Protecting Assets from a Spouse as a Future Creditor; North Carolina Courts Will Enforce "Divorce Clauses" in Trusts

As published in *The Will and the Way*, a publication of the North Carolina Bar Association

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Recently, the North Carolina Court of Appeals held that a clause in a trust settled by a husband for the benefit of his wife that terminated her beneficial interest upon divorce was enforceable and not contrary to public policy. **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 N.C. LEXIS 287 (N.C. Apr. 9, 2015). This decision confirms the validity of an important tool for asset protection from spouses as creditors and points out some areas of caution for practitioners.

Ward v. Fogel

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. **Ward**, 2014 N.C. App. LEXIS 1248, at 24 (*quoting* N.C.G. S. § 36C-4-404). 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. *Id.* (*citing* N.C.G.S. § 31-5.4). 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." *Id.* (*quoting Restatement (Second) of Trusts § 62 comment e).* 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 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.

Features Present In Trust I.

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;[i] (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;[ii] (g) the wife was not involved in the creation of the Trust.

It is not known whether literally all of the above features need to be present for a future trust to be upheld.

Attorney/Client Issues.

The same attorney drafted Trust I and Trust II. Even though the husband was the Settlor of Trust I and the wife was the Settlor of Trust II, the attorney testified that he believed he represented only the husband in both transactions. The wife testified that she believed the attorney represented her in connection with the creation and execution of Trust II. This confusion about representation could have been avoided through the use of clear written agreements and acknowledgments of representation or absence of representation executed by the Husband and the Wife.

Conclusion

A trust settled for the benefit of a spouse for only so long as the spouse remains married to the settlor is a potentially powerful asset protection tool that does not violate North Carolina's public policy. Practitioners employing this tool should take care that the trust is otherwise valid and ensure that the scope of their representation is clear. The precise factors that need to be present to make such a trust valid under North Carolina Law remain to be developed by future cases.

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[i] The existence of creditors at the time of the creation of the Trust could cause the transaction to be deemed a transfer in fraud of creditors in violation of N.C. Gen. Stat. § 39-23.4

[ii] The trustees of Trust I were authorized to reimburse the Grantor for any tax on trust income or principle that was payable by the Grantor, as authorized by N.C. Gen. Stat. § 36C-5-505(a)(2a).

Biographical Data

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