



# **Pioneer Bank & Trust**

## **Trust & Investments**

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## Living trusts and bankruptcy protection

In the usual case, you cannot employ a living trust as a mechanism to protect your own assets from your creditors. However, you may provide such protection for legacies for your heirs with a properly drafted trust. Trust assets may be out of reach if the heir declares bankruptcy, becomes divorced, or has some other financial calamity. A “spendthrift clause” may be used to achieve this objective. It puts full discretion over trust distributions in the hands of the trustee.

In the unusual case, living trusts may yet provide another layer of protection.

### **Unusual facts**

Faith Campbell created a living trust worth \$1.8 million for the benefit of her four children, one that included a spendthrift provision. The trust was to terminate after Faith’s death “upon the settlement of her estate.” Faith died in 2011.

One of Faith’s grandchildren was the trustee of her trust. One child, Linda, was in financial difficulty resulting from the last recession. After Faith died, before her estate was settled, Linda wrote to the trustee suggesting that he exercise his discretion allowed under the trust. He took the hint and placed her share in a Merrill Lynch account, for which he continued to be the trustee. Distributions to the other children from the living trust continued as before.

A month later, Linda declared bankruptcy. She included her trust interest in her bankruptcy petition, but noted that she was simply a discretionary beneficiary subject to the spendthrift clause. The bankruptcy trustee challenged that characterization and sued Linda for her share of the trust’s assets. He also characterized the creation of the Merrill Lynch account for her as a fraudulent transfer.

The Bankruptcy Court agreed. The Court also was concerned that the trustee of the spendthrift trust was Linda’s nephew. In its decision on the case, the Court worried that the trustee simply would follow Linda’s instructions, which gave her effective control of the money. The Court ruled against Linda on every issue.

### **Reversed on appeal**

Linda appealed the Bankruptcy Court’s decision to Federal District Court, which found in her favor. The key to the District Court’s reasoning is that by its terms the living trust had not yet terminated, because Faith’s estate had not been finally settled. Considerable work may be required to settle an estate. Until that work is finished, trust administration was required, which gave continued life to the trustee’s spendthrift powers. Linda had not yet acquired a property interest in the trust that could be included in her bankruptcy estate.

Linda received an extra layer of financial protection from her mother’s living trust by an accident of timing, the fact that her bankruptcy occurred before the trust reached its termination point. Her mother could have deliberately provided for such creditor protection for the inheritance for Linda or for all of her children by having the living trust continue for the children’s lives. Her single trust could have been divided into four continuing trusts, one for each beneficiary. If the successor trusts also included spendthrift provisions, creditor protection could have lasted a lifetime.

On the other hand, adult children may prefer unfettered access to their inheritance. They may feel uncomfortable making their case to the trustee each time that a substantial trust distribution is wanted. They may harbor the feeling that the parent did not trust them with the family fortune.

The balance needs to be struck by the trust grantor. If the long-term asset protection plan is selected, the benefits and burdens should be explained carefully to all beneficiaries, in order to avoid misunderstandings and litigation later.