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TRUSTS AND MARITAL PROPERTY

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I. INTRODUCTION

Marital rights raise complex questions in trust and estate planning. These questions may arise unintentionally as when a spouse desires to transfer assets to a company, trust or family member for the purpose of reducing his or her wealth transfer tax exposure. In other cases, a spouse may intentionally transfer assets in an effort to reduce or eliminate his or her spouse's interest in those assets. The timing, purpose and methods of transfer as well as the assets used to accomplish the transfer are crucial in evaluating the rights of the non-transferring spouse.

This manuscript primarily analyzes the effectiveness of trusts as asset protection devices against marital claims. Part II proceeds with a general discussion of asset protection in trust and estate planning, appellate court decisions on the enforceability of trust arrangements, tax considerations, and the ability to modify or alter the terms of an irrevocable trust. In Part III, the general legal considerations for effective asset protection planning using trusts are identified and discussed. Part IV addresses both the procedural and substantive aspects to challenging a trust arrangement in an equitable distribution proceeding.

This manuscript is not intended to be, and is not, a comprehensive discussion of all asset protection tools available or issues to be considered when evaluating or engaging in asset protection planning. Practitioners should, however, glean a general understanding of the primary options available for a client interested in asset protection planning using trusts as well as the arguments for and against honoring those arrangements in the marital context.

II. ASSET PROTECTION IN TRUST AND ESTATE PLANNING

Clients may be motivated to engage in asset protection planning for a variety of reasons. Their profession or business may pose a potentially high degree of personal liability or they may perceive a risk of susceptibility to an aggressive plaintiff's bar. Some clients may simply have the goal of avoiding a specific creditor like a spouse. Asset protection planning generally encompasses planning for all these purposes. However, a client's options are substantially affected by the circumstances existing at the time planning is desired. Forward-looking clients enjoy a wider range of available tools to achieve their objectives while clients engaging in crisis-planning are faced with substantial challenges and limitations. In all cases, practitioners should carefully consider their own ethical and legal obligations prior to advising clients in this area.

Trusts and business entities are two commonly employed asset protection tools often in conjunction with one another. Their appropriateness depends on a series of factors ranging from plan development and implementation costs to the degree of control desired over the assets as well as the present status of creditors. In the marital context, a spouse may have significant interests in the client's assets or the client may owe certain duties to the spouse when engaging in certain transactions. These interests and duties must be assessed prior to engaging in any

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protection planning strategies. Part III outlines many of these considerations. This Part provides a general overview of trust and business entities as asset protection tools.

A. TRUSTS AS ASSET PROTECTION DEVICES

Trusts can be valuable asset protection tools in appropriate circumstances. However, a trust's usefulness in this context is highly dependent on a series of factors including: the timing of the trust's creation; the identity and status of the settlor, trustee and beneficiaries; the terms of the trust, including its governing law; and the type of creditor. As discussed below, with one narrow exception, revocable trusts never protect assets from claims by the settlor's creditors. Accordingly, this section focuses primarily on the ability of irrevocable trusts to serve as asset protection tools.

1. Key Trust Provisions

A trust is commonly defined as "a fiduciary relationship with respect to property, subjecting the person for whom the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it." *See, e.g.*, Sinclair v. Travis, 231 N.C. 345, 353, 57 S.E.2d 394, 400 (1950); Restatement (Third) of Trusts § 2 (2003). The relationship results from the separation of equitable and legal title to identifiable property. Sinclair v. Travis, 57 S.E.2d at 400. The settlor of a trust relinquishes legal title to property conveyed to a trust. Legal title to trust property is generally vested in the trustee with equitable title vested in the beneficiaries. Accordingly, questions arise regarding a creditor's ability to reach assets transferred in trust when a creditor is pursuing a claim against a settlor or beneficiary of the trust. Certain key trust provisions are initially controlling in this regard.

a. Governing Law

The trust's governing law generally determines whether the trust was effectively created and the rights of creditors to reach the assets in the trust. Under North Carolina law, the meaning and effect of the terms of a trust are determined either by (i) the law of the jurisdiction designated in the terms of the trust unless the designation of that jurisdiction's law is contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue, or (ii) in the absence of a controlling designation in the terms of the trust, the law of the jurisdiction having the most significant relationship to the matter at issue. G.S. §36C-1-107(a). As a result, a trust created in North Carolina may be governed by the laws of another jurisdiction subject to certain important limitations. As discussed below, a court may not respect a settlor's choice of law when doing so would be contrary to a creditor's rights in the forum state. *See, e.g.*, In re Huber, 493 B.R. 798 (W.D.Wash. 2013)(declining to apply settlor's choice of Alaska law where assets and beneficiary were located in Washington State and Washington State had strong public policy against creditor protection for self-settled trusts). However, it is possible that a settlor may choose a jurisdiction's law that is more favorable to creditors than the forum state's law. Such a designation would appear to be enforceable in North Carolina.

b. Debtor's Relationship to Trust

A creditor's ability to reach trust assets depends largely on the debtor's relationship to the trust. A debtor may have one or more relationships to the trust, including possible status as settlor, trustee, beneficiary, trust protector or holder of a power of appointment. In North Carolina, a creditor of a debtor who merely serves as trustee of a trust cannot reach the assets of the trust. G.S. §36C-5-507. Other relationships, however, require more analysis particularly when the debtor maintains multiple relationships to the trust simultaneously.

Practitioners should be careful to distinguish creditor claims based on the status of the debtor from claims against the trust directly. Applicable law may prevent trust assets from being used to satisfy the creditor's claims based solely on the status of the debtor. The trust, however, may incur liability on some other basis as in the case of a fraudulent transfer. Part II.A. of this manuscript generally discusses a creditor's ability to reach trust assets based on the status of the debtor. Part III discusses alternate theories in which a creditor may reach trust assets.

2. Self-settled Trusts and Trusts Created for Third-parties

A debtor's relationship with a trust will generally cause the trust to be categorized as either a self-settled trust or a trust created for third parties. There is generally no protection in the former and greater protection in the later. However, the line between the categories is not always clear. Clever practitioners have developed a myriad of devices to provide settlors and beneficiaries substantial control over trust operations and distributions without causing the settlor or beneficiaries to expressly assume a non-protected status with respect to the trust. As a result, a trust that appears on its face to be created by a settlor for the benefit of a third party may be functionally akin to a self-settled trust. Likewise, a trust established by a third party for the benefit of a debtor may also be functionally akin to a self-settled trust depending on how the trust is funded. While voluminous tax cases have discussed the effect of a settlor or beneficiary's powers over trust property for tax purposes, courts in other contexts have struggled to address the effect of a debtor's powers on a creditor's ability to reach trust assets.

a. Self-settled Trusts

(1) General Rule: No Protection for Settlor

A self-settled trust is a trust in which the settlor is both the creator and beneficiary (or partial beneficiary) of the trust. Accordingly, self-settled trusts may include both revocable and irrevocable trusts.

Revocable trusts are self-settled trusts and the assets of such trusts are subject to the claims of the settlor's creditors. G.S. §36C-5-505(a)(1). This rule is true both during the lifetime of the settlor and upon the settlor's death. G.S. §36C-5-505(a)(3); Livesay v. Carolina First Bank, 192 N.C. App. 234, 665 S.E.2d 158 (2008); Rush University Medical Center v. Sessions, 980 N.E.2d 45, 55 (Il. 2012)(stating the general common law rule). A trust is considered revocable if the settlor can revoke the trust without the consent of a trustee or person holding an adverse interest in the trust. G.S. §36C-1-103(16). As a result, a trust is not considered revocable if a person other than the settlor has the right to revoke the trust.

> Illustration #1: Peter creates a trust naming his wife and children as beneficiaries and his friend, Thomas, as Trustee. The trust provides that Peter reserves the right at any time to amend and revoke the trust in whole or in part by an instrument delivered to the Trustee. Peter alone funds the trust with $50,000. The trust is a revocable trust and the trust's assets are subject to the claims of Peter's creditors.

> Illustration #2: Same facts as Illustration #1 except that instead of providing that Peter reserves the right at any time to amend and revoke the trust, Peter's wife is given the right to amend and revoke the trust. The trust is not a revocable trust. The settlor, Peter, does not have the right to amend or revoke the trust. For a discussion as to whether the trust assets are subject to the wife's creditors, see below.

A trust is presumed revocable unless the settlor specifically provides that the trust is irrevocable.[2] G.S. §36C-6-602(a). Accordingly, a trust governed by North Carolina law must generally provide by its terms that the trust may not be revoked by the settlor in order to be irrevocable. By implication, an irrevocable trust is any trust that is not a revocable trust.

Irrevocable trusts are not, by definition, asset protection devices. In the context of self-settled trusts, the general rule is that a creditor or assignee of a settlor may reach the maximum amount that can be distributed to or for the settlor's benefit from an irrevocable trust. G.S. §36C-5-505(a)(2).[3] Accordingly, the identity of the "settlor" is paramount is not always clear. A "settlor" includes any person who "creates" a trust or "contributes" property to a trust. G.S. §36C-1-103(17). The act of "contributing" property to a trust suggests a transfer for no consideration, but the term "contribution" is not defined. If more than one person creates or contributes property to a trust, each person is a settlor of the portion of the trust property attributable to that person's contribution except to the extent another person has the power to revoke or withdraw that portion. Id.

> Illustration #3: Peter creates a trust for the benefit of his wife, Paula, but does not contribute any property to the trust. Paula contributes $50,000 to the trust. Peter and Paula are settlors of the trust. The trust property is subject to the claims of Paula's creditors.

> Illustration #4: Same facts as Illustration #3 except that Peter retains the right to withdraw the trust property at any time. Peter and Paula are settlors of the trust. The trust property is subject to the claims of Peter's creditors.

[2] Other jurisdictions may employ a contrary presumption. A practitioner must be careful to evaluate the law governing the trust and determine its terms in accordance with that law.

[3] In North Carolina, this rule is subject to one notable exception. It is not uncommon for an irrevocable trust to be a "grantor trust" within the meaning of IRC §671 resulting in the trust being disregarded for tax purposes and the assets of the trust, including any income, gain or loss, being attributed to the grantor. In such a case, a trustee's discretionary authority to pay amounts to tax authorities or to the grantor for reimbursement of taxes on trust income or principal is not considered an amount that can be distributed to the grantor or for the grantor's benefit. G.S. §36C-5-505(a)(2a).

Illustration #5: Peter is the sole beneficiary of a testamentary trust established by his late father. Under the terms of the trust, Peter has the right to distribute property to himself for his health, education, support and maintenance in his discretion. Rather than create his own separate trust, Peter contributes $50,000 to the testamentary trust after his father's death. Peter is considered the settlor of the testamentary trust to the extent of his $50,000 contribution. The $50,000 contributed to the trust (together with any additions attributable to that contribution) is subject to the claims of Peter's creditors.

Illustration #6: Peter's is the sole beneficiary of a testamentary trust established by his later father. Under the terms of the trust, Peter has a right to distribute property to himself for his health, education, support and maintenance his discretion. Peter personally sells valuable farmland to the testamentary trust in exchange for a promissory note. Peter's status as a "settlor" of the trust with respect to the contributed property is not clear, however, Peter has a strong argument that he neither created the trust nor "contributed" property to the trust as the transfer was presumably for adequate consideration.

Importantly, a creditor's ability to reach a settlor's interest in the trust applies without regard as to whether the irrevocable trust contains provisions that would otherwise provide for creditor protection, including spendthrift provisions, discretionary trust interests, and protection trust provisions discussed below. G.S. §36C-5-505(a).

Illustration #7: Peter creates an irrevocable trust, funds the trust with $50,000, and names himself as beneficiary and his friend, Thomas, as Trustee. The trust provides that the decision to make a distribution to Peter is within the sole discretion of Thomas. The trust also contains a spendthrift provision and states that Peter's interest in the trust will terminate immediately if any creditor attempts to reach Peter's interest in the trust. The trust property is subject to the claims of Peter's creditors.

(2) Exception: Statutory Protective Trusts

The traditional rule that assets held in self-settled trusts are subject to the claims of the settlor's creditors is not without exception. At least fifteen states have enacted legislation providing various levels of creditor protection for self-settled trusts. North Carolina considered legislation providing protection for self-settled trusts in the last legislative session. For the reasons discussed below, these so-called "domestic asset protection trusts" ("DAPTs") are vulnerable in many circumstances. Offshore protective trusts may provide a remedy for some of these deficiencies but are accompanied by certain disadvantages, including cost and complexity that make them unappealing to many clients. A discussion of offshore protective trusts is beyond the scope of this manuscript, but such trusts may be a viable option in appropriate cases. Similarly, DAPTs may prove useful in certain circumstances. The following discusses the general features and limitations of DAPTs.

(a) Jurisdictions

Nevada, South Dakota, Ohio, Tennessee, Alaska, Wyoming, Delaware, Missouri, New Hampshire, Hawaii, Rhode Island, Utah, Mississippi, Virginia and Oklahoma have enacted statutes providing protection to varying degrees for self-settled trusts. Alaska Stat. §34.40.110; Nev. Rev. Stat. §166.010; Del. Code. Ann. tit. 12, §3570 (2009); S.D. Code Laws §55-16-1; Utah Code Ann. §25-6-14; R.I. Gen. Laws §18-9.2-1; Okla. Stat. tit. 31, §10; Mo. Stat. Ann. §456.1-101; Ohio Rev. Code §5816.01; Tenn. Code. Ann. §35-16-101; Wyo. Stat. Ann. §4-10-501; Miss. Code §91-9-701; H.R.S. 554G; N.H. Rev. Stat. Ann. §564-D:1-18; VA Code §55-545.03:2.

(b) Required and Permissive Provisions

A settlor must comply with the applicable statutory requirements in order to gain protection under a DAPT. There is some commonality among jurisdictions with regard to certain basic structural requirements and greater variance with respect to the rights of the settlor in the trust. DAPTs must generally be irrevocable and must apply the law of the applicable jurisdiction. Most jurisdictions further require that the trust contain a spendthrift provision. DAPTs were largely adopted under the belief that they could attract assets or revenue to the adopting jurisdiction. Accordingly, most DAPTs require appointment of an in-state trustee or the presence of a portion of the trust assets in the state. The following chart sets forth the common requirements for a trust instrument to qualify as a DAPT:

REQUIRED PROVISIONS BY JURISDICTION

Trust Provision	**Jurisdiction**
Trust must be irrevocable	AK, DE, HI, MO, NV, NH, RI, SD, TN, UT, VA, WY, OH, MS OK (may be revocable or irrevocable subject to certain limitations)
Trust must expressly state jurisdiction’s laws govern	HI, OK, RI, TN, VA, WY, OH, MS, AK, DE, NH, SD
Trust must contain a spendthrift provision	AK, DE, MO, NH, RI, SD, TN, UT, VI, WY, OH, MS
All or part of trust corpus must be located in jurisdiction	DE, NV, NH, OK, RI, TN, UT, VA, WY, OH
One or more trustees must be located within jurisdiction	AK, DE, HI, NV, NH, OK, RI, SD, TN, UT, VA, WY, OH, MS MO (required if no part of administration occurs in jurisdiction)
Trustee must be trust company located within jurisdiction	OK, UT (although individual co-trustees may serve together with institutional trustee)
Beneficiaries must be only qualified beneficiaries (spouse, ancestor, descendants, etc.)	OK (settlor cannot be beneficiary, although possesses right to revoke)
Trust must contain mandatory state income tax language	OK

Trust assets may not exceed set limit	OK ($1,000,000 limit)
Trust must have at least one beneficiary other than the settlor	MI, VA (during any period distributions may be made to settlor)
Settlor must have personal liability insurance	WY, MS ($1,000,000 personal liability insurance required) (In MS, up to $1,500,000 can be reached in trust if no insurance)
Affidavit of solvency required from settlor	AK, TN, WY, OH, MS
Jurisdictional trustee must perform certain administrative functions	AK, DE, HI, NV, NH, OK, RI, SD, TN, UT, VA, WY, OH

In addition to the required provisions reviewed above, many statutes expressly state the interests that the settlor may retain in the trust. Commonly, these interests include the right to discretionary distributions, the right to income or a percentage of trust assets annually, and the right to remove and replace the trustee or trust advisors. The following is a general summary of a settlor's right to retain interests in a DAPT:

PERMISSIVE PROVISIONS BY JURISDICTION

Trust Provision	**Jurisdiction**
Right to income	DE, HI, NV, NH, RI, SD, TN, WY, OH
Right to at least 5% of trust assets annually	AK, DE, HI, NV, NH, RI, SD, TN, VA, WY, OH, MS
Interest in GRAT, GRUT, QPRT and IRA	AK, DE, NV, NH, RI, SD (QPRT), TN (CRT and QPRT), UT (CRT), VA (CRT, QPRT, GRAT), WY, OH (CRT), MS (CRT)
Right to reimbursement of taxes	AK, DE, HI, NV, NH, RI, TN, VA
Trust assets may be used to pay estate debts upon settlor's death	DE, NV, NH, TN, VA, MS
Right to discretionary distributions	AK, DE, HI, MO, NV, NH, RI, SD, TN, UT, VA, WY, OH, MS
Right to veto distributions	AK, DE, HI, NV, NH, RI, SD, TN, UT, WY, OH, MS
General testamentary power of appointment	HI (testamentary power for debts, administrative expenses, taxes), NV
Non-general testamentary power of appointment	AK, DE, HI, NV, NH, RI, TN, UT, VA, WY (general or limited power of appointment), OH
Retain right to remove and replace trustee	AK, DE, HI, NV, NH, SD, TN, UT, VA, WY, OH, MS
Right to remove and replace trust advisor	AK, DE, HI, NV, NH, SD, TN, UT, VA, WY, OH, MS
Out of state trust may move to jurisdiction and receive coverage as DAPT	AK, DE, HI, NV, NH, SD, TN, UT, VA, WY

While the above summaries are obviously a simplification of the complex jurisdictional options, they serve to demonstrate that potentially significant distinctions exist based on the retained powers of the settlor, the identity of the trustee, and the location of the trust property.

(c) Creditor Protection

Not all creditor claims are barred simply because the DAPT was properly implemented. Each jurisdiction excludes various claims from protection. Common exclusions include claims for alimony or property division if the spouse was married to the transferor on or before the date of the transfer. Claims for child support are generally also excluded. A minority of jurisdictions exclude claims for injury to person or property arising before the transfer.

In addition, each jurisdiction employs statutes of limitations permitting a creditor a period of time to void a transfer to the trust. The limitation periods range from eighteen months to five years after the transfer is made to the trust. Accordingly, practitioners should use caution when selecting a jurisdiction to ensure that the primary claims of concern are barred. The following chart outlines the common exceptions from DAPTs:

CLAIMS EXCLUDED FROM PROTECTION

Type of Claim	**Jurisdiction**
Eighteen months existing creditor statute of limitation	OH – if longer, six months after transfer was or could reasonably have been discovered
Two year existing creditor statute of limitation	HI, NV, MS, SD NV, MS, SD – if longer, six months after transfer was or could reasonably have been discovered
Four year existing creditor statute of limitations	AK, DE, MO, NH, OK, RI, TN, UT, WY NH, OK, RI, TN, UT, WY - if longer, one year after transfer was or could reasonably have been discovered
Five year existing creditor statute of limitations	VA or, if longer, five years after transfer should have been discovered
Eighteen month future creditor statute of limitation after transfer	OK
Two year future creditor statute of limitation after transfer	NV, MS, SD
Four year future creditor statute of limitations after transfer	AK, DE, MO, NH, OK, RI, TN, UT, WY AK, DE, MO, OK, UT, WY – if longer, one year after transfer was or could reasonably have been discovered
Child support	AK, DE, HI, MO, NH, OK, RI, TN, VA, WY, OH, MS
Alimony	DE, HI, MO, VA, WY, NH, RH, TN, OH, MS

Property division upon divorce	HI, VA, WY AK - if assets transferred to trust 30 days prior to marriage) DE, NH, RI, TN, OH, MS - if spouse was married to settlor before or on date of transfer
Tort claims for death or bodily injury	DE, HI, NH, RI, MS - if arises from death, personal injury or property damage occurring before the transfer) UT – under certain conditions
Elective share and other marital rights upon death	MO, OK, RH, SD, UT, VA, WY

(d) Public Policy Limitations

The advent of the domestic asset protection trust is counter to the traditional rule against self-settled trusts. In a nation of many jurisdictions, questions remain as to whether and to what extent the courts of federal or state jurisdictions that retain the traditional rule will protect beneficiaries of domestic asset protection trusts established and governed by the law of another jurisdiction. Courts could use their conflict of law rules to avoid the application of another jurisdiction's debtor-friendly laws.

Section 270 of the Second Restatement of Conflict of Laws provides in relevant part as follows:

> An inter vivos trust of interests in movables is valid if valid . . . under the local law of the state designated by the settlor to govern the validity of the trust, provided that this state has a substantial relation to the trust and that the application of its law does not violate a strong public policy of the state with which, as to the matter at issue, the trust has its most significant relationship under the principles stated in § 6 . . . .

Thus, § 270 permits a court to consider the public policy of the jurisdiction with which a trust has its most significant relationship (which might or might not be the law designated by the trust instrument) in assessing the validity of a trust. However, the more important inquiry concerns the extent, if any, to which creditors can reach the assets of such a trust. Section 273 of the Second Restatement of Conflict of Laws is the starting point for this analysis. It provides in pertinent part as follows:

> Whether the interest of a beneficiary of a trust of movables is assignable by him and can be reached by his creditors is determined . . . in the case of an inter vivos trust, by the local law of the state . . . in which the settlor has manifested an intention that the trust is to be administered . . . .

Unlike § 270, § 273 and its comments do not contemplate that a different rule might apply if the law of the trust's situs violates a strong public policy of another state.

Even so, if some place other than the asset protection trust state is the forum, then the trust state's relation to the trust is arguably diminished, and a local judge may conclude that his or her state has a greater relation to the trust, and may choose to apply that state's policy. FTC v. Affordable Media, LLC, 179 F3d 1228, 1231 (9th Cir. 1999) (affirming district court's rejection of argument that Cook Islands trust law divested ownership interest, noting that "a district court judge and his common sense" are not "easily parted"); ***See*** In re Smith, 415 B.R. 222, 234-35 (Bankr. N.D. Tex. 2009); Dexia Credit Local v. Rogan, 624 F. Supp. 2d 970, 975-76 (Bankr. N.D. Ill. 2009); In re Lawrence, 227 B.R. 907, 917 (Bankr. S.D. Fla. 1998); In re Brooks, 217 B.R. 98, 101-02 (Bankr. D. Conn. 1998); In re Portnoy, 201 B.R. 685, 698 (Bankr. S.D.N.Y. 1996) (refusing to permit Jersey Island law to defeat creditor's claim to assets held in a Jersey Island trust).

Courts appear more willing to use the "public policy" exception imbedded in the conflict of law jurisprudence to prevent debtors from benefitting from out of state asset protection trusts when the debtor has engaged in attempts to evade existing or known potential creditors and not mere innocent estate planning. In the recent case of *Waldron v. Huber (In re Huber)*, 493 B.R. 798 (U.S. 2013), a federal district court struck down a domestic asset protection trust created in a state other than the grantor's residence. The debtor was a citizen of Washington and placed nearly all of his assets into an Alaska domestic asset protection trust prior to the failure of his real estate business. The debtor then filed for chapter 11 bankruptcy protection.

The bankruptcy judge granted summary judgment to the bankruptcy trustee, finding that the trust did not protect its assets from the claims of Donald's creditors and should be set aside on three separate bases, including applying Washington state law to the trust and not Alaska state law. The court held that the trust was not protected from the claims of the settlor's creditors by the provisions of Alaska law that expressly recognize the validity of self-settled asset protection trusts, but instead were invalid under the provisions of Washington law that reject self-settled spendthrift trusts. ***Compare*** Alas. Stat. § 34.40.110 ***with*** Rev. Code Wash. § 19.36.020. The court stated that the conflict between the laws of the two states must be settled under federal choice of law rules, rather than state choice of law rules, citing ***Lindsay v.*** *Beneficial Reinsurance Co. (In re Lindsay*), 59 F.3d 942, 948 (9th Cir. 1995). The court followed the choice of law rules set forth in the Restatement (Second) of Conflict of Laws, which states that a provision in the instrument governing an inter vivos trust of personal property that declares that the validity of the trust will be controlled by the law of a specific state will be followed only if (a) the state declared in the instrument as controlling has a substantial relation to the trust, and (b) the application of its local law does not violate a strong public policy of the state with which as to the matter at issue the trust has its most significant relationship. Restatement (Second) of Conflict of Laws § 270 (1971); Liberty Tool & Mfg. v. Vortex Fishing Sys., Inc. *(In re Vortex Fishing Sys., Inc.)*, 277 F.3d 1057, 1069 (9th Cir. 2002).

Under the court's analysis, Alaska law would apply only if Alaska had a substantial relation to the trust. When this trust was created, neither the debtor nor the beneficiaries were domiciled in Alaska and the trust assets were not located in Alaska. The trust's only connection with Alaska was the location of the trustee and the administration of the trust in Alaska. On the other hand, when the trust was created, the debtor and the trust beneficiaries all resided in Washington, the trust assets were transferred from Washington, debtor's creditors were located in Washington, and the drafting attorney was located in Washington. When the trust was created, therefore, Alaska had only a minimal relation to the trust, but Washington had a substantial relation to the trust. Washington had a strong public policy against self-settled asset protection trusts; its statutes declare them void against both existing and future creditors. Rev. Code Wash. § 19.36.020; Carroll v. Carroll, 18 Wash. 2d 171, 175, 138 P.2d 653 (1943); Rigby v. Mastro *(In re Mastro)*, 465 BR 576, 611 (Bankr. W.D. Wash. 2011). Therefore, as the trust was a self-settled trust, Donald's transfers of assets into the trust were void, and the trustee was entitled to summary judgment voiding the transfers.

The court held that the transfers to the trust were fraudulent under the Bankruptcy Code. Section 548(e)(1) of the Bankruptcy Code states that the trustee in bankruptcy may avoid any transfer to a self-settled trust or similar device made by the debtor on or within 10 years before the bankruptcy petition if the debtor is a beneficiary of such trust or device and the debtor made the transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became indebted, on or after the date that such transfer was made. 11 U.S.C. § 548(e). The court found that the parties conceded all of the elements required by Section 548(e)(1), except for the "actual intent to hinder, delay, or defraud...."

The Bankruptcy Code also gives the bankruptcy trustee authority to bring suit to avoid fraudulent transfers under state law, and the court applied the Washington Uniform Fraudulent Transfer Act (UFTA) and not the more debtor friendly Alaska fraudulent transfer law. The court had already determined that the debtor was threatened with litigation when the transfers occurred; the transfers included substantially all the debtor's assets; and the debtor retained control of the transferred property. The court held that the evidence also established that: (a) as a self-settled trust, the transfer from the debtor to the trust was to an insider; (b) the debtor conceded that he did not receive consideration for transferring his assets to the trust; (c) by transferring the property into the trust, the debtor was attempting to remove the assets from the creditors' reach; and (d) the debtor was desperate to protect and shield his assets. The court held that the trustee was entitled to summary judgment as a matter of law on its UFTA claim based on actual fraudulent intent.

Other reported cases have addressed domestic self-settled asset protection trusts in the context of debtors that attempt to use their trusts to avoid known or reasonably known creditors, and the courts do not favor the debtors in these situations. United States v. Evseroff, 2007-1 U.S. Tax Cas. (CCH) ¶ 50,222 (E.D. N.Y. 2006), *rev'd and rem'd*, 2008-1 U.S. Tax Cas. (CCH) ¶ 50,240 (2d Cir. 2008), on remand, 2012-1 U.S. Tax Cas. (CCH) ¶ 50,328 (E.D. N.Y. 2012), *aff'd*, 528 Fed. Appx. 75 (2d Cir. 2013) (applying New York fraudulent conveyance law to permit federal government to collect a tax debt from trust after proving actual fraud by debtor); Kilker v. Stillman, 2012 WL 5902348 (Cal. Ct. App.) (express effort to shield assets from liability to "reasonably foreseeable" future judgment creditors constituted a fraudulent conveyance; alter ego concept also applied to defeat the trust); Rush University Medical Center v. Sessions, 980 N.E.2d 45 (Ill. 2012) (designation of Cook Islands governing law ignored when trust real estate assets located in Illinois were sufficient to satisfy a charitable pledge the settlor had failed to honor before dying); Watterson v. Burnard, 986 N.E.2d 604 (Ohio Ct. App. 2013), *appeal not accepted*, 135 Ohio St. 3d 1449 (2013) (the fact that the settlor died before a judgment was rendered did not alter the plaintiff's right to secure payment from the settlor's inter vivos trust).

In the case of off-shore asset protection trusts, the courts universally apply United States Law, and are willing to hold beneficiaries of self-settled asset protection trusts in civil contempt and jail the beneficiaries until the assets are made available to the court's jurisdiction. FTC v. Affordable Media, LLC, 179 F.3d 1228 (9th Cir. 1999), and In re Lawrence, 279 F.3d 1294 (11th Cir. 2002); *See also* Securities and Exchange Commission v. Solow, 682 F. Supp. 2d 1312 (S.D. Fla. 2010), In re Coker, 251 B.R. 902 (Bankr. M.D. Fla. 2000), and Securities and Exchange Comm'n v. Bilzerian, 112 F. Supp. 2d 12 (D. D.C. 2000) (all finding trust settlors in contempt for failure to comply with court orders to repatriate assets in offshore asset protection trusts). To date, courts have only applied this extreme sanction in cases involving offshore asset protection trusts.

Self-settled asset protection trusts are a relatively new phenomena in American law, and to date, there are no reported cases of a non-asset protection jurisdiction applying the law of an asset protection jurisdiction to enforce an asset protection trust.

(3) NC Proposed Protective Trust Statute

North Carolina has not adopted a self-settled trust statute to date, but has considered self-settled trust legislation. Senate Bill 466 (the "SB 466"), introduced during the 2015-2016 legislative session, would have provided protection for certain transfers to "qualified self-settled trusts" from creditors other than claims for child support, alimony, post-separation support, or other spousal support or maintenance, a division or distribution of property or debts incident to marriage, certain damages for death, bodily injury or property damage, or claims by a surviving spouse for an elective share. Given the express non-application of the statute to marital rights, SB 466 would appear to have no express effect on the ability of a spouse to reach assets transferred to a qualified self-settled trust for purposes of alimony, spousal support, child support or equitable distribution. However, as the scope and effect of the SB 466 was hotly debated between certain segments of the legal bar, the proposed legislation or a similar version may well be proposed in the future. Accordingly, the general scope of the bill is discussed below with particularly emphasis on its effect, or lack thereof, on the marital rights of a spouse upon the dissolution of a marriage.

SB 466 would have added a new Article 5A to the North Carolina Uniform Trust Code. The legislation generally tracts similar asset protection statutes from other jurisdictions. Proposed §36C-5A-1 provides that "a settlor may transfer assets to a qualified self-settled trust ... and retain in that trust a qualified interest...." In such cases, a creditor or assignee of the creditor would have "only those rights with respect to a transfer to a qualified self-settled trust" as provided in Article 5A. A creditor is expressly prohibited from reaching the settlor's qualified interest or a distribution from a qualified trust before the distribution is received by the settlor and the creditor may not compel a distribution from the trust even if the Trustee has abused the Trustee's discretion.

A "qualified self-settled trust" is a trust for which all the following apply: (1) the trust is irrevocable; (2) the trust is created during the settlor's lifetime; (3) the settlor has a "qualified interest;" (4) there is at all times during the existence of the settlor's qualified interest at least one beneficiary other than the settlor to whom income or principal may be distributed; (5) the trust has at all times at least one qualified trustee; and (6) the trust instrument expressly incorporates the law of North Carolina to govern the meaning and effect of the trust. Proposed G.S. §36C-5A1.

As one of the requirements is that a trust be "irrevocable," the proposed statute makes clear that a "trust instrument shall not be deemed revocable" on account of the inclusion of any one or more of 14 enumerated rights, powers or interests of the settlor:

- The settlor's power to consent to a distribution from the trust.

- The settlor's power to consent to a trustee's investment decisions.

- A power of appointment exercisable by the settlor by will or other written instrument effective only upon the settlor's death, other than a power to appoint to the settlor's estate or the creditors of the settlor's estate.

- The settlor's qualified interest in the trust. A "qualified trust interest" is the settlor's right to receive discretionary distributions of trust income, principal or both in the discretion of a qualified trustee. Proposed G.S. §36C-5A-3.

- The settlor's right to receive income or principal pursuant to an ascertainable standard.

- The settlor's potential or actual receipt of income or principal from a charitable remainder unitrust or charitable remainder annuity trust (each within the meaning of section 664(d) of the Internal Revenue Code) and the settlor's power at any time, and from time to time, to release, in writing delivered to the qualified trustee, all or any part of the settlor's retained interest in that trust.

- The settlor's receipt each year of a percentage, not to exceed five percent (5%), specified in the trust instrument of the initial value of the trust assets or their value determined from time to time pursuant to the trust instrument.

- The settlor's power to remove a trustee.

- The settlor's power to appoint a trustee.

- The settlor's power to appoint a power holder.

- The settlor's potential or actual use of real property held under a personal residence trust, within the meaning of section 2702(c) of the Internal Revenue Code.

- The settlor's potential or actual receipt of use of a qualified annuity interest, within the meaning of section 2702 of the Internal Revenue Code.

- The ability of a qualified trustee, whether pursuant to discretion or direction, to pay, after the settlor's death, all or any part of the settlor's debts outstanding at the time of the settlor's death, the expenses of administering the settlor's estate, or any estate inheritance tax imposed on or with respect to a settlor's estate.

- A settlor's potential or actual receipt of income or principal to pay, in whole or in part, income taxes due on trust income, or the direct payment of those taxes to the applicable tax authorities, pursuant to a provision in the trust instrument that expressly provides for the direct payment of those taxes or the reimbursement of the settlor for those tax payments.

Prop. G.S. §36C-5A-2(b).

A transfer to a qualified self-settled trust retaining a qualified interest receives the protection of the statute even if the settlor retains any and all of the above powers and the settlor or the settlor's spouse retains certain rights as a power holder. Prop. G.S.§36C-5A-10(a). Importantly, however, a settlor may have only such rights and powers as are conferred by the trust and permitted under proposed Article 5A. A settlor can have no rights or authority with respect to trust property or income of the trust other than the rights set forth above and the right as a power holder to consent to a trustee's investment decisions, the right to consent to distributions from the trust, and the right to appoint a successor trustee.

A creditor seeking to reach a qualified interest could do so only for avoidance of a transfer to the trust pursuant to the North Carolina Uniform Fraudulent Transfer Act, Article 3A of Chapter 29 of the General Statutes with certain exceptions. Prop. G.S. §36C-5A-7(a). A creditor whose claim arose after a transfer to a qualified self-settled trust may not bring a claim unless the transfer was made with the actual intent to hinder, delay, or defraud the creditor. However, the one-year limitation period found in G.S. §39-23.9(1) does not apply to a creditor whose claim arose after the transfer to a qualified self-settled trust was made. A transfer is not deemed to have been made with intent to delay, hinder or defraud creditors merely because that transfer was made without receiving reasonable equivalent value in exchange. Prop. G.S. § 36C-5A-7(b).

If a creditor were successful in avoiding a transfer, the interest is only avoided to the extent necessary to satisfy the settlor's debt to the creditor together with any costs and attorneys' fees that the court may allow. Prop. G.S. §36C-5A-8(a). Unless the trustee or applicable beneficiary has acted in bad faith, the trustee has the right to collect the costs of defending the creditor's claim, including attorney's fees, and to honor any preexisting rights, claims, and interest of the trustee and the beneficiary has the right to retain distributions made upon the exercise of a trust power vested in the trustee or a power holder. Prop. §36C-5A-8(b). A creditor would generally not have any claims against the trustee, a power holder, or the attorneys that helped advise, create or fund the self-settled trust. Prop. §36C-5A-11.

As stated above, the proposed legislation expressly exempts claims for child support, alimony, post-separation support, or other spouse support or maintenance, claims for division or distribution of property or debt incident to divorce, marriage or separation, and claims by a surviving spouse for an elective share. This significant carve-out means that a qualified self-settled trust under the proposed legislation could not be used to shield claims arising from a spouse's marital rights. It would also lead some to argue it implies that the public policy of North Carolina prohibits self-settled trust protections for marital claims. Others argue that, if enacted, the legislation would permit North Carolina residents to establish DAPTs in other states that allow less or no family law claims and argue that North Carolina courts should enforce them because North Carolina no longer has a broad public policy against self-settled trusts.

e. Trusts Created for Third-parties

Trusts in which the settlor does not retain a beneficial interest are by definition trusts created for third-parties. Trust assets generally have protection from creditors when non-settlors exclusively enjoy the beneficial interests. However, a settlor may wish to retain certain powers over the trust property or may even want to serve as trustee. In addition, a beneficiary may be given withdrawal rights over trust property or may serve as Trustee. Questions arise over the degree of separation between the debtor and the trust needed to maintain creditor protection. In certain circumstances, courts have struggled to determine where to draw the line. This section examines a creditor's ability to reach assets in a trust created for the benefit of someone other than the settlor.

(1) Debtor is Beneficiary

Trusts are generally effective tools for shielding trust assets from the claims of a beneficiary's creditors provided the trust contains certain protective terms. Historically, North Carolina courts have generally found trust assets to be beyond the reach of creditors when the beneficiary's right to distributions is either entirely discretionary or subject to a prohibition against alienation, commonly known as a "spendthrift clause." *See* Chinnis v. Cobb, 210 N.C. 104, 185 S.E. 638 (1936); Lineback by Hutchens v. Stout, 79 N.C. App. 292, 339 S.E.2d 103 (1986). Today, a creditor is generally statutorily prohibited from reaching a beneficiary's interest in such a trust.

The North Carolina Uniform Trust Code broadly provides that the court may authorize a creditor to reach a beneficiary's interest for present or future distributions. G.S. §36C-5-501(a). However, this general rule does not apply if the trust (i) contains a spendthrift provision, (ii) the beneficiary's interest is discretionary, or (iii) the beneficiary's interest terminates or changes to a discretionary interest if a creditor attempts to attach to the interest. G.S. §36C-5-501(b). These restrictive provisions operate independently and serve distinct purposes. Accordingly, trusts may contain one or more of these restrictions depending on the purpose of the trust.

A "spendthrift provision" is a provision term of a trust that restrains both voluntary and involuntary transfers of a beneficiary's interest. G.S. §36C-1-103(18). As a result, a beneficiary may not assign his or her interest in the trust to any other person or entity. Any attempt to do so is void. G.S. §36C-5-502(c). North Carolina law facilitates the incorporation of such provisions into a trust. It is sufficient to state that the interest of a beneficiary is subject to a "spendthrift trust" or other words of similar import to gain the protection of the statute. G.S. §36C-5-502(b). Significantly, a spendthrift provision does not mean that a beneficiary is prohibited from receiving mandatory distributions under the terms of a trust. A trust may require a beneficiary to receive distributions annually or upon the occurrence of some other milestone. A spendthrift provision prohibits a beneficiary from alienating that interest. It does not, however, relieve the trustee from making a required distribution. A creditor may reach the funds after distribution to the beneficiary. If a trustee fails to make a mandatory distribution within a reasonable time after the designated distribution date, a creditor may reach the trust assets to the extent of the distribution regardless of the spendthrift provision. G.S. §36C-5-506(b). Accordingly, a spendthrift provision has limited usefulness for a beneficiary with a continuing right to distributions.

To fill the gap left by a spendthrift provision, a trust may also provide a beneficiary's interest is a "protective trust interest." G.S. §36C-5-501(b). A protective trust interest is an interest that either terminates or becomes discretionary if the beneficiary attempts to alienate the interest, becomes insolvent or files bankruptcy, or a creditor attempts to reach the interest. G.S. §36C-5-508. Protective trust interests provide flexibility for settlors desiring to give beneficiaries' a right to distributions with a degree of asset protection.

In many cases, a settlor may not want a beneficiary to be entitled to mandatory distributions. The beneficiary may have present creditors or have a general propensity for frivolous spending. Alternatively, the settlor may simply want to preserve assets for future generations or protect assets from wealth transfer taxes. A settlor may therefore elect to provide a beneficiary with a discretionary trust interest. A "discretionary trust interest" is simply an interest in a trust that is subject to the trustee's discretion. G.S. §36C-5-504(a)(2).[4] In a discretionary trust, the trustee determines when and to what extent to make distributions to a beneficiary. In some cases, the trustee's discretion is absolute, subject only to the general prohibition against acting in bad faith, dishonestly, with an improper motive, or failing to act prudently in accordance with the purposes of the trust and the interests of the beneficiaries. G.S. §36C-8814(a). In other cases, the trustee is required to make distributions in accordance with a standard of distribution, commonly for the beneficiary's health, education, maintenance and support. In either case, the trust is generally considered a fully discretionary trust for asset protection under North Carolina law and receives protection from the beneficiaries' creditors by statute. G.S. §36C-5-504(a).[5] Not every jurisdiction observes the same protection for trusts subject to a standard of distribution. *See, e.g.,* N.Y. EPTL §7-3.4. Practitioners should, therefore, carefully

[4] A discretionary trust interest includes, by statutory application, a prohibition against the transfer of the interest by a beneficiary, whether voluntarily or involuntarily. G.S. §36C-5-504(b).

[5] The authors note that G.S. §36C-5-504(a)(2)b. provides that a discretionary trust includes a trust in which the trustee, in the trustee's discretion, determines distributions are appropriate for "support, education, or maintenance of the beneficiary." The statute does not include "health" within the applicable standard of distribution. Therefore, some question exists as to the purpose and effect of this omission. G.S. §36C-5-504(f) provides that a creditor may not reach the interest of a beneficiary who also serves as a trustee if the trustee's discretion to make distributions for the trustee's own benefit is limited by an ascertainable standard. G.S. §36C-1-103(2) defines an "ascertainable standard" to mean a standard relating to an individual's health, education, support, or maintenance with the meaning of the Internal Revenue Code. It makes little sense, in the authors' view, to conclude a discretionary trust interest generally does not include a trust that contains a distributional standard including "health" but does include that standard when the beneficiary serves as trustee. Moreover, G.S. §36C-5-504(a)(2) broadly includes a discretionary trust interest to include discretionary distributions "whether or not the discretion is expressed in the form of a standard of distribution."

review the law of the applicable jurisdiction to determine whether a discretionary interest subject to an ascertainable standard receives creditor protection.

The general rule of asset protection for a beneficiary's interest is not without exceptions. Notwithstanding the inclusion of a spendthrift provision, discretionary trust interest, or protective trust interest in the trust document, a beneficiary's child who has a judgment or court order against the beneficiary for support or maintenance may obtain from a court an order attaching present or future distributions to or for the benefit of the beneficiary. G.S. §36C-5-503.

(2) Debtor is Beneficiary and Trustee

In North Carolina, a beneficiary's service as trustee will not subject the beneficiary's interest to the claims of creditors if the trustee's ability to distribute assets for the trustee's own benefit is limited to an ascertainable standard. G.S. §36C-5-504(f). As a general rule, a trust governed by the laws of the State of North Carolina which appears to permit discretionary distributions by a trustee-beneficiary without reference to a standard is so limited by statute. Unless the terms of a trust indicate with express reference to the applicable default statute that the rule does not apply, a beneficiary of a trust who serves as trustee and has a power that otherwise constitutes a general power of appointment will be deemed to have the ability to exercise that power only in accordance with an ascertainable standard. G.S. §36C-8-814(b)(2). Accordingly, in most cases a beneficiary may serve as trustee and receive the same protections as other beneficiaries.

(0) Debtor is Holder of Power of Withdrawal

In addition to status as beneficiary and trustee, a debtor may hold a power of withdrawal over trust property. A power of withdrawal is defined as a presently exercisable general power of appointment other than a power exercisable by a trustee and limited by an ascertainable standard or exercisable by another person only upon consent of the trustee or a person holding an adverse interest. G.S. §36C-1-103(13). A general power of appointment is generally understood to include the power to appoint trust property in favor of a category of persons that include the power holder, the power holder's estate, the power holder's creditors, or the creditors of the power holder's estate. Accordingly, a general power of appointment usually gives the power holder the right to instruct the trustee to distribute assets to or for the power holder's benefit. *See* G.S. §36C-8-814(b)(referencing IRC §2041(b)(1) and 2514(c)). The question therefore is whether a creditor can require a beneficiary to exercise the power and have funds distributed to himself and therefore become available to pay creditors.

In North Carolina, a creditor may not force the holder of a general power of appointment to exercise that power so long as the power holder is not the settlor. G.S. §36C-5-505(b). However, the property subject to the exercise of the power is subject to the claims of the creditors of the power holder when and to the extent the power is exercised. The lapse, release, or waiver of such a power is not deemed an exercise of that power. This rule does not appear to be subject to exception even for child support claims.

As a practical matter, the above rule seems to be at odds with the prohibition discussed earlier for a beneficiary serving as trustee. A trustee who has the right to make fully discretionary distributions for the trustee's benefit would subject the entire trust estate to the creditor of the trustee-beneficiary unless distributions are limited to an ascertainable standard. However, it appears the same debtor, while serving as trustee, could be given a power of withdrawal permitting the debtor to appoint all or any part of the assets to the debtor and the assets would be protected from the debtor's creditors unless the debtor exercises the power. In both situations, the debtor can unilaterally confer the benefit of the trust assets upon himself. In fact, in the latter situation the debtor's right to withdraw assets is not subject to exercise in a fiduciary capacity. Accordingly, the disparate treatment of a debtor serving as a trustee-beneficiary and a debtor who has the power to make withdrawals from a trust has little policy justification. Practitioners looking for maximum flexibility, however, may wish to structure plans accordingly.

<u>(4) Debtor is Settlor: No Strings</u>

A settlor-debtor who conveys assets to a trust and retains no interest or other rights in the trust has usually made a gift to the trust for federal gift tax purposes. IRC §2501. A creditor's rights will be the same as if the settlor-debtor conveyed a gift to a spouse, child, parent, friend or other third party. A creditor's ability to reach the trust assets will depend largely on whether a fraudulent conveyance, discussed below, has occurred or constructive fraud taints the transfer of assets to the trust.

<u>(5) Debtor is Settlor: Strings</u>

If the debtor-settlor retains a beneficial interest in a trust, then the trust is "self-settled" and creditors may usually reach that beneficial interest for the reasons discussed above. In many cases, however, a settlor-debtor may retain certain rights or powers over trust property that fall short of granting the settlor-debtor an outright beneficial interest in the trust. Most commonly these rights include one or more of the following: the right to remove and replace the trustee; the right to serve as trustee; a lifetime or testamentary power of appointment; the right to substitute trust property for property of equivalent value; and the right to remove and replace a trustee or trust protector. One or more of these powers can give the settlor-debtor considerable control over trust operations and, importantly, even indirect benefits from the trust. For example, a settlor-debtor could threaten to exercise his or her power of appointment to remove a beneficiary who refuses to make gifts of trust property to the settlor-debtor.

As a general rule, powers like those mentioned do not subject trust assets to creditors of the settlor-debtor. From time to time, however, courts have struggled with the degree of control a settlor-debtor or even a beneficiary-debtor may have over the trust without causing the trust to simply become an alter ego of the debtor. *See, e.g.,* <u>In re Schwarzkopf</u>**,** 626 F.3d 1032 (9th Cir. 2010)(holding trust liable to creditor as alter-ego of settlor-debtor); <u>U.S. v. Evseroff</u>, 2007-1 U.S. Tax Cas. (CCH) ¶ 50,222 (E.D.N.Y. 2006), *rev'd and rem'd*, 2008-1 U.S. Tax Cas. (CCH) ¶50,240 92d Cir. 2008), on remand, 2012-1 U.S. Tax. Cas. (CCH) ¶50,328 (E.D.N.Y. 2012), *aff'd* 528 Fed. Approx. 75 (2d Cir. 2013)(trust liable as alter-ego of settlor-debtor); <u>U.S. v. Hart,</u> 2006 WL 3377626 (2006); <u>In re Harman</u>, 512 B.R. 321 (N.D. Ga. 2014)(declining to apply alter-ego theory under Georgia law).

Courts have used the alter-ego theory to include the value of certain trust assets in a divorce proceeding. In *In re Marriage of Dick*, 18 Cal. Rptr. 2d 743 (Cal. App. 1993), the husband claimed that he had no net monthly disposable income to provide support for wife. After an extensive trial, the trial court awarded wife $35,000 a month in spousal support. In ruling for wife, the appeals court found that husband had the ability to pay. The court found that while the husband lacked virtually any assets in his own name, the husband had created a labyrinth of trusts and corporations to shield and protect the husband from creditors. The husband had placed over $20,000,000 into the control of others who then acted for his benefit. The court pointed to a number of factors supporting the husband's control over the trusts. The husband used certain residences held by the trusts without the payment of rent or other compensation and the husband's children, the alleged beneficiaries, had never received a distribution from the trusts. The purported trustee appeared to work exclusively for husband, husband's brother, and husband's business associate. The husband also instructed the trustee on investments and the trustee never made an investment contrary to the husband's instructions. The court appeared particularly concerned with the fact that the husband had placed assets in trust with trustees who were related or subordinate to the husband and could be expected to operate at the husband's behest.

The alter ego theory appears to be available to creditors in North Carolina. In *U.S. v. Greer*, the U.S. attempted to enforce a federal tax lien against a twenty acre property held in trust. U.S. v. Greer, 383 F. Supp. 2d 861, 867 (W.D.N.C. 2005). The debtor served as trustee of the trust and was also a beneficiary. The U.S. District Court for the Western District of North Carolina found that a trust could be set aside on the basis of the alter ego theory under North Carolina law. The court held that a plaintiff must show that the defendant (i) controls, through complete domination, the policy and business practice of the trust such that at the time the trust had no separate mind, will or existence of its own, (ii) such control must have been used by the defendant to commit fraud or wrong, to perpetrate a violation of a statutory or other positive legal duty, or a dishonest and unjust act in contravention of plaintiff's legal rights; and (iii) the aforesaid control and breach of duty must proximately cause the injury or unjust loss complained of. U.S. v. Greer, 383 F. Supp. at 867. The court concluded that the U.S. had not met its burden as the defendant had not acted inconsistently from his role as trustee and beneficiary.

In the recent case of *Nicks v. Nicks*, discussed more fully below, the North Carolina Court of Appeals arguably applied, in part, an alter ego analysis to determine that a "strong argument" existed that the assets of a limited liability company controlled by husband but owned by an irrevocable trust of which the husband was a beneficiary were marital property subject to equitable distribution.

Cases like *Dick* and *Greer* indicate that the alter ego theory may be used to set aside abusive trust arrangements and, while not expressly referring to the alter ego theory, it can be reasonably argued that *Nicks* follows that line of cases in reaching its holding. However, a plaintiff must show that the debtor did more than simply retain certain rights in the trust. The debtor must have complete domination over the trust either directly by its terms or indirectly through the debtor's domination of the trustee and beneficiaries.

3. Case Studies

a. Ward v. Fogel

Many of the complexities surrounding a spouse's right to assets unilaterally transferred in trust by the other spouse are exemplified in the case of *Ward v. Fogel*, 768 S.E.2d 292, 2014 N.C. App. LEXIS 1248. (N.C. Ct. App. Dec. 2, 2014), disc rev. denied, 2015 LEXIS 287 (N.C. Apr. 9, 2015). In Ward**,** the husband and wife married in 1987. Husband became a fifty percent owner of a successful closely-held business in 1997. He conveyed his fifty percent interest in the business to an irrevocable trust ("Trust I") in 2005. Wife was named as a current beneficiary of Trust I during her lifetime, however, Trust I contained a "divorce clause" providing that wife would retain her beneficial interest only so long as she remained married to husband. Husband's son and future grandchildren were also named beneficiaries of Trust I. The purpose of Trust I was to protect family assets from the claims of potential future creditors given the high risk nature of the husband's business. Wife was not involved in the drafting of Trust I and claimed that she did not discover the divorce clause until after the parties separated.

In 2006, wife created an irrevocable trust ("Trust II") naming husband as primary beneficiary. Trust II was funded with various membership interests titled in the sole name of wife at the time of the conveyance. Trust II did not contain similar language terminating husband's beneficial interest upon divorce from wife. Together, Trust I and Trust II contained most of the couple's wealth.

The wife contended that the Trusts should be dissolved based on claims of breach of fiduciary duty and actual and constructive fraud. With respect to Trust I, the wife also asserted that the "divorce clause" was contrary to public policy.

The Court of Appeals upheld the Trial Court's entry of summary judgment dismissing the wife's claims regarding Trust I. The fact that the wife was completely excluded from the drafting and execution of Trust I meant that no fraud could have occurred, for no representations of any type were made to the wife in connection with the creation of Trust I. The exclusion of the wife from the creation of the Trust also meant that no breach of fiduciary duty occurred. In a marital setting fiduciary duties only arise in connection with transactions involving both the husband and the wife. Here, there was no transaction involving both the husband and the wife. The wife's only status with respect to Trust I was the recipient of a gift from the Husband.

The Court of Appeals also held that the divorce clause in Trust I did not violate the public policy of North Carolina. In so holding the court recognized that a trust may only exist to the extent that its purpose is lawful, not contrary to public policy, and possible to achieve. The court provided three rationales for why the divorce clause did not violate public policy. First, North Carolina law already allows for certain similar rights to terminate upon divorce, such as those in a will. Second, the clauses that may run afoul of public policy are those that provide a payment to a beneficiary if he or she would procure a divorce, because "enforcement would tend to encourage the disruption of the family by creating an improper motive for terminating the family relation." The court found that, rather than disrupting the family unit, the divorce clause in Ward incentivized the wife to remain married to husband so that she could continue to enjoy distributions from Trust I. Third, the court found similar divorce clauses in common estate planning form manuals and held that ruling such divorce clauses against public policy would disrupt the estate plans of citizens who have already planned their estates using similar clauses.

The following features were present in Trust I: (a) the Trust was irrevocable; (b) the Trust was created at a time when divorce was not contemplated and there were no claims from creditors or potential creditors of the Grantor; (c) there was a valid reason for creating the Trust which had nothing to do with divorce; (d) the Trust was funded with assets held in the husband's name (The Court of Appeals took no position as to whether the corpus of Trust I included marital property.); (e) the Trustees of Trust I were independent parties and the husband retained no control over the Trust; (f) the husband surrendered all of his legal and equitable interest in the corpus of the Trust; (g) the wife was not involved in the creation of the Trust.

The Court of Appeals overturned the trial court's entry of summary judgment with respect to Trust II. The wife was the Grantor of Trust II and testified that she had been misled in connection with its creation. Based on this testimony the Court of Appeals found that issues of fact existed on the wife's claims of fraud, constructive fraud and breach of fiduciary duty with respect to Trust II.

b. Nicks v. Nicks

The NC Court of Appeals grappled with a spouse's right to assets held in trust in the recent case of *Nicks v. Nicks*, 774 S.E.2d 365 (N.C. App. 2015). Mike and Sally Nicks were married on May 1, 1983. In 2003 Mike had an affair with a twenty-one year old employee. During the last six years of the marriage Mike would move out of the house for weeks or even months at a time. Mike left for good on June 22, 2009. On January 4, 2008, Mike's father established the CMN 2008 Trust, an irrevocable trust with Premiere Trust, Inc. of Las Vegas, Nevada as the Trustee. Mike's father contributed $10,000.00 to the Trust. Mike and Sally were the only beneficiaries of the Trust. The Trust provided that Mike had the power to make withdrawals from the Trust, Mike had a lifetime appointment over the Trust assets, Mike served as the investment manager of the Trust property, and Mike had the right to remove any trustee, with or without cause.

The Trust was also funded with the transfer of 100% of the interests in Entrust, LLC, a Delaware LLC. Entrust is a manager-managed LLC, with Mike as the sole manager. In addition, Mike had the authority to decide whether to make distributions of assets and/or profits from Entrust. The Operating Agreement for Entrust was signed by Mike and Premiere Trust, Inc.

In December of 2007, Mike and Sally transferred 125 acres of land they owned in Catawba County to Green Park LLC. Mike was the sole member-manager of Green Park. On January 24, 2008, 100% of the interest in Green Park was sold to Entrust in exchange for a note for $2,200,000.00 bearing interest at 5% per year, with annual payments to Mike and Sally of $10,000.00 per year, and payment in full due on January 31, 2033. On that same date Mike transferred to Entrust $100,000.00 in cash and shares of stock and mutual funds with an estimated value of $560,000.00. In return, Entrust executed a promissory note for $660,000 payable to Mike.

Although Sally was only directly involved in the transactions involving Green Park, all the transactions were discussed between she and Mike. Sally testified that she expressed reservations about the transactions and that Mike assured her that the transactions were for their mutual protection and that they could take their funds out if they wanted to.

The trial court found that Entrust and the promissory notes it executed were marital property with a value of $3,046,071.27. The court also found that an in-kind division was not practicable and awarded 100% of Entrust to Mike and ordered that he pay Sally a distributive award of $1,546,352.11. The Court of Appeals reversed, because the Trust was not made a party to the action. However, the Court offered the following guidance to the trial court upon remand:

> Finally we note that in spite of the errors discussed *supra*, the majority of the trial court's findings of fact regarding the Trust, Entrust, and the control Mike exercises over them are amply supported by the evidence in the record. Further, we find wholly incredible and without reasonable basis Mike's argument that Entrust should not be distributed as marital property despite the trial court's well-supported factual findings that it is composed almost entirely of marital assets. The trial court's findings that Mike engineered this elaborate scheme as an estate planning vehicle, effectively manages all the assets it conceals, and has the right to decide whether to make distributions of profits and assets from Entrust are similarly well supported. In short, it is clear from the record that once the Trust – which holds legal title to Entrust and the marital assets therein – is joined as a necessary party to this action. Sally will have a strong claim for the imposition of a constructive trust. We remand this issue to the trial court for further findings and proceedings consistent with this opinion.

Id. 774 S.E.2d at 375.

c. Dahl v. Dahl

In *Dahl v. Dahl*, __ P.3d ___, 2015 WL 5098249, 794 Utah Adv. Rep. 5, 2015 UT 79, an unpublished opinion, the Court encountered a domestic asset protection trust in the marital context. Dr. Dahl created a self-settled asset protection trust and was the settlor. The trust document stated that Nevada law governed. Nevada has the strongest DAPT statute in the United States with no exceptions for child support, alimony or equitable distribution claims. The trust document stated the trust was irrevocable. It also stated: "Settlor reserves any power whatsoever to alter or amend any of the terms or provisions hereof." Ms. Dahl did not sign the trust document but she signed a deed and other documents transferring property to the trust. The parties separated and lengthy, hotly contested litigation followed on all family law issues (including child custody and alimony). The Supreme Court of Utah ruled:

> Because Utah has a strong public policy interest in the equitable division of marital assets, we will not enforce the choice-of-law provision contained in the

> Trust. Instead, we construe the Trust according to Utah law. We hold that the Trust is revocable under Utah law and that Ms. Dahl has an interest in the Trust property as a settlor of the Trust."

Because the Supreme Court of Utah concluded that the trust was revocable it held Ms. Dahl has the right to withdraw her contributions to the trust. The opinion has not yet been released for publication and amends and supersedes a prior opinion. Ms. Dial subsequently filed a petition for writ of certiorari with the U.S. Supreme Court which was denied.

4. Tax Considerations

While a broad discussion of tax matters is beyond the scope of this manuscript, no discussion of trusts would be complete without mentioning taxation. The creation of an irrevocable trust necessarily implicates federal wealth transfer tax concerns as well as federal and state income tax planning. Estate and gift tax treatment will largely depend on the terms of the trust, including the rights and powers of the settlor. Additionally, trusts are generally considered legal entities for income tax purposes, but may be completely disregarded in certain circumstances. IRC §641, et. seq. An unwary settlor could be responsible for all income taxes recognized by the trust and have no right to assets from the trust to pay those taxes. For these and other reasons, a qualified tax professional should be consulted prior to the creation of a trust.

5. Altering Irrevocable Trusts

Irrevocable trusts, despite their label, are not rigid arrangements incapable of change. To the contrary, a variety of methods exist to address desired changes to the actual terms or function of an irrevocable trust. A practitioner should only narrowly infer that the label "irrevocable" means that the trust cannot be unilaterally revoked by the settlor. A trust's function can be substantially altered by the addition or removal of trustees, the exercise of a power of appointment or power of withdrawal, or through the amendment of the trust's administrative terms. Such changes can often be made without any technical alteration to the terms of the trust, generally by the exercise of certain powers by persons enumerated in the trust. In other cases, however, a trust term is no longer favorable or the term would defeat the material purpose of the trust and no power holder exists that could affect a change to the trust term. In those cases, a trust may be modified or decanted under certain circumstances even over the objection of the settlor or beneficiaries.

a. Power Holders

In many cases the function of a trust may be significantly altered without modification or decanting proceeding. This is possible when the terms of the trust provide a method for altering the trust. For example, a settlor that has no right to distributions from a trust may have retained substantial rights and powers that permit the settlor to greatly change the operation of the trust. For example, a settlor may have retained a power of appointment, a power to remove and replace trustees, or even the power to veto distributions or investment decisions. Many of these powers are, however, adverse to favorable wealth transfer tax treatment. Accordingly, a trust will generally provide for a third party "power holder" and grant that individual one or more powers over the trust in a capacity other than as trustee.

In North Carolina, a "power holder" includes anyone who under the terms of the trust has the power to take certain actions with respect to a trust and is not a trustee or a settlor. G.S. §36C-8A-1.[6] A power holder may be given a power to direct or consent to a number of actions by the Trustee, including investment decisions, discretionary distributions, trust administration matters, or the removal or appointment of a trustee. G.S. §36C-8A-2. The power holder may even have the ability to grant a power of appointment to a beneficiary, increase or decrease the interests of a beneficiary, or to modify or amend the trust to take advantage of more favorable asset protection laws.

A significant advantage to naming a power holder rather than a trustee to exercise certain powers is that the power holder does not necessarily have to exercise his or her power in a fiduciary capacity, meaning that in some statutory instances or when the trust expressly provides that the power can be exercised in a non-fiduciary capacity the power can be exercised based on the power holder's personal desires and not based on the interests of the beneficiaries. G.S. §36C-8A-3(a); G.S. §36C-1-105 (discussing default and mandatory rules for trusts). A trustee is not generally liable for following the directions of a power holder unless such compliance would constitute intentional misconduct on the part of the trustee. G.S. §36C-8A-4. Accordingly, a settlor could grant a trusted third party the right to significantly alter the interests in the trust over time and the third party could exercise the power in a nonfiduciary capacity, leaving a beneficiary no recourse against the third party.

b. Trust Decanting

Many trusts lack the incorporation of a comprehensive power holder capable of addressing substantive concerns regarding the terms of a trust or the power holder may simply refuse to exercise the power. In such cases, a trustee may believe that the amendment of a trust provision is appropriate and furthers the interests of the beneficiaries. For example, a trustee may seek to prohibit a required distribution to a spendthrift beneficiary or a beneficiary suffering from substance abuse. Alternatively, a trustee may wish to amend an administrative term of a trust to create tax savings.

At common law, it was argued that a trustee's discretionary power to distribute trust property to or for the benefit of a beneficiary necessarily included the power to appoint the trust property to a second trust for the benefit of a beneficiary subject to different terms. The uncertainty surrounding the ability of a trustee to exercise this special power of appointment – more commonly called "decanting" – caused many states to adopt laws expressly granting a trustee broad decanting powers under certain conditions.

In North Carolina, G.S. §36C-8-816.1 provides a trustee with the express power to appoint trust property to a second trust. A trustee may, without authorization by a court, exercise the trustee's discretionary power to distribute principal or income to or for the benefit of one or more current beneficiaries of the original trust by appointing all or part of the principal or income

[6] Note that the provision of G.S. §36C-8A-1 are default rules and may be changed by the terms of the trust.

of the original trust subject to the power in favor of a trustee of a second trust. G.S. §36C-8816.1. The trustee can exercise the power whether or not there is a current need to distribute principal or income under any standard provided in the terms of the original trust. Importantly, this power also includes the power to create the second trust. Id.

The second trust must comply with a series of mandatory rules unless the original trust instrument expressly alters those rules. These include the following:

- The beneficiaries of the second trust may include only beneficiaries of the original trust. However, the second trust does not necessarily need to include all beneficiaries of the original trust.

- A beneficiary who has only a future beneficial interest cannot have that interest accelerated in the second trust.

- If contributions to the original trust qualified for certain deductions or treatment for federal tax purposes, then the contributions must continue to qualify under the terms of the second trust for that same treatment.

- If any beneficiary has a power of withdrawal over trust property, then the second trust must either give the beneficiary the same right or the original trust must hold sufficient trust property to satisfy the withdrawal right.

- If a beneficiary is entitled to discretionary distributions subject to an ascertainable standard (i.e, health, education, maintenance or support) then the second trust must continue to provide discretionary distributions for this purpose.

G.S. §36C-8-816.1(c).

Despite a prohibition against adding new beneficiaries to the second trust, North Carolina's decanting statute provides a method to at least indirectly do so. G.S. §36C-8-816.1(8) provides that a "second trust may confer a power of appointment upon a beneficiary of the original trust to whom or for the benefit of whom the trustee has the power to distribute principal or income of the original trust." Significantly, the "permissible appointees of the power of appointment conferred upon a beneficiary may include persons who are not beneficiaries of the original or second trust." To illustrate, consider the following:

Illustration #1. Trust provides that settlor's spouse, Jane, and son, Paul, are discretionary beneficiaries of the trust. Grandchildren are not current beneficiaries of the trust. Jane and Paul have substantial means and each would like the trustee to make distributions to the grandchildren. The trustee may not decant the trust assets to a second trust that includes the grandchildren as current beneficiaries.

Illustration #2. Same facts as Illustration #1 except that the trustee desires to decant trust property to a second trust that grants Paul the power to appoint the trust property to any one or more of the grandchildren of the settlor. Following the decanting, Paul plans to exercise the power in favor of his grandchildren. The decanting is statutorily permissible.

The procedure for decanting trust assets is expressly set forth in the statute. G.S. §36C-8-816.1(f). Only a disinterested trustee may exercise the decanting power by appointing the property by an instrument in writing that is signed and acknowledged by the trustee, setting forth the manner of the exercise of the power, including the terms of the second trust and the effective date of the exercise of the power. The trustee must give written notice, which includes the written instrument exercising the power, to all qualified beneficiaries of the original trust at least 60 days prior to the effective date of the exercise of the power to appoint of the trustee's intention to exercise the power. All qualified beneficiaries can waive the notice period by a signed written instrument delivered to the trustee, which entitles the trustee to exercise the power earlier than the end of the 60 day period. The trustee's notice cannot limit the right of a beneficiary to object to the exercise of the trustee's power to appoint and bring an action for breach of trust. A trustee or beneficiary may commence a proceeding to approve or disapprove a proposed exercise of the trustee's special power to appoint to a second trust.

Decanting can be a useful tool to, in effect, modify an irrevocable trust in appropriate circumstances, particularly if all beneficiaries consent to the change. There are, however, significant pitfalls that should be considered. First, a trustee exercises the power in a fiduciary capacity. Changing beneficial interests in the trust should not be considered lightly as a trustee could be held liable to a disgruntled beneficiary. Second, the tax implications of decanting a trust are not clear. While many have argued that the second trust should be treated as a modification of the original trust, the Internal Revenue Service has not issued official guidance to date. Consequently, practitioners are concerned that the exercise of the decanting power could result in negative income or wealth transfer tax results in certain circumstances.

c. Trust Modification or Termination.

If a trust lacks a designated power holder willing and able to effect a necessary change and decanting is not available or advisable, a trustee or beneficiary is not without options. The terms of a trust may still be modified for any one of several statutory reasons.

(1) Settlor and Beneficiaries Consent. A noncharitable irrevocable trust may be modified or terminated without court approval if the settlor and all beneficiaries consent. G.S. §36C-4-411(a). If consent is obtained, the modification may be compelled over the objection of the trustee and even if the action is inconsistent with a material purpose of the trust. A settlor's power to consent to a trust's modification or termination may be exercised under certain circumstances by the settlor's attorney-in-fact or court appointed guardian. This is the only available method to modify or terminate an irrevocable trust without court approval.

(2) Consent of Beneficiaries with Court Approval that Action furthers Material Purpose of Trust. In many cases, a settlor will not wish to participate in the modification or termination of a trust because of potentially negative wealth transfer tax consequences. *See* Example 7, Treas. Reg. §26.2601-1(b)(4)(i)(E); PLR 200917004. In such

cases, G.S. §36C-4-411(b) provides that a noncharitable irrevocable trust may be modified upon consent of all of the beneficiaries, if the court concludes that modification is consistent with a material purpose of the trust. Likewise, a noncharitable irrevocable trust can be terminated upon consent of all of the beneficiaries if the court concludes that continuance of the trust is not necessary to achieve any material purpose of the trust. Id. Accordingly, the beneficiaries have the right to compel a modification over the objection of a trustee if the court concludes that the action will not impede a material purpose of the trust.

(3) Consent of Beneficiaries with Court Approval if Reason Substantially Outweighs Material Purpose of Trust. Pursuant to G.S. §36C-4-411(c), a court may still authorize the modification or termination of a trust even if the court finds that the trust is necessary to carry out the purpose of the trust or where the modification is inconsistent with a material purpose of the trust if the court determines that the reason for modifying or terminating the trust under the circumstances substantially outweighs the interest in accomplishing a material purpose of the trust. Accordingly, if all beneficiaries consent, a court may engage in a balancing test to determine if the modification or termination is appropriate under the circumstances.

(4) Court Approval without Beneficiary Consent if Non-consenting Beneficiary's Interest Adequately Protected and Action Otherwise Permitted. If all of the beneficiaries do not consent to the modification or termination, G.S. §36C-4-411(d) provides that the court may approve the modification or termination if (i) all of the beneficiaries had consented, the trust could have been modified or terminated under G.S. §36C-4-411 and (ii) the interests of a beneficiary who does not consent will be "adequately protected." A court, therefore, has substantial leeway in determining whether a modification or termination is appropriate, particularly given that the subjective determination of whether a beneficiary's interest is adequately protected.

(5) Modification or Termination for Unanticipated Circumstances. G.S. §36C-4-412(a) provides a court may modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not anticipated by the settlor, modification or termination will further the purposes of the trust. In such cases, to the extent practicable, the modification must be made in accordance with the settlor's probable intention.

(6) Modification for Effective Administration. G.S. §36C-4-412(b) provides a court may modify the administrative or dispositive terms of a trust if continuation of the trust on its existing terms would be impracticable or wasteful or impair the trust's administration. Notably, this provision only permits a modification of the trust.

(7) Termination of Uneconomic Trust. G.S. §36C-4414 permits a trustee to terminate a trust without court approval if the trust has a total value of less than $50,000 and the trustee concludes that the value of the trust property is insufficient to justify the costs of administration. No consent of the beneficiaries is required. A trustee may seek judicial approval of a termination of modification of an uneconomic trust. Upon

termination, the trust assets are required to be distributed in a manner consistent with the purposes of the trust.

(8) Reformation to Correct Mistakes. G.S. §36C-4-415 permits a court to reform the terms of a trust, even if unambiguous, to conform the terms of the trust to the settlor's intention if it is proved by clear and convincing evidence that both the settlor's intent and the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement.

(9) Modification to Achieve Settlor's Tax Objectives. G.S. §36C-4-416 provides that a court may modify the terms of a trust in a manner that is not contrary to the settlor's probable intention to achieve the settlor's tax objectives. In doing so, the court may provide that the modification has retroactive effect.

d. Judicial Proceedings

Any action to modify, terminate or decant a trust would be properly brought as a civil action in the superior court. A trustee or beneficiary may bring an action to modify or terminate a trust under G.S. §36C-4-411 through §36C-4-416. A settlor may bring an action to modify or terminate a trust under G.S. §36C-4-411 or §36C-4-413. A trustee is a necessary party to the action. The North Carolina Rules of Civil Procedure govern the procedural aspects of such proceedings subject to notable exceptions with respect to venue and the virtual representation of certain trust beneficiaries. *See* G.S. §36C-2-201, et. seq. Significantly, Article 3 of the North Carolina Uniform Trust Code governs the representation of incompetent, minor, unascertainable, unborn or non-locatable beneficiaries. A guardian ad litem is not required except in circumstances where a party seeking to represent another party has a conflict of interest.

B. BUSINESS ENTITIES AS ASSET PROTECTION DEVICES

1. General Utility

Business entities are usually considered effective asset protection tools for limiting the liability of business owners for liabilities arising from the business. Shareholders, members and limited partners are not generally liable to the creditors of the business unless grounds exist to pierce the veil of limited liability provided by statute. G.S. §55-6-22(b); G.S. §57D-3-30; G.S. §59-303. Business entities may, however, provide limited protection for claims against the owner arising outside of the business. While a creditor may be able to reach an owner's interest to a limited degree, the presence of certain factors may promote settlement. This is most often due to the unappealing nature of the owner's interest in the business or the creditor's inability to seize the owner's actual interest and not the underlying assets of the business.

a. Lack of Control

Often an owner's interest is a minority interest that gives the creditor no control over the affairs of the business. The presence of a minority interest may directly impact the marketability of that interest as discussed below. In addition, the creditor may have no ability to force distributions from the entity. This is a particular problem in the case of entities that pass through taxable income or gain to the owners and are not required to make a corresponding distribution to pay those taxes except in the discretion of management.

In some cases, a creditor cannot gain control over an entity because of the statutory nature of the owner's interest. Limited liability companies and limited partnerships are particularly useful for this purpose. By statute, a creditor may only receive a charging order against the owner's membership interest or partnership interest. G.S. §57D-5-03; G.S. §59-703. In the case of an LLC, the creditor has only a right to receive distributions that would have otherwise been paid to the interest owner. In the case of a limited partnership, the creditor has only the rights to distributions and allocations from the partnership. In both cases, the owner retains the actual ownership interest including any voting rights associated with the interest. Accordingly, a charging order may have little appeal to the creditor.

b. Lack of Marketability

Creditors are generally most interested in seizing and selling assets to satisfy their claims. Any inhibitors to selling an interest will generally impact a creditor's decision to invest resources into pursuing the asset. Often closely-held business interests are not marketable. As discussed above, a creditor cannot generally seize and sell an owner's interest in an LLC or limited partnership. Moreover, minority interests are generally unappealing to purchasers. Even controlling interests may be subject to transfer restrictions that affect the marketability of that interest. A buy-sell agreement may entitle another owner to purchase the debtor-owner's interest on unfavorable terms and likely at a discounted price.

3. Trusts as Owners of Business Entities

Business entities have long been used in conjunction with trusts in an effort to achieve tax savings. A settlor desiring wealth transfer tax savings may create a limited liability company, transfer assets to that company, and thereafter gift a portion of the membership interests in the company to a trust claiming substantial valuation discounts for the gift. Such strategies are common place in wealth transfer tax planning and, if structured properly, may result in considerable tax savings. Importantly, however, the settlor must generally depart with any beneficial interest in the business interest transferred in trust to achieve the tax savings.

The advent of protective trust strategies has generated a potential use for business entities in conjunction with trusts. Clever planners have used business entities as a method for settlors to retain control over their assets when placed in trust. Most commonly, the settlor is named as the investment trustee and given the sole authority to direct trust investments, including the right to vote the trusts interest in closely held companies. An administrative trustee or distribution trustee is given other administrative tasks and the right to determine distributions from the trust. The result is that settlor retains control over the business entity, including the right to set his or her salary as manager of the business entity and the right to determine use of the company's property and distributions from the company to the trust. The legality of such arrangements is highly dependent on the applicable statutes of the controlling jurisdiction. The potential for abuse is great particularly in instances where the business entity is funded with personal use assets and there is no other trustee who is charged with reviewing and questioning the actions of the interested trustee.

III. CONSIDERATIONS FOR EFFECTIVE ASSET PROTECTION PLANNING

A spouse attempting to engage in asset protection planning with marital property will encounter a series of initial barriers and potential pitfalls that must be addressed in order to effectively protect his or her assets. These initial considerations include (i) the status of property as marital or separate property for equitable distribution purposes, (ii) the marital or separate status of funds transferred to the irrevocable trust, (iii) the possibility of committing a fraudulent conveyance, (iv) possible breaches of fiduciary or other similar duties to a spouse, and (v) the effectiveness of the irrevocable trust to terminate a spouse's marital interest, if any, in the funds both during life and at death. Each consideration is discussed below.

A. EQUITABLE DISTRIBUTION AND INHERITANCE

A preliminary consideration for any spouse attempting to engage in asset protection planning is the characterization of the property to be transferred as either marital or separate property. There is a presumption that all property acquired by either spouse during the marriage is marital property. Caudill v. Caudill, 131 NC App, 854, 509 S.E.2d 246 (1999). The parties seeking to have property classified as separate property must show by the greater weight of the evidence that the property is separate. Fountain v. Fountain, 148 N.C. App. 329, 559 S.E.2d 25 (2002). However, property acquired by a spouse during marriage through a gift from a third party, devise or descent is separate property. G.S. §50-20(b)(2). Accordingly, a client's inheritance or a gift from a parent, at least initially, should be classified as separate property.

The deposit of client's inheritance or gift into a joint account should not be construed to conclusively convert the client's separate property to marital property. Property acquired in exchange for separate property generally remains separate property regardless of whether the title is in the name of the husband or wife or both and is not to be considered to be marital property unless a contrary intention is expressly stated in the conveyance. G.S. §50-20(b)(2). Given sufficient proof, our courts have allowed a party to trace separate property through a series of transactions. Fountain v. Fountain, 148 N.C. App. 329, 559 S.E.2d 25 (2002).

With respect to joint bank accounts, the results may vary depending on the facts of the case. In O'Brien 131 N.C. App. 411, 508 S.E 2d 300 (1998), the wife placed funds she received by inheritance and gift into a securities account in the joint names of her and her husband. In addition, the parties deposited $4,500 of marital funds in the account and withdrew $38,658 from the account for marital purposes. Over the next several years assets in the account were moved to three different securities firms and additional monies received by the wife by gift or inheritance were placed into the account. Based on these facts, the Court of Appeals upheld the trial court's finding that the funds in the investment account were separate property and were not subject to distribution. On the other hand, in Holterman v. Holterman, 127 N.C. App. 109, 488 S.E.2d 265 (1997), the parties were married for over forty-five years. Mrs. Holterman inherited $508,000 in 1952 and $100,000 in 1964. The parties maintained various checking, savings and brokerage accounts during their marriage. All of the wife's inheritance was comingled with the funds the husband earned as well as the proceeds from the sale of a succession of homes. During the marriage all of the parties' property was jointly held. Based on these facts, the Court of Appeals upheld the trial court's determination that all of the parties' investments were marital property. The Court so ruled on two grounds. First, the Court found that the wife was unable to trace her inheritance to the assets jointly owned by the parties on the date of separation. Id. 127 N.C. App. at 112, 488 S.E.2d at 268. Second, the trial court found that the plaintiff intended her inherited assets to be a gift to the marital estate. Id.

In addition to the commingling, the client's wife may claim that the client's assets transferred to the joint account were a gift, either in whole or in part, to wife. Property acquired by gift from a spouse during the marriage is not considered a gift unless the other spouse's intention to make a gift is stated in the conveyance. G.S. §50-20(b)(2).

A spouse's unilateral transfer of funds from a joint account to an irrevocable trust does not necessarily terminate the relevance of those assets in the divorce proceeding even if the client retains no interest in the irrevocable trust. Under North Carolina law, marital property can be traced even if it is titled in the name of a third party. In Upchurch v. Upchurch, 128 N.C. App. 461, 459 S.E.2d 738 (1998), the Court of Appeals found that $67,733 in church bonds were marital property even though they were held in the name of Mr. Upchurch's son. This finding was based on the trial court's ability to trace marital funds through several transactions which ended in the transfer of the bonds in question to Mr. Upchurch's son. The court ruled that the bonds were held by the son in a constructive trust in favor of the marital estate. Despite the holding of *Upchurch, Lee's North Carolina Family Law* explains:

> A spouse has no claim on property that once belonged to the marital estate but is gone at the date of separation. In North Carolina, even if a spouse has converted marital assets, if those assets or their exchange are not owned by either or both spouses on the date of separation, the assets are not properly identified as part of the marital estate. In some states, the court may classify converted assets as marital and award them to the wronged spouse. In North Carolina the Court of Appeals has concluded that the equitable distribution act allows the trial court to consider the dissipation of assets in deciding how to divide the property that there is, but not in deciding how to classify property in the first place. In community property states, the approach is different. Each spouse has a present ownership interest in community property throughout the marriage, not just when the marriage is dissolving. The community property states, thereafter, have a much different approach to the dissipation of community assets.

Reynold's, *Lee's North Carolina Family Law* (Matthew Bender 5th Ed. 2011) at §12.30.

B. FRAUDULENT CONVEYANCES

1. Present and Future Creditors

The general sentiment of fraudulent transfer laws in the United States is that the law declares void conveyances or transfers designed to delay, hinder, or defraud creditors. *See e.g.*

N.G.C.S. § 39-23.4. (North Carolina has adopted the Uniform Fraudulent Transfer Act, which is the law in at least 39 states). Fraudulent conveyance laws affect three types of creditors (1) present creditors, (2) known potential future creditors, and (3) unknown future creditors.

A present creditor is one who has obtained a judgment against the client, or with whom a debt was contracted by the client prior to the transfer in question. A known potential future creditor is a creditor whom a client could reasonably foresee as a claimant. Examples of known potential future creditors include spouses and victims of torts committed by the client that have not yet obtained a judgment. An unknown future creditor is a creditor whom a client cannot reasonably foresee, for example, a tort victim injured by the client after the transfer in question.

2. Solvency

The solvency of a debtor is a key element in many fraudulent transfer actions. A transfer is void as fraudulent to a present creditor if the transfer renders the transferor insolvent. G.S. §39-23.5(a). A present or future creditor may avoid a transfer as fraudulent if the debtor transfers property without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor was engaged in a business or transaction for which the debtor's assets were unreasonably small or intended to incur debts beyond the debtor's ability to pay as they became due. G.S. § 39-23.4(a)(2).

North Carolina's version of the UFTA defines insolvency to include a debtor who is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation. G.S. §39-23.2. Importantly, a debtor who is generally not paying the debtor's debts as they become due is presumed to be insolvent. A partnership is insolvent if the sum of the partnership's debts is greater than the aggregate, at a fair valuation, of all of the partnership's assets and the sum of the excess of the value of each general partner's nonpartnership assets over the partner's nonpartnership debts. Debts under this section do not include an obligation to the extent it is secured by a valid lien on property of the debtor not included as an asset.

The UFTA provides a creditor with additional methods to show insolvency using North Carolina's prior case law. For the purposes of fraudulent conveyance cases, North Carolina courts historically determined solvency by contrasting a person's assets with his liabilities. Silver Valley Mining Co. v. North Carolina Smelting Co., 119 N.C. 417, 418-19, 25 S.E. 954, 954-55 (1896); Unaka and City National Bank of Johnson City, Tennessee v. Lewis, 201 N.C. 148, 153, 159 S.E. 312, 314 (1931).

Even if the debtor is not insolvent, a present or future creditor may avoid a fraudulent transfer if the creditor can show that the debtor transferred assets "[w]ith intent to hinder, delay, or defraud any creditor of the debtor." G.S. §39-23.4(a)(1). Because intent may be difficult to prove, courts look to several "badges of fraud" to determine a transferor's intent. No single badge of fraud is conclusive in and of itself, but the badges may be construed together to support an inference of fraud. Common badges of fraud include: (i) the debtor's retained possession or control of the transferred property after the transfer; (ii) the debtor's transfer of substantially all of his or her assets; (iii) a transfer occurring shortly before or shortly after a substantial debt was incurred; and (iv) before the transfer was made or obligation was incurred, the debtor was sued or threatened with suit. G.S. §39-23.4 (*See* Official Comment and North Carolina Commentary for a comprehensive list of the most common badges of fraud cited by the courts). There is no bright-line rule for proving intent in a fraudulent transfer case, and the practitioner is encouraged to examine the totality of the circumstances surrounding the transfer.

3. Federal vs. State Law

Federal law deals with fraudulent transfers primarily through the Bankruptcy Code. *See* 11 USCS § 548. The fraudulent transfer language used in section 548(a)(1)(A) of the Code can be traced directly to the original statute from Elizabethan England providing that a transaction entered into with “the intent to hinder, delay or defraud” creditors is fraudulent as to creditors. 5 Collier on Bankruptcy P 548.01. Section 548 covers two classes of unfair and improper transactions: ones in which the debtor intended the transfer to harm or hinder creditors; and ones in which the unfairness stems from a disparity of exchange coupled with the debtor’s lack of other assets. 11 USCS § 548. Pursuant to the Bankruptcy Code, the bankruptcy trustee may avoid any transfer of an interest of the debtor if the debtor made such transfer (1) with actual intent to hinder, delay, or defraud a present or future creditor, or (2) received less than a reasonably equivalent value in exchange for such transfer and was insolvent, operating with unreasonably small capital, intended to incur debts the debtor could not pay, or made the transfer to an insider. 11 USCS § 548(a).

The principals behind section 548 of the Code may seem familiar to practitioners familiar with the North Carolina’s version of the UFTA, because, for the most part, the UFTA tracks section 548. The Uniform Fraudulent Transfer Act (UFTA) has been adopted by at least 39 states, including North Carolina. There are some important differences, however:

- The UFTA has a four-year statute of limitations; that is, an unsecured creditor may seek to set aside a vulnerable transaction for up to four years after it was made. G.S. §39-23.9.

- It permits a finding of balance sheet insolvency based upon cash flow insolvency. G.S. §39-23.2(b).

- It has an insider preference provision. G.S. §39-23.5(b).

- It has expanded remedies—it permits the injunction of further transfers of property fraudulently transferred. G.S. §39-23.7(a)(3).

- It has expanded defenses; it specifically states that a debtor conclusively receives reasonably equivalent value at a regularly conducted, noncollusive foreclosure sale G.S. § 39-23.7(3)(b), provides an absolute defense for a lawful lease termination G.S. § 39-23.8(e)(1), and also provides an absolute defense for a transfer, such as a foreclosure, that “results from ... enforcement of a security interest in compliance with Article 9 of the Uniform Commercial Code. G.S. § 39-23.8(e)(2)

In addition to the powers to avoid transfer granted by section 548, the trustee may also avoid transfers based upon state fraudulent transfer law. 11 USCS § 544(b). Section 544(b) operates by giving the trustee the power to avoid any transaction that could be avoided by an unsecured creditor of the debtor. Most often, the source of avoidance will be fraudulent transfer law, such as the UFTA.

4. Statutes of Limitation

The UFTA provides for a four year statute of limitations for an action on a fraudulent conveyance. Also, UFTA § 9(a) permits creditors to attack a transfer made with actual intent to hinder, delay or defraud creditors within one year after the transfer is or reasonably could be discovered by a defrauded creditor, if later than the general four-year limitations period. North Carolina has adopted the default UFTA statutes of limitations. G.S. §39-23.9.

The Bankruptcy Code has a shorter limitations period for avoiding transfers pursuant to section 548. The bankruptcy trustee may only reach back two years prior to the bankruptcy filing to avoid a transfer pursuant to section 548. 11 USCS § 548(a). The trustee may also pursue a UFTA action pursuant to section 544(b) if the transaction is within the four year statute of limitations provided by the UFTA. Notably, there is a ten year statute of limitations for transfers made to self-settled trusts or similar devices with the intent to hinder, delay or defraud creditors. 11 USCS § 548(e).

Unusually, while Nevada has adopted the UFTA, it has shortened the statute of limitations for transfers to Nevada asset protection trusts. In Nevada, an existing creditor may not bring a fraudulent transfer claim against an asset protection trust unless the action is commenced within two years after the transfer is made or six month after the person discovers or reasonably should have discovered the transfer. Nev. Rev. Stat. Ann. § 166.170(a). A future creditor must bring an action within two years of the transfer. Nev. Rev. Stat. Ann. § 166.170(b).

5. Avoidance of Transfer

The primary remedy for a creditor injured by a fraudulent transfer is to file suit to seek an avoidance of the transfer to the extent necessary to satisfy the creditor's claim. G.S. § 39-23.7(a)(1) (North Carolina's statute is in line with the wide majority of UFTA states). The statute also permits powerful equitable remedies such as: an injunction against the debtor or transferee, appointment of a receiver, or any other appropriate equitable relief. G.S. § 39-23.7(a)(3). Creditors have been able to avoid fraudulent transfers in the following examples:

- Ivey v. Swofford *(In re Whitley)*, 463 B.R. 775 (Bankr. M.D.N.C. 2012). Trustee had sufficiently alleged claims under 11 U.S.C.S. § 548(a)(1)(A) and G.S. 39-23.4(a)(1) when he alleged that individuals transferred funds to the debtor for the purpose of investing in factoring programs; that the debtor was conducting very little or no actual commerce or legitimate commercial activities, but represented that he was conducting legitimate business operations; that no actual profits or earnings were produced in any material fashion from the operation of the fictitious factoring program; and that to the extent any alleged profits or returns were made on the investments, they were funded through additional funds obtained from additional investors into the fictitious factoring program. The trustee had therefore successfully invoked the "Ponzi presumption" under which payments made in furtherance of such a scheme were presumed to be fraudulent.

- Jenkins v. Ward *(In re Jenkins)*, 2013 U.S. Dist. LEXIS 128936 (W.D.N.C. Sept. 6, 2013). Actual fraud was proven where a creditor had obtained a judgment against the debtor prior to the bankruptcy petition, and the debtor's wife's repeated admissions that the debtor transferred the funds with the purpose of retaining access to them for his own use, spoke so directly to the intent of the parties as to vitiate any genuine issues of material fact; the transfer was fraudulent and designed to allow the debtor to continue to use the funds even as they were placed outside the reach of the creditors.

- Triangle Bank v. Eatmon, 143 N.C. App. 521, 547 S.E.2d 92 (2001). Summary judgment was properly granted to a bank seeking to set aside real property transfers by a loan guarantor to her children and their spouses based on the following statutory factors: transferring the property to insiders; retaining control and income of the property after the transfers; making the transfers after a suit had been threatened or initiated; transferring almost all of the transferor's assets; and receiving less than reasonably equivalent value for deeded property.

- Teague v. Thompson *(In re Teague)*, 2013 Bankr. LEXIS 1742 (Bankr. W.D.N.C. Apr. 29, 2013). Pursuant to 11 U.S.C.S. § 548 and 550, trustee was allowed to recover property fraudulently transferred by debtor to his wife prior to filing for bankruptcy because the evidence showed several badges of fraud with respect to these transfers, including badges of fraud listed under North Carolina's version of the Uniform Fraudulent Transfer Act (UFTA), G.S. 39-23.4(b), leading to the conclusion that the debtor sought to shield assets from creditors by transferring them to his spouse, and the parties' separation and eventual divorce was simply a tactic to shield any appearance of impropriety. Trustee, however, was not permitted to recover all the property listed in the complaint because some of the transfers occurred more than two years before the petition was filed or were otherwise not supported by competent evidence.

In the following examples, the creditor was unable to avoid an alleged fraudulent transfer:

- Norman Owen Trucking Inc. v. Morkoski, 131 N.C. App. 168, 506 S.E.2d 267 (1998)(decided under pre-UFTA law). The creditor contended that certain payments to the debtor employee were fraudulent conveyances. The court reversed the trial court and remanded for entry of JNOV in favor of the debtor employee. The court found that the conveyances were not fraudulent because the creditor failed to present sufficient evidence. Fraudulent conveyances were not proven where (1) the checks, or alleged paychecks, were not shown to be voluntary or "not for value," (2) the agreed pay was not shown to be unreasonable, and (3) the creditor failed to show that fraudulent intent existed with debtor employee's knowledge. At a minimum, an actual intent to defraud creditors on the part of the debtor had to be shown, and more than "balance sheet insolvency" was required to be shown.

- Mascaro v. Mountaineer Land Group, LLC, 2006 NCBC 18 (N.C. Super. Ct. 2006). Dismissing for failing to state a claim under N.C.G.S. § 39-23.4(a)(1) when plaintiff did not make an allegation of debtor's intent to hinder, delay, or defraud creditors.

C. FIDUCIARY DUTIES AND CONFIDENTIAL RELATIONSHIPS

A careful lawyer will usually wonder what the client is not telling them. This is particularly true when considering asset protection planning or asset availability to pay creditors. A careful lawyer will ask a client what, if any, discussions the client may have had with his or her spouse about the creation and funding the creation and funding of a trust. The client's responses are relevant not just for determining the spouse's potential marital interest in the trust in a future equitable distribution proceeding but also considering whether the client may have committed constructive fraud.

1. Confidential Relationships

North Carolina law places special duties on parties to a confidential relationship. A transaction between the parties must be "fair and reasonable" in order to be valid. Sidden v. Mailman, 150 N.C. App. 373, 377, 563 S.E.2d 55, 58 (2002). This includes a duty to disclose all material facts related to a transaction between the parties. Searcy v. Searcy, 215 N.C. App. 568, 572, 715 S.E.2d 852, 857 (2011). "A presumption of fraud arises where the fiduciary in a confidential relationship benefits in any way from the relationship." Lancaster v. Lancaster, 138 N.C. App 459, 530 S.E.2d 82 (2000). Accordingly, the party asserting the validity of a transaction bears the burden of showing the transaction was entered into voluntarily by the other party. Id.

The marital relationship has been declared the "most confidential of all relationships" Sidden v. Mailman, 150 N.C. App. at 377, 563 S.E.2d at 58. "During a marriage, a husband and wife are in a confidential relationship ... [and] have a duty to disclose all material facts to one another, and failure to do so constitutes fraud." Searcy v. Searcy, 215 N.C. App. at 572, 715 S.E. 2d at 857. Unlike ordinary fraud claims, a constructive fraud claim does not require allegations of a specific misrepresentation. A constructive fraud claim requires only that the aggrieved party allege the presence of a fiduciary or confidential relationship which led to and surrounded the transaction in which the plaintiff alleges damages due to the defendant's breach of his or her position of trust. Id. at 573.

A constructive fraud claim can be a valuable weapon for a divorcing spouse. Some examples include:

- Searcy v. Searcy, 215 N.C. App. 568, 715 S.E.2d 852 (2011). Former wife filed a complaint against former husband alleging breach of fiduciary duty and constructive fraud. Wife claimed that husband had failed to disclose certain assets when the parties entered a separation agreement. The Court of Appeals ruled in favor of ex-wife indicating that at the time the separation agreement was entered, husband and wife were in a confidential relationship. Neither party had retained lawyers or separated from each other. Accordingly, a genuine issue of material fact existed regarding ex-wife's cause of action for constructive fraud. Id. at 574.

- Harroff v. Harroff, 100 N.C. App. 686, 398 S.E.2d 340 (1990). Wife sued to rescind separation agreement after entry of judgment claiming breach of fiduciary duty. Wife specifically claimed husband concealed assets or asset values at a time the parties were in a confidential relationship. The Court ruled that genuine issue of material fact existed as to whether a confidential relationship between husband and wife existed at the time the separation agreement was executed and as to whether husband concealed assets or asset values in breach of his fiduciary duty.

- Cline v. Cline, 297 N.C. 336, 255 S.E.2d 399 (1979). Wife filed an action against husband claiming a resulting or constructive trust should be established over an interest in farm property. The Court held that wife sufficiently pled a cause of action for breach of the confidential relationship by alleging husband took title to farmland in his name alone after representing to wife that the land would be theirs jointly after the mortgage was paid.

- Link v. Link, 278 N.C. 181, 179 S.E.2d 697 (1971). Wife filed suit to rescind transfer of corporate stock and debentures to husband for fraud, undue influence and duress. Wife claimed husband was responsible for business matters and regularly asked her to sign documents related to their personal and business affairs. Wife alleged that husband caused her to sign papers transferring her interest in the stock and debentures to husband without disclosing the purpose of the documents while threatening that husband would take the children if she did not sign. The jury returned a verdict in favor of wife. The Supreme Court affirmed citing, in part, the confidential relationship between the parties and the duty of the husband to exercise the utmost good faith in the transaction and to disclose all material facts relating thereto.

2. Limitations on Claims

Breach of fiduciary duty claims are subject to notable limitations in the context of the marital relationship. First, the confidential relationship generally terminates when the parties separate or one party hires an attorney to commence divorce proceedings, although neither fact is necessarily determinative. Sidden v. Mailman, 150 N.C. App. 373, 563 S.E.2d 55 (2002)(stating "duty ends when the parties separate and become adversaries negotiating over the terms of their separation" and when "one or both of the parties is represented by counsel); Lancaster v. Lancaster, 138 N.C. App. 459, 530 S.E.2d 82 (2000)(holding no confidential relationship where husband was represented by counsel and the exclusive representation was communicated to wife).

Second, breach of fiduciary duty claims must arise from a specific transaction or transactions between the parties. In Smith v. Smith, 113 N.C. App. 410, 438 S.E.2d 457, former husband filed suit alleging breach of fiduciary duty, unjust enrichment and intentional marital destruction against former wife. The plaintiff brought his claims after entry of the equitable distribution order. The trial court dismissed the husband's action and the appeals court affirmed stating, in relevant part:

> Plaintiff has failed to provide evidence of any agreement or transaction between him and the defendant which would constitute the basis for the breach of fiduciary duty. He does attempt to analogize the marital relationship to a business partnership, arguing that marital partners have a duty to exercise good faith and integrity in their dealings with each other in the affairs of their "partnership." According to this argument, since a business partner could be required to account to the partnership for misappropriated partnership funds, defendant should likewise be held accountable for misappropriated marital funds. Although we believe that the relationship between married persons demands the highest level of integrity, we refuse to impose on it the strict duties of a business partnership.

Smith v. Smith, 113 N.C. App. at 413. Accordingly, the marital relationship is not equivalent to a business partnership. *Smith* holds that a spouse is not required to account for every transfer of marital funds. Instead, a spouse must allege breach of a duty with regard to a specific transaction *between* the married couple in order to state a claim for breach of the confidential relationship.

3. Fiduciary Duties based on Non-Marital Relationships

A married couple may owe a fiduciary duty to one another based on a relationship of trust and confidence arising from a status outside the scope of the marital relationship. A nonexclusive list of examples may include circumstances in which the married couple are partners or owners in a business, trustee and beneficiary of a trust, attorney-in-fact and principal, or even joint owners with respect to specific property. *See, e.g.,* Kaplan v. O.K. Technologies, L.L.C., 196 N.C. App. 469, 675 S.E.2d 133 (2009)(stating a "controlling shareholder owes a fiduciary duty to a minority shareholder); N.C. Gen. Stat. §36C-8-801 (duty to administer trust in good faith, in accordance with its terms and purposes and the interests of the beneficiaries); Albert v. Cowart, 727 S.E.2d 564, 570 (N.C. App. 2012)(stating "[t]he relationship created by a power of attorney between the principal and the attorney-in-fact is fiduciary in nature"); Dixon v. Gist 724 S.E.2d 639 (N.C. App. 2012)(holding fiduciary relationship existed by virtue of defendants becoming joint account holders on plaintiff's primary banking account with the purported purpose of helping plaintiff with her daily necessities and monthly obligations). A comprehensive discussion of the circumstances in which a fiduciary duty may arise is beyond the scope of this manuscript. However, practitioners should recognize the potential for a fiduciary relationship under circumstances in which one party has placed special trust and confidence in another party.

D. Marital Rights Upon the Death of a Spouse

It is important to distinguish claims made by spouse during the client's lifetime and claims made upon the client's death. Even if the client's spouse does not have a marital interest in the trust assets during the client's lifetime, the spouse may have an interest upon the client's death. A trust that holds only separate property may be considered an asset of the settlor for certain purposes upon his or her death. As a result, it is imperative that the client consider the spouse's rights upon his death, particularly the spouse's right to an elective share.

In North Carolina, a surviving spouse has a right to claim an elective share against the deceased spouse's estate generally equal to the total value of the deceased spouse's assets minus the value of the property considered passing to the surviving spouse. G.S. §30-3.1(a). A surviving spouse includes a spouse that is living separate and apart from the deceased at the time of his death. For decedent's dying on and after October 1, 2013, the elective share is a percentage of the deceased spouse's estate ranging from 15% to 50% depending on the number of years the couple was married. Id. Importantly, the deceased spouse's assets for this purpose includes more than probate assets. The proceeds of life insurance policies, retirement plan benefits, and even gifts made by the deceased spouse within a year prior to his or her death are generally included. G.S. §30-3.2. Accordingly, assets transferred to a trust within the year prior to death would generally be subject to the spouse's right to an elective share.

The right to an elective share may be waived by a spouse either before or after the marriage in writing provided the waiver is voluntary and the spouse is either provided a fair and reasonable disclosure of the property and financial obligations of the decedent or the spouse waives that right in writing. G.S. §30-3.6. A trust may also be established for the benefit of the spouse that qualifies any property held by such trust as passing to the surviving spouse for elective share purposes.

IV. REACHING ASSETS IN TRUST IN THE MARITAL CONTEXT

A. PROCEDURAL MATTERS

1. North Carolina

In North Carolina, the court's jurisdiction for suits involving trusts has traditionally been in Superior Court. See N.C.G.S. 36C-2-203. If a party believes that a trust is holding marital assets, the trust should be joined as a party in the equitable distribution case filed in District Court. See *Nicks v. Nicks,* 774 S.E.2d 365 (N.C. App. 2015). North Carolina might or might not have jurisdiction over an out-of-state trustee based on our "long-arm" statute and minimum contacts analysis. See N.C.G.S. 1-75.4 and *International Shoe vs State of Washington*, 326 U.S. 310, 66 S.Ct. 154 (1945).

2. Federal Jurisdiction

As a general rule, diversity of citizenship does not grant access to Federal District Courts for divorce, child custody, child support, alimony, and equitable distribution establishment cases. Parties might have access when making tort claims. See the *Marshall v. Marshall* case below and also Justice Ginsberg's dissent in *City of Chicago v. International College of Surgeons*, 522 US 156, 190 n6. In *Cohens v. Virginia,* Chief Justice Marshall famously cautioned:

> It is most true that this Court will not take jurisdiction if it should not: but it is equally true, that it must take jurisdiction if it should... We have no more right to decline the exercise of jurisdiction which is given, than to *299 usurp that which is not given." 6 Wheat. 264, 404, 5 L.Ed. 257 (1821). Among longstanding limitations on federal jurisdiction otherwise properly exercised are the so-called "domestic relations" and "probate" exceptions. Neither is compelled by the text of the Constitution or federal statute. Both are judicially created doctrines stemming in large measure from misty understandings of English legal history. See, *e.g.*, Atwood, Domestic Relations Cases in Federal Court: Toward a Principled Exercise of Jurisdiction, 35 Hastings L.J. 571, 584–588 (1984); *Spindel v. Spindel*, 283 F.Supp. 797, 802 (E.D.N.Y.1968) (collecting cases and commentary revealing vulnerability of historical explanation for domestic relations exception); Winkler, The Probate Jurisdiction of the Federal Courts, 14 Probate L.J. 77, 125–126, and n. 256 (1997) (describing historical explanation for probate exception as "an exercise in mythography"). In the years following Marshall's 1821 pronouncement, courts have sometimes lost sight of his admonition and have rendered decisions expansively interpreting the two exceptions. In *Ankenbrandt v. Richards*, 504 U.S. 689, 112 S.Ct. 2206, 119 L.Ed.2d 468 (1992), this Court reined in the "domestic relations exception." Earlier, in *Markham v. Allen*, 326 U.S. 490, 66 S.Ct. 296, 90 L.Ed. 256 (1946), the Court endeavored similarly to curtail the "probate exception."

<u>Marshall v. Marshall</u>, 547 U.S. 293, 298-99, 126 S. Ct. 1735, 1741, 164 L. Ed. 2d 480 (2006)

In *Marshall*, Vickie Lynn Marshall, a.k.a. Celebrity Anna Nicole Smith, married an elderly wealthy man, J. Howard Marshal. After Mr. Marshall's death, there was a probate battle in Texas State Courts in which Anna Nicole Smith ultimately did not prevail. She filed for Chapter 11 Bankruptcy in California and filed a claim against her deceased husband's son, E. Peirce Marshall, claiming he tortuously interfered with a gift she expected from J. Howard. The United States Supreme Court allowed the claim by stating it was not barred by the "probate exception". See *Marshall v. Marshall*, 547 U.S. 293, 26 S. Ct. 1735, 64 L. Ed. 2d 480 (2006). The case was remanded and both parties died. After both parties died, the case was again appealed to the United States Supreme Court. Howard K. Stern, as Executor of the Estate of Vickie Lynn Marshall, was substituted as Plaintiff. In a 5-4 decision, the Supreme Court held that the Bankruptcy Court lacked authority under Article III of the United States Constitution to enter a final judgment on the claim. See *Stern v. Marshall*, 131 S.Ct. 2594 (2011).

While *Marshall v. Marshall* is a probate case, it might provide a roadmap in family law cases for obtaining Federal jurisdiction over of an out-of-state trustee by filing a Bankruptcy claim in Federal Court. *Stern v Marshall* should be instructive in such litigation.

B. <u>CLAIMS CHECKLIST</u>

The following represents a simple preliminary questionnaire for practitioners seeking to initially evaluate whether the assets held in trust may be subject to the marital rights of a spouse. The questions are not necessarily ordered by importance:

Question 1: Does the Trust contain Marital Property? A threshold question in the marital context is whether the trust contains marital property. If the trust only contains inherited assets or other non-marital property, then there appears to be no basis to claim property in the trust is subject to equitable distribution.

Question 2: What law governs the Trust and a party's right to reach assets in the Trust? If the law designated in the trust instrument is contrary to the "strong public policy" of North Carolina then the Court should apply the law of North Carolina despite a contrary provision in the trust instrument. G.S. §36C-1-107(a)(1) For example, in a Utah equitable distribution action the Court applied Utah law to a trust holding marital assets belonging to a Utah couple. Dahl v. Dahl, *supra*. Other Courts looks to the number and quality of the connections of the trust in question to the matter before the Court. (*See* Section II.A 1.a above).

Question 3: Does the State of North Carolina have Jurisdiction over the Trust? North Carolina's long-arm statute, G.S. §1-75.4(12), gives courts jurisdiction over "any action under Chapter 50 that arises out of the marital relationship within this State" so longs as there are sufficient minimum contacts between the trust and North Carolina to enable the court to exercise personal jurisdiction over the trustee. In the case of foreign trusts, the trustee may be in a jurisdiction that does not recognize the validity of judgments from the United States.

Question 4: Is the Trust a Revocable Trust? If the Trust is revocable by the spouse in question, then the assets are subject to the claims of settlor-spouse's creditors. If the Trust is not a revocable trust, then it is irrevocable and more analysis is needed.

Question 5: Who is the "Settlor" of the Irrevocable Trust? Under G.S. § 36C-1-103(17) a settlor is anyone who contributes property to a trust. At least one jurisdiction has held that when marital property is contributed to a trust, then both spouses are settlors with respect to that marital property. *See* Dahl v. Dahl, *supra*. It remains to be seen whether this rule will be adopted in other jurisdictions.

Question 6. If the Spouse is not the Settlor, but the Spouse sold marital property to the Trust, was the sale an arm's length transaction? Nicks v. Nicks, discussed *supra*, is notable given the spouse sold assets to the beneficiary controlled trust in exchange for notes. The court appeared bothered by the terms of the notes as they did not appear to have a value equivalent to the value of the assets sold.

Question 7: If the Spouse is a Settlor, may Assets in the Trust be Distributed to the Settlor-spouse? If the settlor is also a beneficiary of an irrevocable trust, then, according to North Carolina law, a creditor can reach the maximum amount that can be distributed to the settlor from that irrevocable trust. G.S. § 36C-5-505(a)(2). If there is more than one settlor, then the creditor can only reach the portion of the trust attributable to that settlor's contribution. Id. (*See* Section II.A.2.a. above.) However, exceptions exist for domestic and foreign asset protection trusts to the degree those protective trusts are enforceable in North Carolina.

Question 8: Did a Spouse commit a Fraudulent Transfer? Was the trust in question created or funded at a time when separation was imminent? If so, the transfer may have been intended to hinder, delay or defraud a creditor of the debtor. A fraudulent transfer is void under North Carolina law. (*See* Section III.B above.)

Question 9: Did the Spouse commit Fraud or Constructive Fraud when transferring assets to the Trust or creating the Trust? Were any misrepresentations made? If a fiduciary duty is found to exist, then there may be a duty to disclose material facts as well as a presumption of fraud. A fiduciary duty may exist because of the marital relationship, or it may exist because of the spouses or partners are owners of a business, the trustee and beneficiary of a trust, the attorney-in-fact and principle, or are the joint owners with respect to the property (*See* Section III.C above.)

Question 10: Is the Trust nothing more than the Alter-ego of the Settlor/Beneficiary? If the settlor has complete dominion and control over the trust then an argument exists that the trust is nothing more than the alter-ego of the settlor. Beneficiary's and settlor's may retain significant rights and powers over the trust. It is only when those rights and powers are so extensive that there is really no separation between the identity of the settlor/beneficiary and the identity of the trust that this claim can be asserted. Importantly, North Carolina law expressly permits settlors and beneficiaries to have extensive rights and powers in a trust without subjecting the trust assets to the claims of creditors. Accordingly, just as in corporate law, the alter-ego theory should be rarely applied to trusts.

Question 11: Does the Trust Violate the Public Policy of North Carolina? A trust may only be created to the extent that its purposes are lawful and not contrary to public policy. G.S. § 36C-4-404. The official comment to that statute states that a trust created to defraud creditors is a trust that violates the public policy of North Carolina. Id., Official Cmt. The official comments also provide that a trust that is unlawful or against public policy is "invalid". Id. (*See* Section II.A.1.a above.)

Question 12: May the Court Impose a Constructive Trust over the Trust Property? If marital assets are wrongfully transferred to a third party then, under some circumstances, the Court can impose a constructive trust over those assets for the benefit of the marital estate. Nicks v. Nicks, 774 S.E.2d 365 (N.C. App. 2015). The third party holding the marital assets must be made a party to the equitable distribution action. Id. North Carolina courts have also used a constructive trust theory to pursue marital property being held by a third party. E.g. Upchurch v. Upchurch, 122 N.C. App. 172, 468 S.E.2d 61, disc. rev. denied, 343 N.C. 517, 472 S.E.2d 26 (1996).

V. <u>CONCLUSION</u>

A number of planning tools provide varying degrees of protection from creditors, including a divorcing spouse. Trusts, in particular, can be useful for this purpose provided they are properly timed, structured and implemented. No asset protection tool is absolute. In many cases, the benefit may simply be creating an additional barrier that promotes a more favorable settlement of the matter. Practitioners must be cautious particularly when dealing with the rights of the spouse. Some tools that provide general protection from creditors provide no protection from the claims of a divorcing spouse.