unilateral control to be retained by the settler/grantor of the trust.

Assume an example that literally meets all of the requirements of the Maryland statute. Husband ("H") and Wife ("W") hold as Tenants by the Entireties ("T/E") two residences ("Blackacre" and "Whiteacre") and a brokerage account worth $4 million. They transfer these assets into two revocable trusts: H's Trust and W's Trust. H's Trust holds Blackacre and $2 million of the securities and W's Trust holds the remainder. Each Trust provides a death payout to the surviving spouse of $10,000 (or something not de minimis). Each spouse is the sole Trustee of his or her respective Trust and each has extensive rights over this separate Trust during life (including, a general power of appointment) and each has extensive powers to appoint at death (subject to the $10,000 payout override). Perhaps these Trusts are backstopped by a marital agreement so as to preclude the assertion of an elective share against the Trusts at death instead of blind reliance on *Karsenty v. Schoukroun*, 406 Md. 469, 959 A.2d 1147 (2008).

But for Est. & Trusts § 14-113 (b), H & W would have created self-settled trusts which are ineffective as to the settlors' creditors. Restatement (Second) of Trusts, § 156(1) ("Where a person creates for his own benefit a trust with a provision restraining the voluntary or involuntary transfer of his interests, creditors can reach his interests.") and § 156(2) ("Where a person creates for his own benefit a trust for support or a discretionary trust ... his creditors can reach the maximum amount which the trustee ... could pay to him ...").

The treatment afforded T/E is not an exception to the general rule disfavoring self-settled trusts. Instead, the T/E property is seen as owned 100% by both H & W. Thus, the separate creditors of each spouse cannot attach an individual interest because there is deemed to be no individual interest. Such attachment would prejudice the non-debtor spouse. Historically, it was the survivorship interest that was protected, so before women had extensive property rights, and the husband had control of the property during his lifetime, the husband's creditors could attach the life interest. After the Married Women's Property Acts in the late 1800's, however, both the life interest and the survivorship became equally protected in most jurisdictions. See Fred Franke, <u>Asset Protection and Tenants by the Entirety</u>, 34 ACTEC J. 210 (2009).

In *Watterson v. Edgerly*, 40 Md. App. 230, 388 A.2d 934 (1978), it was held that the transfer by the husband of all of his interest in the T/E property to the wife did not constitute a fraudulent conveyance because the judgment creditor of the husband did not have an attachable interest in the T/E property because of the inseparable unity of ownership. That is not the same as saying that the marriage as an entity makes the transfer. Indeed, there are numerous bankruptcy cases bringing back into the bankruptcy estate *Watterson*-type pre-petition transfers (ones occurring within two years of the filing of the petition). This is because of the sweeping authority given to the trustee to avoid transfers under U.S.C. § 548(a)(1). The result is that the previously exempt property comes back, not as a T/E exempt interest, but as a one-half tenant in common interest because when it comes back it goes to the bankruptcy estate, *not* the debtor/spouse as spouse. Dana Yankowitz, <u>I Could Have Exempted It Anyway": Can a Trustee Avoid a Debtor's Pre-Petition Transfer of Exempt Property?</u>, 23 Emory Bankr. Dev. J. 217 (2006). It is probable that a bankruptcy court would view the transfers by husband and wife into an Est. & Trusts § 14-113 (b) trust as self-settled. I doubt whether any Maryland court would take an opposite view.

If the Maryland statute is seen as reversing the prohibition against settlors sidestepping creditors with self-settled trusts, it would permit sweeping DAPTs that would offer great creditor protection. In the above example, this protection would follow Blackacre and the husband's one-half interest in the brokerage account regardless of whether the wife had any further interest in that property. If H & W had severed the T/E property to accomplish this same result, of course, they would no longer have the T/E "immunity." What will a court decide the "same immunity" means under facts similar to those of the example? How enthused will a court be to interpret the statute in a way, to paraphrase Senior Circuit Court Judge Hainsworth in *Robbins*, 826 F.2d 293 (C.A. 4th 1987), so that the settlors/debtors "can have one's cake and eat it too"?

The pivotal question is whether Est. & Trusts § 14-113 (b) reverses the long-standing rule against denying creditors the absolute right to attach assets controlled by a settlor/debtor. In Maryland, "the cardinal rule of construction of a statute is to discover and carry out the real legislative intention." *Maryland Medical Service, Inc. v. Carver*, 238 Md. 466, 477, 209 A.2d 582, 588 (1965). Obviously, one begins to construe a statute based "on the tacit theory that the Legislature is presumed to have meant what it said and said what it meant." *Witte v. Azarian*, 369 Md. 518, 525, 801 A.2d 160, 165 (2002). But where the statute alters the common law, it is interpreted very narrowly. Id. at 369 Md. 533 and 801 A.2d 169. *Lutz v. State*, 167 Md. 12, 172 A. 354, 355-6 (1934): "'As a rule of exposition, statutes are to be construed in reference to the principles of the common law. For it is not presumed that the legislature intended to make any innovation upon the common law, further than the case absolutely required. The law rather infers that the act did not intend to make any alteration other than which is specified, and besides what has been plainly pronounced.'" (court quoting from another case which, in turn, quoted from a Treatise.) In short, the common law "will not be repealed by implication." *Suter v. Stuckey*, 402 Md. 211, 232, 935 A.2d 731, 743 (2007); also, *Brown v. State*, 359 Md. 180, 189, 753 A.2d 84, 88 (2000) (The Court may be required to look beyond the literal meaning of a statute and "may consider the consequences resulting from one meaning rather than another, and adopt the construction which avoids an illogical or unreasonable result, or one which is consistent with common sense.").

It is probable that a court will try to determine the legislative intent. *Kaczorowski v. City of Baltimore*, 309 Md. 505, 525 A.2d 628 (1987). As with most Maryland legislation, there is not extensive, accessible legislative history spelling out exactly the intent of the Legislature. It appears, however, to have been presented as a way of remedying the unfairness that would occur when spouses change the ownership of their T/E property by transferring it into their trusts for estate planning and probate avoidance purposes. One might speculate that the Legislature did not understand this Bill as creating a super DAPT available to married couples with property in Maryland.

An obvious interpretation of the statute would be that T/E protection survives the transfer into a trust or trusts to the extent that the interests of the spouses mimic their pre-transfer interests. It would be rare indeed if the revocable trust terms actually mimicked the T/E ownership attributes. Many trusts, for example, may continue the property in trust for the benefit of the surviving spouse over his or her lifetime, then provide for it to go to a remainderman without giving the surviving spouse a general power to direct (or redirect) that asset. Such an arrangement, without a power of appointment held by the surviving spouse in the property, would not mimic T/E ownership.

Until these important issues are resolved, one should be cautious in using this technique for clients where asset protection is a serious concern. For the high risk client who is concerned about asset protection (for example, a lawyer, a doctor, a corporate executive with Sarbanes-Oxley exposure), the technique of leaving the T/E property intact and relying on a disclaimer for the estate planning should continue to be considered. On the other hand, for married couples with low risk profiles who want to create revocable trusts regardless of the asset protection exposure (for disability planning or simply to avoid probate at the second death) using an Est. & Trusts § 14-113 (b) trust may prove to be a benefit.

5.6 Other Spousal Property.

By statute, certain joint accounts held by husband and wife are exempt from garnishment. Cts. & Jud. Proc. § 11-603(a) provides:

> "*Spousal property*. – (1) Except as provided in paragraph (2) of this subsection, a garnishment against property held jointly by husband and wife, in a bank, trust company, credit union, savings bank, or savings and loan association or any of their affiliates or subsidiaries is not valid unless both owners of the property are judgment debtors.
>
> (2) Paragraph (1) of this subsection does not apply unless the property is held in an account that was established as a joint account prior to the date of entry of judgment giving rise to the garnishment."

This is not a blanket protection of all joint accounts. A jointly held brokerage account, for example, is not covered by the statute. Under the common law, of course, such accounts could be held as tenants by the entirety. To achieve such a result, a brokerage account should probably be formally titled by the entireties and be subject to the order of both.

Subpart (b) of Cts. & Jud. Proc. § 11-603 affords protection to property held in trust form in the same enumerated financial institutions. Such an account was held free from garnishment even if created after the date of entry of a judgment against one spouse when funded exclusively from the sale of tenants by the entirety property. *Maryland Nat'l Bank v. Pearce*, 329 Md. 602, 620 A.2d 941 (1993).

Fam. Law § 4-301 holds that pre-marital obligations of one spouse do not become the responsibility of the other spouse. Also, spouses are not generally responsible for each other's tort or contract liability.

5.7 <u>The *Craft* Case.</u>

The Supreme Court in *United States v. Craft*, 122 S.Ct. 1415, 535 U.S. 274 (2002) held that property held as tenants by the entirety is subject to a federal tax lien against one (not both) spouse. The federal tax lien statue is, of course, a creature of federal law. It attaches to "property and rights to property" held by the taxpayer/debtor. According to Justice O'Connor's opinion for the Court, whether the lien attaches to one spouse's interest in tenants by the entirety property is ultimately a question of federal law. One looks first to state law to determine what rights a taxpayer has in the property the government seeks to reach. Then, one looks to see whether the rights that a taxpayer has in specific property qualify as "property or rights to property" under federal law. Justice O'Connor concluded that the debtor/taxpayer had sufficient rights in the "bundle of sticks" in tenants by the entirety property to rise to an attachable interest. These rights included the right of possession, of income, of sale proceeds (if the non-debtor spouse agreed to the sale), etc. The "legal fiction" that neither tenant has an interest separable from the other (per Blackstone) is not controlling as to the scope of the federal tax lien: "[I]f neither of them had a property interest in the entireties property, who did? This result not only seems absurd, but would also allow spouses to shield their property from federal taxation by classifying it as entireties property, facilitating abuse of the federal tax system."

Justices Scalia and Thomas dissented. Justice Thomas objected to what he saw as a federalization of the law governing rights to property: "Before today, no one disputed that the IRS, by operation of § 6321, 'steps into the taxpayer's shoes,' and has the same rights as the taxpayer in property or rights to property subject to the lien. I would not expand the 'nature of the legal interest' the taxpayer has in the property beyond those interests recognized under state law." (Citations omitted.) Justice Scalia jointed in Thomas' dissent: "[A] State's decision to treat the marital partnership as a separate legal entity, whose property cannot be encumbered by the debts of its individual members, is no more novel and no more 'artificial' than a State's decision to treat a commercial partnership as a separate legal entity, whose property cannot be encumbered by the debts of its individual members."

The fact that the lien attaches to the debtor/taxpayer's interest does not sever the tenancy. It gives the government the right to either (i) administratively seize and sell the taxpayer's interest or (ii) foreclose the federal tax lien against the entireties property.

The administration option is problematic for the Internal Revenue Service: "Because of the nature of the entireties property, it would be difficult to gauge what market there would be for the taxpayer's interest in the property. The amount of any bid would in all likelihood be depressed to the extent that the prospective purchaser, given the rights of survivorship, would take the risk that the taxpayer may not outlive his or her spouse. In addition, a prospective purchaser would not know with any certainty if, how, and to the extent to which the rights acquired in an administrative sale could be enforced … Levying on cash and cash equivalents held as entireties property does not present the same impediments as seizing and selling entireties property." Notice 2003-60, 2003-39 IRB (9/11/03) (Q & A 7).

The most likely lien enforcement procedure will be foreclosure. Johnson, Why Craft Isn't Scary, 37 Real Prop. Prob. & Tr. J., 439, 473-477 (Fall 2002). Foreclosure is supervised by a court under IRC § 7403 and anyone with an interest in the property is joined and heard. The court may order the sale of the whole property, then order "a distribution of the proceeds of such sale according to the findings of the court in respect to the interests of the parties and the United States." IRC § 7403(c). The value of the respective spouses is an issue of fact:

> Question (by the Court): "But in your review, you always value the taxpayer's interest at 50 percent?"
>
> Answer (by Mr. Jones): "No, I think in the Rodgers -- well, if the property's been sold, yes. If the property hasn't been sold, and we're talking about in a foreclosure context, I believe the Rodgers court goes through the example of the varying life expectancies of the two tenants, and which one -- and I believe what the Court in Rodgers said was that each of them should be treated as if they have a life estate plus a right of survivorship, and the Court explains how that could well -- I think in the facts of Rodgers resulted in only 10 percent of the proceeds being applied to the husband's interest and 90 percent being retained on behalf of the spouse, but --"

Oral argument in *Craft*, page 15 of official transcript. "Rodgers" refers to *United States v. Rogers* (sic), 649 F.2d 1117 (5th Cir. 1981), *rev'd*, 461 U.S. 677 (1983) and *Ingram v. Dallas Dep't of Hous. & Urban Rehab.*, 649 F.2d 1128 (5th Cir. 1981), vacated 461 U.S. 677 (1983).

After *Craft*, the Bankruptcy Court in *In re Basher*, 291 B.R. 357 (Bankr. E. D. of Pa., 2003) ultimately concluded that the taxpayer failed to carry his burden of proof to rebut that the non-debtor spouse's interest is greater than 50%. Nevertheless, the court refused to accept the IRS view of value because it failed to take into consideration the greater survivorship interest of the debtor's younger spouse.

If the lien is not acted upon, and one spouse dies, the property goes to the survivor either free of the lien or not, depending on who is the survivor: "when a taxpayer dies, the surviving non-liable spouse takes the property unencumbered by the federal tax lien. When a non-liable spouse predeceases the taxpayer, the property ceases to be held in a tenancy by the entirety, the taxpayer takes the entire property in fee simple, and the federal tax lien attaches to the entire property." Notice 2003-60 (Q & A 4.)

In *Craft*, the property was quit-claimed to the non-debtor spouse after the debtor spouse incurred the tax lien. Nevertheless, the lower courts held that no fraudulent conveyance was involved because no lien could attach. This point was not preserved on appeal. Justice O'Connor makes clear, however, that that issue will be present in future cases involving federal tax liens: "Since the District Court's judgment was based on the notion that, because the federal tax lien could not attach to the property, transferring it could not constitute an attempt to evade the Government creditor, in future cases the fraudulent conveyance question will no doubt be answered differently." (Citations omitted.) Thus, the technique involved in *Watterson v. Edgerly*, 40 Md. App. 230, 388 A.2d 934 (1978) will not be respected if a federal tax lien is involved.

6. <u>Self Settled Trusts.</u>

6.1 <u>The Maryland View.</u>

The standard rule in most U.S. jurisdictions is that a person may not create a trust, retain an interest in that trust, and have the retained interest immune from his or her creditors:

> "Can a settlor shelter trust assets from creditors' claims by reserving a discretionary interest in the trust? In the United States, the traditional answer to this question is 'no.' Although the settlor of a discretionary trust cannot compel the trustee to distribute trust income or principal to the settlor, the settlor's creditors are able to compel such distributions. The standard formulation of this rule is set forth in Section 156(2) of the Restatement (Second) of Trusts as follows:
>
> 'Where a person creates for his own benefit a trust for support or a discretionary trust, this transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit.'
>
> * * *
>
> Note two essential components of the Restatement rule. First, the rule grants to creditors greater rights than those retained by the settlor himself or herself: the settlor cannot complete trust distributions, but the settlor's creditors can. Second, the rule

> applies notwithstanding that allowing the settlor's creditors to reach the assets of the trust may defeat not just the settlor's interests, but also the interests of other beneficiaries."

Danforth, Rethinking the Law of Creditors' Rights in Trusts, 53 Hastings L.J. 287, 293-295 (January 2002).

Maryland follows the traditional rule: "Since the late 19th Century, it has been the rule in Maryland that a person may not effectively create a spendthrift trust for his own benefit." *In re Robbins*, 826 F.2d 293, 294 (1987). In *Robbins*, the court held that any amount that a trustee is authorized to apply for the benefit of the settlor is available to the settlor's creditors: "One may wish to have one's cake and eat it, but the law need not bring their wish to fruition." Id. at 295.

Robbins distinguished an earlier Maryland decision: *United States v. Baldwin*, 283 Md. 586, 391 A.2d 844 (1978). *Baldwin* was a federal tax lien collection case that went to the Court of Appeals in order to certify a question involving a limited power of appointment. In *Baldwin*, the settlor established an irrevocable trust reserving to himself income for life and retained a limited testamentary power of appointment. Because the power of appointment was not general, the corpus could not be reached by the settlor's creditors. The only interest retained by the settlor was an income interest, and that was the only interest available to his creditors.

The creditors can only reach an interest retained by the settlor. In *Wiltshire Credit Corp. v. Karlin*, 988 F. Supp. 570 (1997), a creditor tried to set aside a trust based on the "alter ego" doctrine applicable to piercing the corporate veil. The settlors established a trust reserving a life estate (income interest) in their residence with the remainder to their children. Because the trustees held legal title and the children held equitable title, only the life estate interest was available to creditors. [The life estate was later sold to the trust and the settlors became tenants of the residence.] The court rejected the "alter ego" attack and upheld the trust.

As noted, the general law of trusts holds that a creditor should be able to "reach the maximum amount which the trustee could pay to him or apply for his benefit." Restatement (Second) of Trusts, § 156(2) (emphasis added). This rule was narrowed somewhat in *Est. of German v. United States*, 7 Cl. Ct. 641 (1985). *German* involved whether the decedent's gross estate included the value of trusts created *inter vivos* for the benefit of children but where the trustee could make discretionary payments to the settlor if those children consented to the distribution. The court concluded that the trusts were not includable in the gross estate because the creditors of the decedent could not reach those assets. In *German*, the question was not certified to the Court of Appeals because the then existing Uniform Certification of Questions of Law Act did not permit questions coming from the U.S. Court of Claims. Now Cts. & Jud. Proc. Art. § 12-603 enables the Court of Appeals to answer questions submitted by any U.S. Court.

As noted above, an exception to the general rule may have been created by the tenant by the entirety trust.

6.2 Offshore Trusts.

One claimed advantage for offshore trust is that those jurisdictions permit self-settled trusts and asset protection from the settlor's creditors:

> "Offshore protection trusts have become one of the most talked about estate planning techniques in recent years. They are heavily promoted as effective barriers against claims of creditors because the laws of most offshore trust havens make it difficult for creditors to obtain jurisdiction over, or levy against, a trust, even if the settlor retains an interest in the trust property. Unlike most states of the United States, a number of foreign jurisdictions permit a settlor to create a spendthrift trust for the settlor's own benefit. These barriers often insulate the property entirely from creditors or encourage creditors to agree to inexpensive settlements."

Fox and Huft, Asset Protection and Dynasty Trusts, 37 Real Prop. Prob. & Tr. J. 286, 297 (Summer 2002).

Offshore trusts can be somewhat problematic:

> "Taxpayers who have established offshore trusts are beginning to discovery that those trusts do not always provide the level of creditor protection advertised. The fundamental problem is that a U.S. resident who moves assets to an offshore trust is still personally subject to the jurisdiction of the U.S. Courts."

Id. at 301. See *In re: Lawrence*, 251 B.R. 630 (Bankr. S.D. Fla. 2000), off'd, 279 F.3d 1294 (11th Cir. 2002); *F.T.C. v. Affordable Media, LLC*, 179 F.3d 1228 (9th Cir. 1999).

6.3 Domestic Asset Protection Trusts.

Recently several states have enacted enabling legislation to permit self-settled asset protection trusts (Alaska, Delaware, and other jurisdictions). Although untested, the domestic asset protection trust offers the promise of asset protection without some of the more unacceptable risks associated with offshore trusts: "The risk of fine or incarceration should be lower in the case of a DAPT (domestic asset protection trust) because the controversy will be adjudicated in the U.S. legal system." Nenno, Planning with Domestic Asset-Protection Trusts: Part I, 40 Real Prop. Prob. & Tr. J., 263, 247 (Summer 2005). To the extent a client needs a self-settled trust with a significant retained interest, the domestic version is probably the most attractive vehicle.

As with the offshore variety, a detailed discussion of domestic asset protection trusts is beyond the scope of this paper. See: Lischer, Domestic Asset Protection Trusts: Pallbearers to Liability, 35 Real Prop. Prob. & Tr. J., 479 (Fall 2000); Nenno, Planning with Domestic Asset-Protection Trusts: Part I, 40 Real Prop. Prob. & Tr. J., 263 (Summer 2005); Nenno, Planning with Domestic Asset-Protection Trusts: Part II, 40 Real Prop. Prob. & Tr. J., 477 (Fall 2005).

As noted above, an exception to the general rule may have been created by the tenant by the entirety trust.

7. Third Party Spendthrift Trusts.

7.1 In General.

A spendthrift trust may be created when the creator of a trust manifests the intention (expressly or by implication) that the beneficiaries receive an equitable interest in the trust free of the claims of their creditors. *Cherbonnier v. Bussey*, 92 Md. 413, 48 A. 923 (1901). No specific language is needed to create a spendthrift trust. The earliest Maryland case, for example, determined that the direction that the trustee make payments "into his (the beneficiary's) hands, and not into another, whether claiming by his authority or otherwise" was an expressed manifestation of such an intent. *Smith v. Towers*, 69 Md. 77, 15 A. 92, 93 (1888). Other manifestations of an intention to create a spendthrift trust are more elaborate:

> "No interest of any beneficiary of this Will or any rust [sic] created thereby shall be assignable in anticipation of payment thereof in whole or in party by the voluntary or involuntary acts of any such beneficiary or by operation of law. Neither the corpus of any trust created hereby, nor the income resulting therefrom, while in the hands of my fiduciaries, shall be subject to any conveyance, transfer, or assignment, or be pledged as security for any debt or obligation of any beneficiary thereof, and the same shall not be subject to any claim of any creditor of any such beneficiary through legal process or otherwise. Any such attempted sale, anticipation, or pledge of any of the funds or property held in any such trust or will, or the income therefrom, by any beneficiary shall be null and void, and shall not be recognized by my fiduciaries."

DuVall v. McGee, 375 Md. 476 (2003), n.5.

7.2 <u>Theoretical Underpinning.</u>

A spendthrift trust has been defined as "a trust that restrains voluntary and involuntary alienation of all or any of the beneficiaries' interests." Restatement (Third) of Trusts § 58. "The Validity of Spendthrift Trusts," 34 A.L.R. 2d 1335: "[T]his particular type of trust, created with the view of providing a fund for the maintenance or use of another, and at the same time securing it against his improvidence, incapacity, misfortune, by means of such a restrictive provision, to which the term spendthrift trust was originally and is now generally applied…" Spendthrift trusts are upheld because the donor of the trust has the right to dispose of his or her property:

> "Now common honesty requires, of course, that everyone should pay his debts, and the policy of the law for centuries has been to subject the property of a debtor of every kind which he holds in his own right, to the payment of his debts. He has as owner of such property the right to dispose of it as he pleases, and his interest is, therefore, liable for the payment of his debts. But a cestui que trust does not hold the estate or interest in his own right; he has but an equitable and qualified right to the property or to its income, to be held and enjoyed by the beneficiary on certain terms and conditions prescribed by the founder of the trust. The legal title is in the trustee, and the cestui que trust derives his title to the income through the instrument by which the trust is created. The donor or devisor, as the absolute owner of the property, has the right to prescribe the terms on which his bounty shall be enjoyed, unless such terms be repugnant to the law. And it is no answer to say that the gift of an equitable right to income to the exclusion of creditors is against the policy of the law. This is begging the question. Why is it against the policy of the law? What sound principle does it violate? The creditors of the beneficiary have no right to complain, because the founder of the trust did not give his bounty to them. And if so, what grounds have they to complain because he has seen proper to give it in trust to be received by the trustee and to be paid to another, and not to be liable while in the hands of the trustee to the creditors of the cestui que trust. All deeds and wills and other instruments by which such trusts are created, are required by law to be recorded in the public offices, and creditors have notice of the terms and conditions on which the beneficiary is entitled to the income of the property. They know that the founder of the trust has declared that this income shall be paid to the object of his bounty to the exclusion of creditors, and if under such circumstances they see proper to give credit to one who has but an equitable and qualified right to the enjoyment of property, they do so with their eyes open. It cannot be said that credit was given upon such a qualified right to the enjoyment of the income of property, or that creditors have been deceived or mislead; and if the beneficiary is dishonest enough not to apply the income when received by him to the payment of his debts, creditors have no right to complain because they cannot subject it in the hands of the trustee to the payment of their claims, against the express terms of the trust."

Smith v. Towers, 69 Md. 77, 88-89, 14 A. 497, 499-500 (1888) (as quoted in *DuVall v. McGee*, 375 Md. 476, 826 A.2d 416 (2003)).

7.3 Special Status Creditors.

Despite the general respect afforded a spendthrift trust, it is not inviolate against certain claims: alimony arrearages, *Safe Deposit & Trust Co. v. Robertson*, 192 Md. 653, 65 A.2d 292 (1949); child support, *Zouck v. Zouck*, 204 Md. 285 (1954), and federal income taxes, *Mercantile Trust Co. v. Hofferbert*, 58 F. Supp. 701 (D. Md. 1944). In the case of alimony and child support, the Court has made the distinction that such claims are not for debts of a beneficiary but are rather duties of the beneficiary: "We think the view expressed in the Restatement is sound. The reason for the rejection of the common law rule (prohibiting spendthrift provisions), that a condition restraining alienation by the beneficiary is repugnant to the nature of the estate granted, was simply that persons extending credit to the beneficiary on a voluntary basis are chargeable with notice of the conditions set forth in the instrument…. This reasoning is inapplicable to a claim for alimony which in Maryland at least, is 'an award made by the court for food, clothing, habitation and other necessities for the maintenance of the wife…'. The obligation continues during the joint lives of the parties, and is a duty, not a debt." *Robertson*, at 662. See also, *Prince George's County Police Pension Plan v. Burke*, 321 Md. 699, 584 A.2d 702 (1991) upholding, as part of a marital property award, a transfer of a partial interest in a county pension plan despite spendthrift protections because the spouse is entitled to her the equitable distribution of her "rightful portion" of the retirement fund. When discussing these cases, the Court of Appeals noted that "none of these cases was premised on there having been a lack of notice given to the claimants as to the trust beneficiary's limited interest in the trust. Rather, the courts recognize a fundamental difference between these obligations and those of ordinary creditors." *DuVall* at 499-500. This distinction in *DuVall* is important, of course, as *DuVall* involved a tort creditor who certainly lacked notice of the debtor/tortfeasor's limited interest in the trust. One could argue that a prospective spouse may have notice when he or she marries a person primarily supported by a trust fund that a subsequent spousal award may be difficult to collect.

Every edition of the Restatement of Trusts has recognized that a spendthrift trust can be reached to satisfy claims "for necessary services rendered to the beneficiary or necessary supplies furnished to him," Restatement § 157 or based on "services or supplies provided for necessities or for the protection of the beneficiary's interest in the trust." Restatement (Third) § 59. The Comment to Restatement (Third) states: "Failure to give enforcement to appropriate claims of this type (based on supplying necessities) would tend to undermine the beneficiary's ability to obtain necessary goods and assistance; and a refusal to enforce such claims is not essential to a settlor's purpose of protecting the beneficiary." These rules suggest that the trust in question is either explicitly or implicitly a "support trust." To the extent that the trust is wholly or partially discretionary, of course, no creditor will be able to enforce a judgment for providing necessities. See *First Nat'l Bank of Maryland v. Dept. Health and Mental Hygiene*, 284 Md. 720, 399 A.2d 891 (1979): "A support trust, it is generally recognized, is one that provides that 'the trustee shall pay or apply only so much of the income and principal or either as necessary for the education or support of the beneficiary,' thereby barring the beneficiary from transferring his interest and precluding his creditors from reaching it." Id. at 725. The beneficiary of a support trust has enforceable rights to compel the trustee to make appropriate distributions. *Offutt v. Offutt*, 204 Md. 101, 102 A.2d 554 (1954). The *First Nat'l Bank of Maryland* court cited *Robertson* for the proposition that a creditor of the beneficiary likewise may compel the support distributions. *Robertson*, 192 Md. 653, 65 A.2d 292 (1949). The creditor in *Robertson*, of course, was a spouse who is afforded super-creditor status.

7.4 Tortfeasor Access.

The Court of Appeals refused to extend the class of claims that may breach a spendthrift trust to include claims by tortfeasors. The facts underlying *DuVall* are egregious. The beneficiary of a spendthrift trust was convicted of felony murder. The estate of the victim brought suit to enforce its judgment against the trust. The Court distinguished "a mere judgment creditor" from a spouse or child to whom a beneficiary owes a "duty" of support: "Indeed, to permit the invasion of the Trust to pay the tort judgments of the beneficiary, in addition to thwarting the trust donor's intent by, in effect, imposing liability on the Trust for the wrongful acts of the trust beneficiary, is, as the appellees argue, to create an exception for "tort victims" or "victims of crimes." Comment a. to Restatement (Third) (2003) § 59 takes a different position: "The nature or pattern of tortious conduct by a beneficiary, for example, may on policy grounds justify a court's refusal to allow spendthrift immunity to protect the trust interest and lifestyle of that beneficiary, especially one whose willful or fraudulent conduct or persistently reckless behavior causes serious harm to others." See also, *Sligh v. First Nat'l Bank of Holmes County*, 704 So. 2d 1020 (Miss. 1997) which, as noted in a footnote in *DuVall*, prompted a legislative reversal so to reinstate immunity from tort claims in 1998. The Commissioners of the Uniform Trust Code (2005) "declined to create an exception for tort claimants" to its exceptions to spendthrift provisions (Section 503).

7.5 Spendthrift Clauses and Trust Termination.

Maryland follows the general American rule that a trust may be terminated when all beneficiaries consent to the termination and when termination is not contrary to the settlor's intention. *Probasco v. Clark*, 58 Md. App. 683, 474 A.2d 221 (1984). When a trust contains a spendthrift provision, however, one of the material purposes of the trust is the protection afforded a beneficiary by that clause. Consequently, a trust containing a spendthrift provision may not be modified by a Maryland Court regardless of whether all beneficiaries consent:

> "These cases and many others in Maryland have upheld the immunity of spendthrift trusts from attempted invasion by creditors of the beneficiaries. A necessary corollary of such a policy is that spendthrift trusts must be immune from attempts by the beneficiaries themselves to reach the corpus. As Dean Griswold has pointed out, to permit premature termination by the beneficiaries, either in whole or in *pro tanto*, would amount to an assignment of the corpus, the very thing that a restraint on alienation, such as we have in the case at bar, forbids. Griswold, *'Spendthrift Trusts,'* (2 Ed.) § 517, 517.1. If a beneficiary be forbidden to assign her interest in the trust, should she be allowed to accomplish the same result by termination? We think the answer is apparent. The purpose of the restraint on alienation such as the one in this

trust is not only to protect the beneficiaries from the claims of creditors, but also to assure the maximum annual income."

Kirkland v. Mercantile Safe Deposit & Trust Co., 218 Md. 17, 23, 145 A.2d 230, 233 (1958). See also *Mahan v. Mahan*, 320 Md. 262, 577 A.2d 70 (1990) ("[W]e hold that paragraph six of Frances's deed of trust created a spendthrift trust, and that a spendthrift trust cannot be terminated by the consent of the beneficiaries, even though all are sui juris and all join in seeking termination.")

The *Kirkland* case is instructive as to the type of circumstances where a spendthrift clause may, in fact, injure the beneficiary that the trust was presumably established to protect. In *Kirkland*, a mother established a trust to protect her three daughters. The trust directed 'all income' to go to the daughters but no distributions of corpus. Almost forty years after the mother's death, one of the two remaining daughters suffered a stroke and 'was left in such a condition that she was unable to care for herself, which involved expenses in excess of the income from the trust.' *Kirkland* at 21. The remaining daughter – who was guardian for the sister – sought a termination of the trust so that principal could be used for her sister. It was under those circumstances that the Court held that the trust could not be terminated. With the addition of '§ 104' of the new Uniform Principal and Income Act, Maryland law provides a trustee with a partial potential remedy to this sort of situation.

8. Powers of Appointment.

8.1 The Maryland "General" Power.

Maryland has a unique rule that holds that a "general" power of appointment is not really a general power of appointment unless it specifically provides that the donee of the power may appoint to his or her self, creditors, or the creditors of his or her estate. Merely stating that one is granting a "general power of appointment" is insufficient. *Bryan v. United States*, 286 Md. 176, 406 A.2d 423 (1979) (a power designated "a general power of testamentary disposition" was held not to be a power to appoint to self, creditors, estate or creditors of estate and therefore did not qualify as a general power of appointment marital trust); *Pierpont's Est. v. Comm'n,* 336 F.2d 277 (Md. 1964) (no marital deduction under IRC § 2056); but see *Guiney v. United States*, 425 F.2d 145 (Md. 1970) (holding that a "general power of appointment" qualified for § 2056 treatment where the Will specifically stated it was a "general power" in order to qualify for the federal marital deduction).

Therefore, in order to create a general power of appointment in Maryland, the donor of the power must specify that the donee may appoint to his or her self, estate, creditors or creditors of his or her estate.

8.2 <u>Creditors and Limited Powers of Appointment.</u>

As a general rule, creditors of the donee of a limited or special power of appointment cannot reach the property. In *Mercantile Trust Co. v. Bergdorf & Goodman Co.*, 167 Md. 158, 173 A. 31 (1934), a woman created a self settled trust and retained an income interest for life and retained a testamentary power of appointment to heirs. In the absence of a showing of fraud in the inception of the trust, creditors had no recourse against the principal of the trust. Likewise in *United States v. Baldwin*, 283 Md. 586, 391 A.2d 844 (1978), a settlor retained income for life, could name himself as trustee, and retained a broad (but not general) testamentary power of appointment. The Court held that the principal was beyond the reach of creditors (including the U.S. as creditor based on income tax liability.) As discussed below, however, a settler may not create a trust and retain a presently exercisable limited power of appointment, even subject to ascertainable standards, without exposing the maximum amount that he or she could reach to creditors. *In re Robbins*, 826 F.2d 293 (C.A. 4th Md. 1987).

8.3 Creditors and General Testamentary Powers of Appointment.

In *United States v. Field*, 255 U.S. 257 (1921), the Court held that the existence of the power does not shift the subject property to the donee. If the donee exercises the power, however, then the exercise to someone other than the creditor is deemed a fraudulent conveyance:

> "Where the donee dies indebted, having executed the power in favor of volunteers, the appointed property is treated as equitable, not legal, assets of his estate; *Clapp v. Ingrahm, 126 Massachusetts, 200, 203; Patterson & Co. v. Lawrence, 83 Georgia, 703, 707;* and (in the absence of statute), if it passes to the executor at all, it does so not by virtue of his office but as a matter of convenience and because he represents the rights of creditors. *O'Grady v. Wilmot* [1916] 2 A.C. 231, 248-257; *Smith v. Garey, 2 Dev. & Bat. Eq. (N.C.) 42, 49; Olney v. Balch, 154 Massachusetts, 318, 322; Emmons v. Shaw, 171 Massachusetts, 410, 411; Hill v. Treasurer, 229 Massachusetts, 474, 477.*
>
> Where the power is executed, creditors of the donee can lay claim to the appointed estate only to the extent that the donee's own estate is insufficient to satisfy their demands. *Patterson & Co. v. Lawrence, 83 Georgia, 703, 708; Walker v. Treasurer, 221, Massachusetts, 600, 602-603; Shattuck v. Burrage, 229 Massachusetts, 448, 452.*
>
> It is settled that (in the absence of statute) creditors have no redress in case of a failure to execute the power."

The rule has been repeated (and, perhaps expanded albeit in dicta) in various Maryland decisions. See, for example, *Frank v. Frank*, 253 Md. 413, 253 A.2d 377 (1969):

> "In *Connor v. O'Hara, 188 Md. 527*, in holding that for purposes of the Maryland inheritance tax laws, property passing by exercise of a testamentary power of appointment is regarded as passing not from the donee of the power but from the donor, Judge Markell, for the Court, said that this theory of passage not only is as fully applicable in Maryland as elsewhere but has been carried further here than in many other jurisdictions, and continued:
>
> > "In England, and generally but not universally in this country, this rule is qualified by a rule that when a general power of appointment is exercised, equity will regard the property appointed as part of the donee's assets for the payment of his creditors in preference to the claims of his voluntary appointees. In such cases the appointed property is treated as equitable, not legal, assets of the donee's estate, and may pass to the executor, not by virtue of his office but as a matter of convenience and because he represents the rights of

> creditors. *United States v. Field, 1921, 255 U.S. 257, 262, 263, 41 S. Ct. 256, 65 L. Ed. 617, 18 A.L.R. 1461*. In Maryland this English rule has been rejected. Decisions of dicta of this court indicate that a donee has no power (unless expressly conferred) to appoint for payment of his own debts. *Balls v. Dampman, 69 Md. 390, 16 A. 16, 1 L.R.A. 545; Price v. Cherbonnier, 103 Md. 107, 110, 111, 63 A. 209; cf. Wyeth v. Safe Deposit & Trust Co., 176 Md. 369, 376, 4 A. 2d 753;* appointed property is not part of the donee's estate, not subject to the jurisdiction of the Orphans' Court, and not subject to payment of the donee's debts. *Prince de Bearn v. Winans, 111 Md. 434, 472, 74 A. 626." [188 Md. At 530-531]*"

Indeed, the *Conner* decision continued to reference *O'Hara v. O'Hara*, 185 Md. 321, 44 A.2d 813 (1945) for the proposition that a donee of a testamentary power could not during his life bind himself by contract as to the exercise of the power and that the subject matter of the power was not the donee's property but that of the donor. *Connor* did not involve a creditor claiming against the donee of a power so its pronouncements are dicta. It is not fully clear which English rule has been rejected by Maryland but the passage strongly suggests that it is the rule pertaining to exercised powers. It may, however, merely be a reference to the restrictive nature of a Maryland general power of appointment without explicit authority to appoint to creditors, etc. See Rolling-Tarbox, <u>Powers of Appointment Under the Bankruptcy Code: A Focus on General Testamentary Powers</u>, 72 Iowa L. Rev. 1041 (1987) (a discussion of the potential inclusion of a general power in the bankruptcy estate. Even if included, the court should not have the authority to trigger exercise absent a specific statute under state law authorizing same).

8.4 <u>Creditors and Non-Testamentary General Powers of Appointment.</u>

The rule as to a presently exercisable general power of appointment, however, is not without ambiguity. Under U.S. Bankruptcy law, the assets subject to such a power would be brought into the estate of the debtor/donee of the power regardless of whether exercised. 11 U.S.C.A. § 541(b). Also, where the settler creates a power of appointment exercisable by the settler in favor of the settler, the assets subject to the power is exposed to creditors. *In re Robbins*, 826 F.2d 293 (C.A. 4th Md. 1987) (A retained limited power of appointment subject to ascertainable standards is reachable as a self-settled trust). Whether such a power created by a third party creates a sufficient property interest in the donee is not decided in Maryland. The Restatement (Third) Trusts § 56 cmt. b holds that it is the equivalent to ownership. See, however, *University Nat'l Bank v. Rhoadarmer*, 827 P.2d 561 (Colo. App. 1991) (A "5 & 5" power was not attachable because it is not an ownership of property but merely a conduit for the donor of the power.)

8.5 The Beneficiary as Trustee of Third Party Trusts.

There is little question but that a beneficiary may serve as the sole trustee of a trust established by a third person for his or her own benefit and not be treated as the owner of the trust assets for estate tax purposes as long as the distribution discretion is limited by an ascertainable standard. For asset protection purposes, however, such limitations on the beneficiary/trustee will probably not be respected and the entire trust will be exposed to the creditors of the beneficiary/trustee.

The rule, at least in the abstract, is that the creditors of a debtor should be "able to reach from time to time the maximum amount the trustee-beneficiary can *properly* reach." Restatement (Third) Trusts, § 60 (g) (emphasis added). Thus, in illustration 9 of the Restatement comment for § 60 (g), a testamentary trust with a daughter as the beneficiary/trustee that contains a sprinkle provision limited by ascertainable standards for her benefit and for that of her children exposes to the daughter's creditors "the maximum amount of trust funds that she may, without abuse of her discretion, distribute to herself for the authorized purposes…" This implies that the restrictions afforded by the ascertainable standards may, in fact, be respected. The cases, however, are not as nuanced. In *In re McCoy,* 274 B.R. 751 (Bankr. N.D. Ill. 2002), for example, the Court essentially examined a situation closely paralleling illustration 9. In that case, the beneficiary/trustee was the sole income beneficiary and could distribute to herself or her children such amounts as may be "desirable" for health, education, maintenance or support. The Court held that because the beneficiary/trustee could distribute funds to herself as may be "desirable" that constituted "unfettered" discretion so the creditor could reach the entire fund. The Court claimed that it looked to the state law to make this determination. One could argue that the result be different in Maryland by virtue of Est. & Trusts § 14-109 ("Prohibition from exercising powers conferred upon trustee") which limits powers of a beneficiary/trustee to ascertainable standards regardless of the terms of the instrument. As with the *McCoy* case, the cases elsewhere, however, do not show respect for the restrictions imposed by the ascertainable standards on the discretion by the beneficiary/trustee. Regardless of how the rule may be stated, if the beneficiary could reach the asset under a distribution power, even only by abusing that distribution power, the creditor be also be able to reach the asset.

To immunize trust assets from the creditor claims of the beneficiaries, the most prudent approach is to use an independent trustee and not use the beneficiary as trustee. Many clients, however, may want to permit their beneficiaries to control their own lives to the greatest extent possible and they only create trusts to minimize estate and generation skipping transfer taxes. Those clients may want to name the beneficiaries as trustee and rely on ascertainable standards for the sought-after tax savings. One approach may be to name the beneficiary as trustee subject to an automatic removal and replacement if that beneficiary/trustee is the subject of any claim or suit. Because of the uncertainty of that approach, it should be used only when asset protection considerations are not as important to the client as beneficiary autonomy and the client is aware that it is an unproven asset protection technique that potentially may fail.

9. Discretionary Trusts.

9.1 In General.

A discretionary trust, in contrast to a support trust, creates no enforceable distribution rights in the beneficiary: "[I]f, by direction of the settlor, all or part of the trust assets can be totally withheld from the beneficiary by the trustees then, to the extent it can be so retained, a discretionary trust would be created." *First Nat'l Bank of Maryland v. Dept. Health and Mental Hygiene*, 284 Md. 720, 725, 399 A.2d 891, 894 (1979). The *First National* case involved potentially ambiguous language: "My Trustees … shall pay from time to time the net income and so much of the principal as they, in their absolute and uncontrolled discretion, may determine, to my daughter, Annesley Bond Baugh, or, in their absolute and uncontrolled discretion, may apply the same for her maintenance, comfort and support." The Trustee's position was that it was to pay the net income for the daughter's support but that it had sole discretion over any payment from principal. The Court agreed. It distinguished the language of the trust under review from the "typical" support trust language: "For example, 'the trustees shall pay to the beneficiary of this trust so much of the income or principal as they deem necessary for his health, comfort, and support,' is a fairly typical clause that clearly shows the testator's intent to create a support trust."

As with all interpretation cases, the testator's (or settlor's) intent is to be gleaned from the four corners of the document. *Johnson v. Hall*, 283 Md. 644, 649, 392 A.2d 1103, 1106 (1978). An issue is created when wholly discretionary language is amplified by what may appear to be a distribution standard. Often, the distinction between a "support trust" and a "discretionary trust" is not a bright line. Ultimately, the Court determines whether the settlor intended a support trust or a discretionary trust: "Sitting in Loretta's (the testatrix's) armchair, her testamentary intent becomes clear." *Bregel v. Julier*, 253 Md. 103, 251 A.2d 891 (1969). "There has been much litigation on the issue of whether or not a trust is a support trust. If the trust is discretionary with a support standard, some cases have held that the beneficiary cannot compel a distribution. In these cases, the trust property is not an available resource and the beneficiary is not disqualified from eligibility of means-tested governmental benefits. Other cases have held that the beneficiary can compel a distribution and that the trust property is therefore an available resource. The question becomes one of settlor intent…" Davis and Kent, <u>The Impact of the Uniform Trust Code on Special Needs Trusts</u>, 1 NAELA J. 235, 247-8 (2005).

9.2 <u>Trustee Standards.</u>

Once establishing that a discretionary trust was created in *First National*, the Court found that its review of the Trustee's failure to distribute principal was limited to whether "it can be shown that they acted 'dishonestly or arbitrary or from improper motive.' Restatement (Second) of Trusts § 128, Comment d (1957)." In *Offutt v. Offutt*, 204 Md. 101, 109, 102 A.2d 554, 558 (1954), the Court declared "[t]he principle that the exercise by a trustee of a personal discretion conferred upon him is not subject to control by the court, except to prevent an abuse of discretion." A "personal discretion" is one "which the instrument conferring it (a power given a trustee) declared should be exercised by him or not according to his own volition or at his own discretion." (*Offutt* at 108, quoting from *Gottschalk v. Mercantile Trust and Deposit Co.*, 102 Md. 521, 62 A. 810 (1906)). "Thus, where a personal power of discretion is vested in the trustees, the Chancellor, even after an assumption of jurisdiction, will require a showing of abuse of discretion before substituting his judgment for that of the trustees, even though he might control their imperative, impersonal, or ministerial powers." (*Offutt* at 109).

This was the traditional approach that courts took to "enforcing" discretionary trusts, an approach that gave a beneficiary little recourse against a trustee who declined to make a distribution. Other Maryland cases seem to drift from the traditional "hands-off" rule. In *Waesche v. Rizzuto*, 224 Md. 573, 587, 168 A.2d 871, 877 (1961), the Court restated the rule for discretionary trusts: "A court of equity will not interfere in the exercise of the discretionary power conferred on the trustees provided that this power was honestly and reasonably exercised. However, it must appear that the trustees acted in good faith, having a proper regard to the wishes of the testator and the nature and character of the trust reposed in them." This language was cited in *Jacob v. Davis*, 128 Md. App. 433, 461, 738 A.2d 904, 918-9 (1999), which famously held that a remainderman is entitled to accountings despite a limitation to the contrary in the trust instrument, at least when the current income beneficiary is a co-trustee. In *Jacob*, the Court found that the trustee abused his discretion by delegating to the co-trustee/income beneficiary the discretion to invade principal. Once that abuse of discretion was found, the burden shifted to the trustee to justify the distributions. As to the broader holding that a trust necessarily grants rights to accountings to the beneficiaries, the Court quoted Bogart, The Law of Trusts and Trustees, § 973 (Rev. 2d ed. 1983): "A [testator] who attempts to create a trust without any accountability in the trustee is contradicting himself. A trust necessarily grants rights to the beneficiary that are enforceable in equity. If the trustee cannot be called to account, the beneficiary cannot force the trustee to any particular line of conduct with regard to the trust property or sue for breach of trust. The trustee may do as he likes with the property, and the beneficiary is without remedy. If the court finds that the settlor really intended a trust, it would seem that accountability in chancery or other court must inevitably follow as an incident. Without an account the beneficiary must be in the dark as to whether there has been a breach of trust and so is prevented as a practical matter from holding the trustee liable for a breach." This principle, coupled with what may be an expanded standard of judicial review suggested by *Waesche* and *Jacob*, may create unintended consequences.

9.3 The Restatement (Third) Approach.

The traditional standard for judicial review permitted intervention only to prevent abuse of discretion caused by trustees acting dishonestly, arbitrarily or because of improper motive. Restatement (Third) § 50 (2003) restates the test: "A discretionary power conferred upon the trustee to determine the benefits of a trust beneficiary is subject to judicial control only to prevent misinterpretation or abuse of the discretion by the trustee." Comment b states that a court not to interfere "when that exercise (of the discretionary power) is reasonable and not based on an improper interpretation of the terms of the trust." Terms creating "extended discretion" such as "absolute," "unlimited," or "sole and uncontrolled" "are not interpreted literally. Even under the broadest grant of fiduciary discretion, a trustee must act honestly and in a state of mind contemplated by the settlor." If the discretion is coupled with a standard (for the comfort, happiness, or whatever of a beneficiary), that standard will be seen as evidence of the settlor's "purpose in granting the discretionary power" and therefore a guide for testing whether the trustee has acted reasonably. Under the Restatement (Third) "reasonableness" test, a court will ascertain the settlor's purpose in setting up the trust, then decide whether the trustee was acting reasonably to accomplish those purposes.

9.4 UTC Approach.

The Uniform Trust Code uses different language from that of the Restatement (Third), although there is debate whether it is really dissimilar in effect. Section 814 of the UTC (2005) provides that: "Notwithstanding the breadth of discretion granted to a trustee in the terms of the trust, including the use of such terms as 'absolute', 'sole', or 'uncontrolled', the trustee shall exercise a discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries." The Commissioners choice of a "good faith" standard tracked their understanding of existing case law and was designed not to impose a "reasonableness" standard:

> "Under these standards, whether the trustee has a duty in a given situation to make a distribution depends on the exact language used, whether the standard grants discretion and its breadth, whether this discretion is coupled with a standard, whether the beneficiary has other available resources, and, more broadly, the overriding purposes of the trust. For example, distilling the results of scores of cases, the Restatement (Third) of Trusts concludes that there is a presumption that the 'trustee's discretion should be exercised in a manner that will avoid either disqualifying the beneficiary for other benefits or expending trust funds for purposes for which public funds would otherwise be available.' Restatement (Third) of Trusts Section 50 cmt. e & Reporter's Notes (Tentative Draft No. 2, 1999).
>
> Subsection (a) requires a trustee exercise a discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries. Similar to Restatement (Second) of Trusts Section 187 (1959), subsection (a) does not impose an obligation that a trustee's decision be within the bounds of a reasonable judgment, although such an interpretive standard may be imposed by the courts if the document adds a standard whereby the reasonableness of the trustee's judgment can be tested. Restatement (Second) of Trusts Section 187 cmt. f (1959).
>
> The obligation of a trustee to act in good faith is a fundamental concept of fiduciary law although there are different ways that it can be expressed. Sometimes different formulations appear in the same source. Scott, in his treatise on trusts, states that the court will not interfere with the trustee's exercise of discretion if the trustee 'acts in good faith and does not act capriciously,' but Scott then states that the trustee will interfere if the trustee 'acts dishonestly or in good faith, or where he acts from an improper motive.' 3 Austin W. Scott & William F. Fratcher, The Law of Trusts Section 187.2 (4th Ed. 1988).
>
> Sometimes different formulations are used in the same case:
>
> [If] the 'sole discretion' vested in and exercised by the trustees in this case . . . were exercised fraudulently, in bad faith or in an abuse of discretion, it is subject to . . . review. Whether good faith has been exercised, or whether fraud, bad faith or an abuse of discretion has been committed is always subject to consideration by the court upon appropriate allegations and proof. *In re Ferrall's Estate*, 258 P.2d 1009 (Cal. 1953).

Section 504 of the UTC largely eliminates the traditional distinction between a discretionary trust and a support trust.

9.5 The UTC/Restatement Controversy.

There are those who argue that both the reasonableness test of Restatement (Third) and the good faith test of the UTC radically change the equation for asset protection purposes: "Once the threshold for the judicial standard of review has been reduced to reasonableness or good faith, in almost all cases, the beneficiary should have an enforceable right to a distribution. This being the case, may a creditor stand in the beneficiary's shoes under the UTC or the Restatement (Third)? Even if a creditor may not stand in the beneficiary's shoes, similar to the *Metz* case in Ohio [145 Ohio App. 3d 304, 762 N.E.2d 1032 (2001) (holding that a discretionary trust is an available resource)], may a governmental agency deny benefits by considering a discretionary trust as an available resource? Also, would the discretionary trust be considered an equitable factor in determining child support, alimony, and possibly an equitable division of marital property? Finally, should a beneficiary be imputed income from a trust for the purpose of computing child support and alimony?" Oshins, Asset Protection Other Than Self-Settled Trusts: Beneficiary Controlled Trusts, FLPs, LLCs, Retirement Plans and Other Creditor Protection Strategies, 2005 Heckerling Institute on Estate Planning, 3-45.

Defenders of the UTC argue that no change to the traditional law governing discretionary trusts was made by Section 814 and, indeed, that UTC simply defers to the case law of the governing jurisdiction. See, Newman, Spendthrift and Discretionary Trusts: Alive and Well Under the Uniform Trust Code, 40 Real Prop. Prob. & Tr. J., 567 (Fall 2005) (Section VII, 601). Interestingly, Newman cites *Jacob v. Davis*, --- for support of the proposition that: "Cases from many jurisdictions explicitly acknowledge the requirement that trustees exercise discretion in good faith even if the trustee is granted extended discretion." Newman at 605-6.

10. Limited Liability Entities.

10.1 The Charging Order.

The use of family partnerships, and to a lesser degree, family limited liability companies, have been largely driven by the valuation discount possibilities. An additional benefit is the asset protection aspects of these entities.

A creditor of a partner has limited ability to attach partnership property or to affect partnership operations. The creditor's initial recourse is by obtaining a charging order:

> "A charging order is the statutory means by which a judgment creditor may reach the partnership interest of a judgment debtor. Bank of Bethesda v. Koch, 44 Md. App. 350, 354, 408 A.2d 767 (1979). Prior to its availability, the courts would resort to common law procedures for collection that were ill-suited for reaching partnership interests. Gose, The Charging Order Under the Uniform Partnership Act, 28 Wash. L. Rev. 1 (1953). Typically, despite the fact that individual partners do not have title in partnership property, partnership property would be seized under writs of execution; the debtor partner's interest in the partnership would be sold, often to the judgment creditor, subject to the payment of partnership debts and prior claims of the partnership against the debtor partners; and the sale of the debtor partner's interest would result in compulsory dissolution and winding up of the partnership. Id. As noted by at least one jurist, '[a] more clumsy method of proceeding could hardly have grown up.' Id. (quoting Lord Justice Lindley of the English Court of Appeal, Brown Janson & Co. v. Hutchinson & Co., 1 Q.B. 737 (1895))."

91st Street Joint Venture v. Goldstein, 114 Md. App. 561, 567, 691 A.2d 272, 275 (1997).

For limited partnerships, a creditor's remedies against a partner are set out at Corps & Ass'ns § 10-705:

> "On application to a court of competent jurisdiction by any judgment creditor of a partner, the court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest. This title does not deprive any partner of the benefit of any exemption laws applicable to his partnership interest."

An assignee of a partnership is not admitted as a partner unless all partners agree or it is otherwise permitted by the partnership agreement. Corps & Ass'ns § 10-703.

The rights of creditors of a general partner are governed by Corps & Ass'ns § 9A-504 (post-2002 law):

> "(a) *As satisfaction of judgment.* – On application by a judgment creditor of a partner or of a partner's transferee, a court having jurisdiction may charge the transferable interest of the judgment debtor to satisfy the judgment. The court may appoint a receiver of the share of the distributions due or to become due to the judgment debtor in respect of the partnership and make all other orders, directions, accounts, and inquiries the judgment debtor might have made or which the circumstances of the case may require.
>
> (b) *Charging order constitutes a lien.* – A charging order constitutes a lien on the judgment debtor's transferable interest in the partnership. The court may order a foreclosure of the interest subject to the charging order at any time. The purchaser at the foreclosure sale has the rights of a transferee.
>
> (c) *Redemption.* – At any time before foreclosure, an interest charged may be redeemed:
>
> (1) By the judgment debtor;
>
> (2) With property other than partnership property, by one or more of the other partners; or
>
> (3) With partnership property, by one or more of the other partners with the consent of all of the partners whose interests are not so charged.
>
> (d) *Exemption.* – This title does not deprive a partner of a right under exemption laws with respect to the partner's interest in the partnership.
>
> (e) *Exclusivity.* – This section provides the exclusive remedy by which a judgment creditor of a partner or partner's transferee may satisfy a judgment out of the judgment debtor's transferable interest in the partnership. (1997, ch. 654, § 2; 1998, ch. 743, § 1.)"

Prior to the changes in § 9A-504, old Corps & Ass'ns § 9-504 provided a similar, although not identical, scheme for the enforcement of a judgment. Both set out more detail as to the enforcement mechanisms of a charging order in contrast to the provision governing limited partnership interests. Corps & Ass'ns § 9A-504 permits a foreclosure of a debtor partner's "transferable interest in the partnership." This phrase is defined as a partner's "share of the profits and losses of the partnership and the partner's right to receive distributions." Corps & Ass'ns § 9A-502. Under the old law, foreclosure of a debtor partner's general partnership interest was likewise a recognized enforcement technique.

Forced sale of a debtor partner's interest is also a remedy for the general and limited partnership interests in a limited partnership. *Lauer Construction, Inc. v. Schrift*, 123 Md. App. 112, 716 A.2d 1096 (1998).

Thus for both general and limited partnerships, a charging order "provides two basic collection methods: (1) the diversion of the debtor partner's profits to the judgment creditors; and (2) the ultimate transfer of the debtor partner's interest should the first collection method prove unsatisfactory." *91st Street Joint Venture v. Goldstein*, 114 Md. App. 561, 572, 691 A.2d 272, 278 (1997). In either case, it is only the partner's financial interest in profits or distributions that is subject of the charging order. Those receiving benefits under a charging order possess rights only of an assignee not as a partner.

10.2 Management Rights; Fiduciary Obligations.

In *Green v. Bellerive Condominiums Limited Partnership*, 135 Md. App. 563, 763 A.2d 252 (2000), the debtor partner defaulted on his personal obligation resulting in a judgment against him. The judgment creditor received a charging order against the partner's interest. The partnership incurred bank debt to finance the project. The partnership defaulted on that debt and the FDIC (the bank having dissolved) began collection remedies against the partnership. The other partners negotiated with the FDIC to purchase the note at a discount. Those partners then sold the property paying themselves the full value of the note with none of the discount passing through to the partnership. The result was that the remaining partners cashed out but no proceeds were left as partnership distributions. The judgment creditor was never paid. The receiver for the judgment creditor asserted the partnership rights of the debtor partner, claiming that he was entitled to notice of the opportunity to purchase the note because he stands in the debtor's partner's shoes. The Court held that the receiver has the rights of a mere assignee, not those of a partner:

> "By limiting a creditor's right to exercise the debtor partner's management rights, we ensure that creditors of a limited partner cannot disrupt partnership business or interfere with the management rights of other partners. In particular, this limitation prevents third party creditors from using a charging order as a license to 'squeeze' other limited partners into paying off obligations of the debtor, as the necessary costs of eliminating the risk of such interference.
>
> * * *
>
> These reasons for excluding third party creditors from a seat at the partnership's management table are no less applicable – and perhaps are even more applicable – when the issue under consideration is what to do about partnership debt or about a partnership opportunity. If a charging creditor is permitted to exercise management rights of the debtor partners in matters pertaining to partnership debt or partnership opportunities, that third party creditor is in an enhanced position to wield any of the debtor partner's management rights as a tool to obtain payment of the judgment debt. Undoubtedly, investors contemplating a limited partnership opportunity would be discouraged by the possibility of having to satisfy or deal with creditors of each partner."

Green v. Bellerive Condominiums Limited Partnership, 135 Md. App. 563, 582-3, 763 A.2d 252, 263 (2000).

It is precisely this inability of a creditor to interfere with the operations of a partnership or to reach partnership property that insulates a partnership from the creditors of its partners. Even the foreclosure of a debtor partner's interest confers limited rights to the transferee:

> "We do not think that the receiver or judgment creditors are burdened unfairly by the denial of these management rights. Like other well-informed creditors, they presumably knew that partnership interests are notoriously poor security for the repayment of a debt. 'Credit extenders who look to a partner's interest in a partnership as a possible source of satisfaction are well advised to take and perfect a security interest rather than rely on a charging order … [because a] partnership interest is not very good collateral…" IV *Bromberg and Ribstein, supra,* at § 13.07(a), at 13:43."

Id. at 584-5.

It is important to note, however, that by statute a transferee may seek judicial dissolution and winding up of a partnership in one circumstance. This can occur upon a judicial determination that "it is equitable to wind up the partnership business" and either (1) the partnership term expires or (2) the partnership has an "at will" term. Corps & Ass'ns §§ 9A-503(b)(3) and 9A-801(a). The partnership term may be, of course, perpetual. Corps & Ass'ns § 10-201(a)(4).

10.3 Proposed Changes to MRULPA.

The National Conference of Commissioners on Uniform State Laws ("NCCUSL") has proposed a revised Uniform Limited Partnership Act (2001) ("ReRULPA"). Section 703 of ReRULPA generally tracks Corps & Ass'ns § 9A-504. The Comment emphasizes that a charging order does not extend beyond the powers of an assignee ("transferee" per RULPA):

> "Under this section, the judgment creditor of a partner or transferee is entitled to a charging order against the relevant transferable interest. While in effect, that order entitles the judgment creditor to whatever distributions would otherwise be due to the partner or transferee whose interest is subject to the order. The creditor has no say in timing or amount of those distributions. The charging order does not entitle the creditor to accelerate any distributions or to otherwise interfere with the management and activities of the limited partnership.
>
> Foreclosure of a charging order effects a permanent transfer of the charged transferable interest to the purchaser. The foreclosure does not, however, create any rights to participate in the management and conduct of the limited partnership's activities. The purchaser obtains nothing more than the status of a transferee.
>
> **Subsection (a)** – The court's power to appoint a receiver and 'make all other orders, directions, accounts, and inquiries the judgment debtor might have made or which the circumstances of the case may require' must be understood in the context of the balance described above. In particular, the court's power to make orders 'which the circumstance may require' is limited to 'giv[ing] effect to the charging order.'
>
> **Example:** A judgment creditor with a charging order believes that the limited partnership should invest less of its surplus in operations, leaving more funds for distributions. The creditor moves the court for an order directing the general partners to restrict re-investment. This section does not authorize the court to grant the motion."

The Reporters for the NCCUSL drafting committee on the 2001 Act defend the new provisions as not enlarging creditor remedies from that afforded under prior law. Kleinberger, Bishop & Gen, Charging Orders and the New Uniform Limited Partnership Act, Dispelling Rumors of Disaster, Real Prop. Prob. & Tr. J. 30 (July /Aug. 2004).

Under current Maryland law, a judgment creditor of a debtor partner could either hold a charging order to receive distributions or foreclose on the right to receive such distributions. This was true under the "old" uniform partnership act and under the revised uniform partnership act. It will continue to be true under the 2001 revisions to the uniform limited partnership act if adapted in Maryland. *91st Street Joint Venture v. Goldstein*, 114 Md. App. 561, 691 A.2d 272 (1997); *Lauer Construction Inc. v. Schrift*, 123 Md. App. 112, 716 A.2d 1096 (1998).

Under the old, new, or proposed acts, the status of a creditors in generally not strong:

> "The lot of a 'naked assignee' is not a happy one: not a partner, not protected by partner-to-partner fiduciary duty, not entitled to participate in partnership affairs in any way, and with virtually no rights to obtain partnership-related information.
>
> Moreover, the naked assignee faces adverse tax consequences. The purchaser of a foreclosed partnership interest is considered a partner for federal tax purposes (even though not a partner under state partnership law), Rev. Rul. 77-137, 1977-1 C.B. 178, which means that the purchaser is subject to tax on its share of the partnership's income regardless of whether the partnership actually distributes any of that income.
>
> The tax situation is different from a mere holder of a charging order. Because that person does not own the underlying interest, the person should not be considered a partner for tax purposes. There is no specific IRS authority on this point. But the point follows from core concepts of partnership tax law and means that -- so long as the charging order is not foreclosed and the interest sold -- the debtor partner remains taxable on it shares of partnership income even though that share is distributed directly to the judgment creditor.
>
> Thus, the typical judgment creditor does not salivate at the prospects of foreclosure, and a foreclosure sale will typically draw no crowd."

Kleinberger, et al. (at 32-33).

10.4 Partnership Interests in Bankruptcy.

The general rule that a creditor has the status of a mere transferee has been tested in bankruptcy. A partnership agreement is an executory contract. Section 365 of the Bankruptcy Act permits the trustee broad control over executory contracts, except for "personal service" contracts. Bishop & Kleinberger, The Bankruptcy of an LLC Member: Does the Trustee Run the Company? ABA Section of Business Law (2005 Annual Meeting at Chicago, Ill. Aug. 5-9 2005) (Available from ABA website).

In re Antonelli, 148 B.R. 443 (D. Md. 1992) involved a Chapter 11 proceeding of the general partner. The partnership operated parking lot facilities in Washington, D.C. and other real estate projects. [As of 1991 the Antonelli bankruptcy was the largest Chapter 11 ever filed in the District of Maryland, "involving almost 2,000 creditors, claims of over $200 Million and assets of over $100 Million."] The plan called for the liquidation of the Antonelli interests to be handled by a committee comprised of creditors. The Plan required Mr. Antonelli to cast his vote as a general partner on partnership matters as directed by the committee. If Mr. Antonelli believed that a specific direction would violate his fiduciary duty to the partnership, he was to file a motion with the bankruptcy court for instructions. Some of the limited partners objected to this arrangement.

In re Antonelli, the court upheld the vote-by-committee plan. In doing so, the court distinguished between partnerships where the identity of the general partner is significant (partners in a law firm) and not as significant (a "mature" real estate project):

> "Obviously, a reorganization plan could not require that a law firm accept as a partner the assignee of one of their partners who had become bankrupt. The nature of the duties which law partners owe, not only to one another but to their clients, make their identities material to the very existence of the partnership. Real estate partnerships, however, cannot be so strictly categorized. As one commentator has noted, the question of whether or not interests (including the exercise of management power) in a real estate partnership should be assignable under Section 365(c) properly depends upon the stage that the real estate project has reached and the substantiality of the duties which the partners must continue to perform."

In re Antonelli, 148 B.R. 443, 448-9 (D. Md. 1992).

10.5 LLCs.

Limited Liability Companies are wholly creatures of statute. Corps & Ass'ns § 4A-301 provides blanket protection to members:

> "Except as otherwise provided by this title, no member shall be personally liable for the obligations of the limited liability company, whether arising in contract, tort or otherwise, solely by reason of being a member of the limited liability company."

Creditors of a member may charge an interest and "to the extent so charged, the judgment creditor shall have only the rights of an assignee…" Corps & Ass'ns § 4A-607. An assignee is generally entitled to distributions but not to participate in management. Corps & Ass'ns § 4A-603.

In the securities fraud arena, the Maryland Court of Special Appeals has held that LLC's are similar to corporations, not general partnerships, in large part because members are not personally liable for company debts. The narrow question in *AK's Daks Commc'n, Inc. v. Maryland Securities Div.*, 138 Md. App. 314, 771 A.2d 487 (2001), was whether a presumption that partnership agreements are not generally "investment contracts" and therefore not regulated securities should be applied to LLCs. The rationale for this rule (the so-called "Williamson presumption") is that partners remain liable for partnership debts by virtue of the form of their ownership interest:

> "Other courts have addressed whether the Williamson presumption for general partnerships applies to interests in limited liability companies. In Great Lakes Chemical Corporation v. Monsanto Company, supra, 96 F. Supp. 2d 376, the court was asked to decide whether interests in a limited liability company were securities and, thus, whether the sale of those interest was governed by federal securities law. The court compared the general partnership form of business entity and the limited liability company form of business entity. It notes that the two forms do share some of the same characteristics. Id. at 391. Like general partners, members in a limited liability company may participate actively in the management and control of the business. Id. The court concluded, however, that the factors distinguishing limited liability companies from general partnerships are significant. Id. at 383. Unlike

> general partners, members in a limited liability company are not personally liable for the obligations of the company solely by virtue of their membership in the company. Rather, their liability is limited, like the liability of shareholders. Id. See also CA § 4A-301. Further, depending on the nature of the particular limited liability company's operating agreement, the members also may be less involved in the management of the business than general partners are. Great Lakes Chem. Corp. 96 F. Supp. 2d at 391. See also CA § 4A-401. Based on these distinctions, the court declined to extend the Williamson presumption, that interests in general partnerships are not securities, to interests in limited liability companies."

[Presumably, limited liability partnership status would also lift a general partnership out of the Williamson presumption for securities fraud purposes. See Corps & Ass'ns § 9A-306(c).]

The statutory direction that a charging order is the method available to judgment creditors may not apply to single member LLC's. *In re Albright*, 291 B.R. 538 (D. Colo. 2003) the Colorado bankruptcy court permitted the Trustee to take possession and control of a single member LLC:

> "[T]he charging order, as set forth in Section 703 of the Colorado Limited Liability Company Act, exists to protect other members of an LLC from having involuntarily to share governance responsibilities with someone they did not choose, or from having to accept a creditor of another member as a co-manager. A charging order protects the autonomy of the original members, and their ability to manage their own enterprise. In a single-member entity, there are no non-debtor members to protect. The charging order limitation serves no purpose in a single member limited liability company, because there are no other parties' interests affected."

In re Albright, 291 B.R. 538, 541 (D. Colo. 2003)

Bankruptcy courts have found non-managing members of LLC's not to hold significant management obligations thus permitting full control by the bankruptcy trustee. These cases turn on whether the non-managing member has to do anything of substance on behalf of the LLC. *In re Ehmann*, 319 B.R. 200 (D. Ariz. 2005); *In re IT Group, Inc.*, 302 B.R. 483 (D. Del. 2003). In effect, these cases hold that the member's interest should be seen as stock in a corporate entity and not as a team of individuals sharing partner-like obligations to each other.

The Delaware Series LLC is a relatively new, and largely untested, variation on the standard LLC. By statute, the Delaware Series LLC permits separate properties to be held in separate compartments in a single LLC. Each compartment purportedly is treated as separate from the other compartments for liability purposes. Although the separateness of the compartments has not yet been tested in the courts, a Delaware Series LLC offers the potential of adding liability protection yet qualifying as a single LLC for Maryland state recordation tax purposes under the "real estate enterprise" exception. Real Prop. § 12-108(bb).

10.6 <u>Corporations.</u>

Corporations, of course, afford protection to shareholders for corporate debts because the corporation is a person separate from its shareholders. To hold shareholders responsible, a creditor must pierce the corporate veil. It is not enough, however, for a court to simply wish to prevent an evasion of a legal obligation: "The common thread running through the Maryland cases – as stated earlier – is that the corporate entity will be disregarded only when necessary to prevent fraud or to enforce a paramount equity." *Bart Arconti v. Ames-Ennis,* 275 Md. 295, 312, 340 A.2d 225, 235 (1975). The Court of Appeals in *Hildreth v. Tidewater Equipment Co.,* 378 Md. 724, 735-6, 838 A.2d 1204, 1210-11 (2003) addressed the criteria for finding a "paramount equity":

> "Although there appears to be no universal rule as to the specific criteria that courts will consider in determining whether to apply the doctrine, Fletcher observes that some of the factors commonly considered, when dealing with a single corporation, are (1) whether the corporation in inadequately capitalized, fails to observe corporate formalities, fails to issue stock or pay dividends, or operates without a profit, (2) whether there is commingling of corporate and personal assets, (3) whether there are non-functioning officers or directors, (4) whether the corporation is insolvent at the time of the transaction, and (5) the absence of corporate records. Id.
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> There is no support in this record for basing personal liability on the 'alter ego' doctrine. With respect to the more general factors mentioned by Fletcher, there is no evidence that Hildreth exercised such complete domination over HCE-NJ to warrant

> a conclusion that the corporation 'had no separate mind, will or existence of its own.' There is no evidence that HCE-NJ was undercapitalized, that corporate formalities were not observed, that the corporation operated without a profit, that there were non-functioning officers or directors, that the company was insolvent when it entered into the arrangement with Tidewater, that there were no or inadequate corporate records."

As with the clear majority of cases, the Court refused to pierce the corporate veil in *Hildreth*.

10.7 Family Entities and Divorce.

Family entities may be exposed indirectly to the effects of monetary awards pursuant to divorce. The key is whether the interest increases during the marriage as a result of the spouse's efforts or whether the increase is due to other factors. If the increase is due to the (otherwise uncompensated) efforts of the divorcing spouse, the increase is considered martial property.

Thus, in *Innerbichler v. Innerbichler*, 132 Md. App. 207, 752 A.2d 291 (2000), the Court examined whether the increase in a husband's stock value was attributable to his efforts and therefore produced a large marital award. In *McNaughton v. McNaughton*, 74 Md. App. 490, 537 A.2d 1193 (1988), on the other hand, the appreciation in value of non-marital stock in the family business did not constitute marital property because the husband was otherwise well compensated and the appreciation was due to factors beyond the husband's contribution.

11. Special Post-Mortem Issues.

In general, a decedent's creditors are expected to submit claims to the personal representative of the debtor/decedent's estate. This procedure predated the non-probate "revolution" which largely changed how assets were held and transmitted at death. The development of this alternative method of transmitting assets at death did not create a corresponding system for settling the claims of creditors.

11.1 The Non-probate "Revolution."

Professor John H. Langbein wrote a seminal article in 1984, addressing various implications of the "non-probate revolution." It is, of course, a fact of life – wealth is increasingly held in forms that avoid probate: joint tenancies, IRAs and 401(k)s, transfer on death accounts, and – of course – revocable trusts. Additionally, planners are increasingly focused on using asset protection techniques most, if not all, involving non-probate devices. Remarkably, creditors seemed disinterested in participating in this revolution or in protecting their interests:

> The puzzle in the story of the nonprobate revolution is not that transferors should have sought to avoid probate, but rather that other persons whose interests probate was meant to serve-above all, creditors-should have allowed the protections of the probate system to slip away from them. Probate performs three essential functions: (1) making property owned at death marketable again (title-clearing); (2) paying off the decedent's debts (creditor protection); and (3) implementing the decedent's donative intent respecting the property that remains once the claims of creditors have been discharged (distribution).
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> The other set of changes that underlie the nonprobate revolution concerns another great mission of probate: discharging the decedent's debts. Many of the details of the American probate procedure, as well as much of its larger structure, would not exist but for the need to identify and pay off creditors. These procedures are indispensable, but-and here I am asserting a proposition that has not been adequately understood-only for the most exceptional cases. In general, *creditors do not need or use probate*. Langbein, supra n.1, at 1120.

John H. Langbein, <u>The Nonprobate Revolution and the Future of the Law of Succession</u>, 97 Harv. L. Rev. 1108, 1116 (1984). Professor Langbein's proposition is that creditors have not been focused on the non-probate revolution, despite its adverse impact on these creditors, because the impact is seen as nominal. Most of the larger creditors look to other security arrangements or payment modalities (mortgage liens or other security arrangements against specific property, life insurance policies backstopping the debt, medical insurance covering most medical expenses, multiple guarantors, etc.). The "smaller" creditors – basically credit card companies – find that moral suasion and/or professional debt collection efforts work well and those creditors are willing to pursue probate estates, showing little interest to date in non-probate transfers. Langbein, supra n.1, at 1120-5. When probate assets exist for the enforcement of creditor rights, of course, that is the simplest collection method because certainty exists as to the procedure. Creditor's rights to enforce against non-probate assets, on the other hand, depend on the nature of the asset, the law governing the treatment of that asset, and, in many instances, the fraudulent conveyance act.

11.2 Joint Tenancy.

For tenants by the entirety property, of course, the creditors of the debtor decedent spouse have no recourse against the property. This would have been true both during the lifetime of the debtor spouse (assuming it's not a joint debt) or thereafter. If the debtor spouse, however, survives the non-debtor spouse, the assets generally become available to the creditor as a result of the instantaneous succession. [There is a potential exception if the surviving debtor spouse disclaims and as a result of such disclaimer the assets are directed by the deceased non-debtor spouse estate plan to a spendthrift trust for the surviving debtor spouse.] See generally Fred Franke, Asset Protection and Tenancy by the Entirety, 34 ACTEC J. 210, 219-21 (2009).

For other forms of joint tenancy, the property may also be free from the decedent's creditors even after a judgment is entered against one of the joint owners. In the *Eastern Shore Building and Loan Corp. v. Bank of Somerset*, 253 Md. 525, 253 A.2d. 367 (1969) the Court of Appeals held that a judgment that constituted a lien on one owner's interest in joint tenancy property did not survive a conveyance to a third party unless or until there is execution on the judgment before the conveyance. This is not an intuitive result because joint tenancies are "disfavored" in Maryland and many unilateral acts by one joint tenant operates to sever the tenancy, thereby converting it to a holding as tenant in common. Thus, for example, if one joint tenant executes a lease, executes a contract of sale, or takes other kinds of individual action, the tenancy is severed and the property "converts" to ownership in common. Nevertheless, the mere fact of a judgment against one joint tenant does not effectuate such a severance and conversion:

> In the present case there was no execution by the judgment creditor prior to the conveyance by the joint tenants, nor was there any contract of sale or lease by one joint tenant or other action prior to the conveyance of October 5, 1967, by the joint tenants which might possibly result in a severance of the joint tenancy prior to the conveyance. That conveyance, it is true, terminated the joint tenancy, but simultaneously with the conveyance, title to the subject property vested in the grantees in fee simple. There was never a time, therefore, that Otho and William ever held title to the subject property as tenants in common so that there was no estate in the land which Otho, alone, held in severalty to which the lien of a judgment against him alone could attach. Inasmuch as the judgment is not against any of the grantees in the deed of October 5, the judgment lien obviously does not attach to any of their interests in the subject property.

Eastern Shore Building and Loan Corp. v. Bank of Somerset, 253 Md. 525, 253 A.2d. 367 (1969), at 531/370-1. Similarly, in *Chambers v. Cardinal*, 177 Md. App. 418, 935 A.2d. 502 (2007), the Court of Special Appeals held that a judgment lien that was not executed upon does not attach and therefore a purchaser of the property will held title to the property clear of such lien.

The holding in *Eastern Shore Building & Loan Corp.* is the common law rule: "At common law, a creditor's rights to a debtor's joint property were limited to the right to sever before the debtor joint tenant died…If the debtor owning an interest in joint tenancy died before the creditor sought to reach the debtor's share, however, his interest was deemed to expire and the survivor held free of any claims against the decedent. This is still the prevailing rule." Thomas R. Andrews, <u>Creditors' Rights Against Nonprobate Assets in Washington: Time for Reform</u>, 65 Wash. L. Rev. 73, 92-3 (1990).

11.3 <u>Transfer of Death Accounts (Title 16, Estates & Trusts Article of the Annotated Code of Maryland).</u>

Est. & Trusts § 16-109(a) provides:

> (b) *Rights of Creditors*. - This title does not limit the rights of creditors of security owners against beneficiaries and other transferees under the laws of this state.

Est. & Trusts Article § 16-109(b). The statute does not provide separate remedies for creditors. This is, in fact, the language of the pre-1998 Uniform Nonprobate Transfers on Death Act. The amendments to the Uniform Act in 1998 took a very different approach – protecting creditors if the probate assets were insufficient to cover all valid claims:

> Except as otherwise provided by statute, a transferee of a nonprobate transfer is subject to liability to any probate estate of the decedent for allowed claims against decedent's probate that estate and statutory allowances to the decedent's spouse and children to the extent the estate is insufficient to satisfy those claims and allowances. The liability of a nonprobate transferee may not exceed the value of the nonprobate transfers received or controlled by that transferee.

Uniform Nonprobate Transfers on Death Act § 102(b). The Comments set out the basis for this reversal:

> 1. Added to the Code in 1998, this section extends protections for family exemption beneficiaries and creditors of decedents to new categories of non-probate transferees of decedents. However, unlike conventional and cumbersome probate protections, the remedy contemplated by this section is to enforce a duty placed on nonprobate transferees to contribute as necessary to satisfy family exemptions and duly allowed creditors' claims remaining unpaid because of inadequate probate estate values. The maximum liability for a single nonprobate transferee is the value of the transfer. Values are determined under (b) as of the time when the benefits are "received or controlled by the transferee." This would be the date of the decedent's death for nonprobate transfers via a revocable trust, and date of receipt for other nonprobate transfers. Two or more transferees are severally liable for proportions of the liability based on the value of transfers received by each.
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> If there are no probate assets, a creditor or other person seeking to use this section would need to secure appointment of a personal representative to invoke Code procedures for establishing a creditor's claim as "allowed." The use of regular probate proceedings as a prerequisite to gaining rights for creditors against nonprobate transferees has been a feature of UPC Article VI since original promulgation in 1969. It works well in practice inasmuch as Article III procedures for opening estates, satisfying probate exemptions, and presenting claims are extremely efficient. Id. cmt.

As stated, the Maryland Act does not include a special remedy for creditors on transfer of death accounts. Presumably, such creditors would need to base its claim on the fraudulent conveyance act.

11.4 Revocable Trusts.

Maryland has yet to adopt the Uniform Trust Code and the rule as to the availability of trust assets for probate creditors is unclear. Presumably, creditors would need to rely on the fraudulent conveyance statute to assert a post death claim against the trust or on a theory that creditors are entitled to reach the assets because the settler held a general power of appointment. See Martin J. Placke, Creditors' Rights in Nonprobate Assets in Texas, 42 Baylor L. Rev. 141, 142-9 (1990).

Generally, of course, a revocable trust is a completed transfer and upon formation and funding the trustee, not the settler, has a present interest in the property. *Karsenty v. Schoukroun*, 406 Md. 469, 495, 959 A.2d 1147 (2008), *Brown v. Fidelity Trust Co.*, 126 Md. 175, 94 A. 523 (1915), *Brown v. Mercantile Trust & Deposit Co.*, 87 Md. 377, 40 A. 256 (1898). This would seem to present a barrier to prevailing on the theory that the transfer at death of the assets of a revocable trust constitutes the fraudulent transfer. See *In re Granwell*, 20 N.Y.2d 91, 228 N.E.2d 779, 281 N.Y.S.2d 783 (1967) where the fraudulent transfer act generally applied when the assets held by the decedent in a revocable trust were gratuitously transferred at his demise thereby causing his estate to be insolvent. In a different setting, however, the Court of Appeals treated the revocable trust as a mere will substitute. *Upton v. Clarke*, 359 Md. 32, 48, 753 A.2d 4, 12 (2000) (Holding that the testamentary rule, not the one governing lifetime gifts, applied for the presumption of undue influence when a confidential relationship exists)("The trust here…is clearly more akin to a testamentary instrument than to an inter vivos gift…").

A revocable trust, of course, is one where the settler retains the right to revoke – in effect, where the settler retains a general power of appointment. At the moment of death, of course, this power disappears. It is unknown whether a Maryland court would make appointive property subject to probate creditor claims. Generally, "The common law provides that creditors cannot reach appointive property as long as a general power remains unexercised." Marie Rolling-Tarbox, Powers of Appointment Under the Bankruptcy Code: A Focus on General Testamentary Powers, 72 Iowa L. Rev. 1041, 1046 (1987); John O. Fox, Estate: A Word To Be Used Cautiously, If At All, 81 Harv. L. Rev. 992, 1007 (1968) ("Although there are cases to the contrary, as a general rule over which a general power of appointment is exercised may be reached by creditors of the donee of the power, if his or her other assets are insufficient for the payment of his or her debts. But if the surviving spouse (the donee) under a power of appointment fails to exercise the power, her creditors cannot acquire the power to compel its exercise nor can they reach the property covered by the power…"). Nevertheless, a Massachusetts case uses this theory to hold the assets of the revocable trust liable for probate estate creditors even when that general power is unexercised. *State St. Bank & Trust Co. v. Reiser*, 7 Mass. App. Ct. 633, N.E.2d 768 (1979). This case held that the probate creditors had an equitable right to the property covered by the general power of appointment even though unexercised based on the position of the Restatement of Property § 328 (1940).

Under the Uniform Trust Code, however, the assets held by a revocable trust would be subject to creditor claims to the extent that the probate asset is inadequate to satisfy such claims, including administrative expenses and statutory shares or allowances. This is a "pure" will substitute approach.

12. Probate Creditors

12.1 Enforcement of Liens.

The claims statutes do not affect actions or proceedings to by secured creditors to enforce mortgages or other liens that are in place at death. Indeed, the limitation on the presentment of claims statute specifically exempts the enforcement of liens. Est. & Trusts Article § 8-103(d). Also, the prohibition against execution or levy against probate estate property does not extend to the enforcement of pre-death liens. Est. & Trusts Article § 8-114 (b). Thus, to the extent a secured creditor has sufficient security, the enforcement of such secured creditor's claim may be made independent of the probate process. (Cts. & Jud. Proc. Article § 11-402 provides that a judgment becomes a lien on all real property of the debtor upon entry if indexed and recorded for property located within that county and upon indexing and recordation in other counties. A judgment, regardless of whether indexed and recorded, does not generally constitute a lien on personal property until execution thereon.)

The Court of Appeals recently clarified that a post-death judgment lien is not afforded the special treatment given to pre-death liens and, in fact, does not create any special status in a decedent's estate. *Elder v. Smith*, 412 Md. 288, 987 A.2d 36 (2010). In that case, a former wife received the marital award before the death of her husband and she was also entitled to receive one-half of the proceeds of the sale of the marital home. The sale of the home never took place but the divorce, of course, converted the holding from by the entireties to in common. The former wife did not reduce her award to a judgment or record it as a judgment lien. (A marital award is held, in Maryland, not to be the equivalent to a judgment and it is not an interest in the other spouse's property. *Herget v. Herget*, 319 Md. 466, 471, 573 A.2d 798, 800 (1990) ("The court may…enter a monetary award against one party and against the other when that action is appropriate to adjust an inequity that would otherwise result from distribution, strictly in accordance with title, of property qualifying as 'marital property.' To the extent a monetary award is immediately due and owing, the court may enter a judgment reflecting it, thereby subjecting the property of the indebted party to lien and execution.").) Having remarried, the former husband died with only his one-half tenant in common interest in the marital home in his probate estate. Thereupon, the former wife reduced her martial award to a money judgment and recorded it in the county where the property was located.

One of the issues in the case was whether the former wife's debt was entitled to any special status because of her post-death "perfecting" of her pre-death claim. Essentially, the Court held that the status of a claim against a decedent is determined at the moment of death. At the date of death, all property passes to the personal representative so any action on the debt thereafter must necessarily be a claim against the estate:

> The Commission (the "Henderson Commission") has rejected the concept … that title to all property passes directly to the heirs or legatees, subject to the power or control over the property by the personal representative. The Commission felt that this dichotomy between title, on the one hand, and power, on the other, is unworkably vague and unnecessarily inconvenient. On the contrary, the Commission recommends the suggested wording of Section 1-301 in order to make it clear that the title to all property both real and personal, and as to both testate and intestate estates, shall pass directly to the personal representative.
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> *Second Report of Governor's Commission to Review and Revise the Testamentary Law of Maryland*, 13 (1968). The underlying principle, then, is that upon death, title to real property passes out of the hands of the decedent. This conclusion holds true even when, as here, the Personal Representative is substituted as the "judgment debtor."
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> We conclude that the judgment obtained and recorded as a lien against Beales Trail after Mr. Elder's death based upon a marital award against him two years prior to his death, is not afforded priority under the statutory scheme embodied in the Estates and Trusts Article, because title to real property passes out of a decedent's hands after death.

Elder v. Smith, 412 Md. 218, 305, 987 A.2d 36 (2010). In *Elder*, the Orphans' Court had also ordered to the former spouse to release her lien from the property to permit the property to be sold to a third party. The Court of Appeals held that the Orphans' Court did not have such jurisdiction and that only a Circuit Court could effectuate such relief because of the limited jurisdiction of the Orphans' Court.

Thus, the remedy of a creditor will fall exclusively to the probate claim process unless such creditor is a secured creditor prior to the decedent's death.

Section 8-111 provides that secured creditors may look to the probate estate for collection. This statute, however, does not require an election of remedies. Instead, it permits a secured creditor three options if it wants to seek payment through the regular probate process: (a) release the lien and become an unsecured creditor in the full amount of its debt (losing, however, any priority in a specific asset and being lumped in with all other general estate creditors), (b) foreclose on the security and receive the deficiency to the extent it has an allowed claim, or (c) receive the difference between the value of the security (as determined by agreement or by the Orphans Court) and the allowed claim. These options require the filing of a claim or protective claim but the filing of such a claim does not waive a creditor's rights to its security. If a secured creditor, however, wants to seek to redress a deficiency judgment against the estate, that creditor must file a claim, or protective claim, within the statutory period. This may become a more common practice given the sharp decline in property values, especially in beach or vacation home properties. In order to foreclose on its security, however, a secured creditor need not file a claim.