Question 5 – July 2014 – Selected Answer 1

(I) The IRS lien can be reached by either Trust and paid likely by principal, Hospital Bill can reach either trust and likely paid by principal, the unpaid child support can reach either trust and likely to be paid by principal, the unpaid shopping channel cannot reach EITHER of the trusts, the adverse judgment can only reach Trust Ii and will likely be paid out of principal. There are several issues here: (1) whether a creditor can go after the settlor of trust who has a revocable power, (2) whether a spendthrift clause protects against the discretion of the trustee, (3) whether child support can be reached even through a spendthrift clause, and (4) out of principal or income must the trustee distribute for each claim.

(a) IRS lien. The IRS lien can be reached through both Trusts and it can be through either the principal or the income. The issue is whether an IRS lien can be reached by the IRS through two trusts that both have a spendthrift clause. Under Trust law, there are five exceptions to the spendthrift clause, and IRS liens are one of the exceptions that can be reached, REGARDLESS of the spendthrift clause. Although a valid spendthrift clause protects the settlor and beneficiary against voluntary or involuntary creditor claims, an IRS lien is an exception to this rule. Therefore, the IRS lien can be satisfied by either Trust I or Trust II. Furthermore, even if IRS lien was not an exception to the spendthrift clause, IRS could still reach Trust II, because any interest held by the settlor or even the whole trust if it is revocable, can be reached by creditors disregarding the valid spendthrift clause. Thus, since Trust II is a revocable trust, Sara's IRS lien can reach Trust II, because she is the settlor and the trust is revocable.

The second issue is whether the principal or income should be used. As for taxes, under the Uniform Interest and Principal Act, the income is used to pay off taxes. And principal is used to pay off improvements or large claims such as insurance casualty claims or liens. Here, this is a lien by the IRS, so although it pertains to taxes, it is likely that it will be paid by the trust principal. Further, since the trust distributions are in the sole discretion of the trustee, if the settlor could reach the trust amount by the trustee's discretion to distribute, then so can the IRS. Therefore, the IRS lien can be reached through Trust I or Trust II, regardless of the spendthrift clause because it is an exception, and it could be distributed from principal or income, because it is a tax so it will likely come out of income, but it is a lien so there is an argument that it will come out of the principal. Note that since the trustee has sole discretion, and under the Uniform Interest and Principal Act, a trustee can distribute obligations between income and principal fairly and according to the needs and wants of the settlor and beneficiaries, here, the trustee will likely split the cost of the lien 50/50.

(b) Hospital Bill. The hospital bill can likely reach Trust II and Trust I, and will likely be paid through the principal. The first issue is whether a hospital bill falls under the necessary exception under the spendthrift clause exceptions, and also whether the sole discretion of trustee allows the hospital to reach the trust amounts because they are considered necessities. Note that we are assuming that the hospital bill is a necessity. Under Trust law, spendthrift clause that are valid (as stated by the facts) are valid against any creditors or even the beneficiaries for voluntary or involuntary transfers. However, there are exceptions to the rule, and necessaries is one such exception. Further, when the trustee has sole discretion to pay the beneficiary for "support, health and maintenance," then the creditors who provided such support, health and maintenance may reach the trust amount, because if the trustee has authority to distribute this amount to the beneficiary then so does the creditor can reach it, however, that argument is likely not as valid as the exception to the spendthrift clause. Thus, although both trusts have a spendthrift trust, the hospital bill because it is a necessity can be reached over the valid spendthrift clause. Second, even if they could not be reached through the exception, because the hospital bill falls under "support, health, and maintenance" and the trusts both give the trustee sole discretion, then the beneficiary could reach the trust amount to get paid for her necessaries, and then so can her creditors.

Second issue is whether this is paid through income or principal. Although usually the trustee has discretion to allocate principal or income distributions and costs per the UIPA, here, the settlor explicitly has allowed the trustee to pay out of the trust principal for "support, health and maintenance," therefore, the hospital bill will be paid through the trust principal.

(c) Unpaid Child Support. The unpaid child support can be reached by the creditor through either Trust I or Trust II, and it will likely be paid through principal. Although a valid spendthrift clause protects the settlor and beneficiary against creditors, there are exceptions including arreared child support. Further, even if a trust has a spendthrift clause, any interest held by the settlor or if it is a revocable trust then the whole trust is subject to creditors, because that is also an exception to the spendthrift clause. Therefore, here, because the obligation is for an unpaid child support of Sara, the settlor, the obligation can be reached through Trust I or Trust II. Furthermore, since the trustee has discretion to pay out of the trust principal for "support, health and maintenance," the court will likely deem the authority to include child support because it is a "support" debt. The second issue is whether it will be paid with principal and/income. The trustee has some

discretion on distribution costs through principal or income amount. A child support, because it is paid monthly and is deemed for support, is income, therefore the obligation will be paid with the income of the trust. However, if the court deems it to fall under the "support" language of the trust, then it may pay out of the trust principal, especially since the income is described to be distributed to the beneficiary only, which is Sarah's mother, and this is Sarah's debt or obligation.

(d) The Unpaid Shopping Channel Charges. The creditors of the unpaid shopping channel of the mother's charges will not be able to reach ANY of the trusts. The issue is whether a charge for jewelry can be charged against trusts that have a valid spendthrift clause. A spendthrift clause protects the beneficiary against both voluntary and involuntary transfers from the trust by the beneficiary's creditors. Here, the mother owes the Shopping Channel for costume jewelry. Further, the jewelry will likely not fall under "support, health, and maintenance." Though there may be an argument that the trustee has sole discretion on distributing to the beneficiary, this will likely not be deemed enough to have the trustee distribute to the Shopping Channel creditors. However, the Shopping Channel could file a claim against the Mother AFTER she receives the income, but it would have to wait for it to be distributed and then file a claim for the distribution, because once income is distributed to a beneficiary, it is no longer protected by the spendthrift clause.

(e) Adverse Judgment Obtained Against Sara. The adverse judgment against Sara by a former business partner in a contract dispute will likely be able to only reach Trust I. The issue is whether a creditor can reach a settlor's trust interest if the trust is revocable by the settlor. Under Trust law, a spendthrift clause protects trust property against creditors, however, any interest retained by the settlor, or even if the trust is revocable by the settlor can be reached by its creditors. Here, Trust II is silent regarding revocability and thus likely deemed revocable, because otherwise it would say irrevocable and it would have to say irrevocable if it was irrevocable. Because it is revocable and Sara is the settlor (because she created the trust), the adverse judgment can reach her interest in Trust II.

(II) The second issue is whether it should be satisfied with principal or income. Adverse judgments are usually satisfied with principal, and therefore this will likely be satisfied with the principal. Further, the trust gives sole discretion to the trustee to distribute the income to the mother, not Sara the settlor, and allows for him to distribute the principal for either Sara or her mother for "support, health and maintenance," therefore the adverse judgment will likely be paid with the principal.

Question 5 – July 2014 – Selected Answer 2

At issue is when a creditor can reach trust property designated as trust income or trust principal. This answer will depend on the type of trust along with the manner of the debt owed. For an irrevocable trust with a valid spendthrift clause, the settlor's creditors generally may not reach the trust principal in which the settlor has not retained an interest. Exceptions to this rule exist for child support obligations, federal and state tax liens and contracts for necessaries. For revocable trusts, the settlor's creditors may reach the principal of the trust property. In Texas, trusts that are silent on the issue of revocability are deemed to be revocable.

A beneficiary's creditor may reach any of the income actually disbursed to the beneficiary. If the trustee has sole discretion over when disbursements may be made, the creditors generally cannot reach the principal. Exceptions include creditors for contracts for necessaries, child support obligations, tax liens, and any obligations expressly authorized by the trust to be paid out of principal.

(a) The IRS lien against Sara may be satisfied by the principal of either trust and the income of either trust that that she receives as a beneficiary of each trust. As noted above, IRS tax liens fit the exception to the general rule and may recover the principal of a settlor's trust, even if the trust is irrevocable. Therefore, the lien may reach the principal of each trust. Furthermore, any income that is to be disbursed to Sara may be used in satisfaction of the lien. Because Sara's mother is not party to the lien, any income disbursed to her is not subject to the lien.

(b) The hospital bill may be satisfied from the principal of either trust, or the income disbursed to Sara's mother (the debtor). Here, the trusts specifically authorize payments from the principal for the "support, health and maintenance," of Sara and her mother. A hospital bill would almost certainly qualify in that manner. The bill would also likely qualify as a contract for necessaries. Therefore, creditors may reach the principal of either trust. They may also reach the income disbursed to Sara's mother, but may not reach Sara's trust income because she is not indebted to the hospital.

(c) Like the IRS lien against Sara, child support obligations are generally not protected against by placing them in a trust, including an irrevocable trust with a spendthrift clause. Therefore, the principal of either trust may be used to satisfy the obligation. Furthermore, any income disbursed to Sara may also be used in satisfaction.

(d) The shopping channel bills can only be satisfied by the income disbursed to Sara's mother. Because Sara's mother has no power to compel disbursements, she has no interest in the trust principal until it becomes hers. Because the shopping channel expenses are not for necessaries nor are they subject to any other exception to the general rules, they may not reach any trust principal.

(e)The judgment creditor may reach the trust income disbursed to Sara from either trust, and the trust principal only from Trust II (the revocable trust). The creditor may not reach the trust principal in Trust I (the irrevocable trust).

Texas gives full effect to spendthrift clauses in Texas with few exceptions. One such exception is for trusts that are revocable, because the settlor could revoke the trust at any time and reclaim all of the property. As mentioned above, trusts that are not specifically made irrevocable are revocable. Therefore, the creditor may reach the principal in Trust I. However, the irrevocable nature of Trust II coupled with a valid spendthrift clause mean that Sara has retained no interest in Trust II principal. The creditor may only levy on the income as it is disbursed to Sara.

Question 5 – July 2014 – Selected Answer 3

1(a). The IRS lien may attach to Sara's income from either trust, and to the principle of either trust. At issue is the scope of an IRS tax lien with regards to trusts. Trusts have the potential to protect assets from creditors. Under a trust agreement, the trustee takes legal title to the trust subject to the beneficiary's rights to income according to the terms of the trust agreement. If the trust agreement contains a valid spendthrift clause, the principal of the trust may be protected from creditors. A spendthrift clause prohibits the beneficiary from assigning or transferring his interest in the trust, and denies creditors the right to collect from the principal of the trust. Income from trusts is always subject to creditor interests, however, because once income under the trust is distributed, the trustee no longer has legal title over it and creditors may treat it as the asset of the beneficiary. Moreover, the principal of a trust is not always safe from creditors. To the extent the debtor beneficiary has control over the principal of the trust, the principal is reachable by creditors. Therefore, revocable trusts may always be reached by the settlor's creditors, because the settlor has ultimate control over the principal of the trust. Trusts in Texas are by default revocable. In order to be irrevocable, the trust agreement must explicitly so state.

Here, Trust I is a valid irrevocable trust with a spendthrift clause. The trust agreement explicitly states it is irrevocable, and the facts indicate the trust has a valid spendthrift clause. However, certain creditor interests overcome even a valid spendthrift clause and can attach to the principal of the trust. Those creditor interests include IRS tax liens and unpaid child support.

Trust II is a valid trust, but is revocable by Sara, the settlor, and has a valid spendthrift clause. As discussed above, trusts in Texas are by default irrevocable unless otherwise specified. The trust agreement here does not explicitly state it is irrevocable, so Trust II is revocable.

Here, Sara has an IRS tax lien for unpaid taxes. That lien can attach to her income from both trusts, which she has legal title to, and to the principal of both trusts because it overcomes the spendthrift clause in Trust I, and overcomes the spendthrift clause in Trust II and would be attachable anyway because Sara is the settlor and Trust II is revocable.

1(b). The money judgment may be collected from Sara's mother's income from either trust, or from the principal of either trust. At issue are a creditor's rights when the debt is explicitly related to a discretionary function of the trustee. While a spendthrift clause generally protects the principal of a trust from creditors, where the trustee has discretion to make distributions from principal for the purpose under which the debt falls, the trustee must do so. Here, the trustee for both trusts is authorized to make distributions from principal for both beneficiaries' "support, health, and maintenance." An unpaid hospital bill qualifies as a debt for "support, health, and maintenance." The judgment creditor can therefore reach the principal of both trusts despite the spendthrift clauses to collect the debt against Sara's mother.

1(c). The unpaid child support may be collected from Sara's income from either trust, or from the principal in either trust. Again, income is reachable by any creditor because it is no longer the legal property of the trustee. And a creditor of the settlor may collect from a trust's principal when the trust is irrevocable, because the settlor has ultimate control over the disposition of the trust. In addition, unpaid child support payments may be collected from trust principal as against a beneficiary regardless of the presence of a spendthrift clause. Here, Trust II can be reached easily because Sara is the settlor of the trust and the trust is revocable. Sara has ultimate control over the disposition of the trust and the child support creditor can reach its principal. Trust I may also be reached because despite its irrevocability and valid spendthrift clause, child support debts overcome spendthrift clauses and render the principal reachable. Child support may be collected from Sara's income and the principal of either trust.

1(d). The unpaid Shopping Channel charges may be collected only from Sara's mother's income from the trusts. As discussed, income from trusts is fully reachable because it becomes the legal personal property of the beneficiary once distributed. However, trust principal is guarded from the beneficiary's creditors if there is a valid spendthrift clause in place. And the revocability of a trust has no bearing on a creditor's rights as to a beneficiary as long as the beneficiary is not also the settlor. Here, Sara's mother is only a beneficiary of Trust I and Trust II. Both trusts contain valid spendthrift clauses. Therefore, neither trust's principal is reachable by a creditor for a shopping debt of Sara's mother. The revocability of Trust II does nothing to bolster a creditor's rights against Sara's mother, who is a beneficiary but not the settlor.

1(e). The former business partner may reach Sara's income from either trust, or the principal of Trust II, but not the principal of Trust I. As discussed, income from a trust may be used to satisfy a creditor's claim because when it is distributed, legal title vests in the beneficiary. However, creditors may not reach the principal of a trust with a spendthrift clause to satisfy claims against a beneficiary, and may not reach principal of an irrevocable trust to satisfy claims against the settlor. Here, Sara is both the settlor and beneficiary of Trust I. Trust I is irrevocable and has a valid spendthrift clause. Thus, the principal is protected from claims against Sara in her role as both settlor and beneficiary. However, Trust II is not irrevocable. As settlor, Sara has the ultimate power of disposition over the trust. Therefore, the former business partner may reach the principal of Trust II to satisfy the claim against Sara.