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Rights of a Creditor of a Settlor to Reach the Corpus of a Revocable Trust

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RIGHTS OF A CREDITOR OF A SETTLOR TO REACH THE CORPUS OF A REVOCABLE TRUST

The purpose of this note is to examine the substantive rights of a creditor to reach the corpus of a trust when the settlor expressly reserves to himself in the trust instrument the power to revoke the trust settlement.

In analyzing this problem, an actual case will help to well-illustrate the situation involved. In *Hill* v. *Cornwall & Bro.s Assignee,*[1] an early Kentucky case, a father made a trust conveyance of real property for the benefit of his daughter at a time when he was in prosperous circumstances. The father retained full power to revoke each or any of the trust provisions. Some fifteen years thereafter, the father became indebted and made an assignment for the benefit of creditors. In attempting to reach the trust corpus, the assignee, representing the creditors, contended that the power of revocation reserved by the father in the trust instrument destroyed the conveyance and left the settlor, so far as creditors were concerned, as if no conveyance had been made. The Court in refusing to sustain this contention stated in effect that the title passed from the settlor at the date of the conveyance and if the transfer was not made for a fraudulent purpose the reservation of a power to revoke would not invalidate the trust even as to creditors. In absence of statute, this undoubtedly represents the great weight of authority.[2] If the settlor revokes the trust and recovers the trust property, the creditors, obviously, can reach the property; but they cannot compel the settlor to exercise his power to revoke the trust for their benefit.[3]

This precise problem seems not to have arisen at common law,[4] however, in modern cases one or more of several explanations are usually given to substantiate the general rule that a power of revocation reserved by a settlor is of no benefit to his creditor in attempting to reach the corpus of the trust. In *Jones* v. *Clifton,*[5] it was stated that a power to revoke is not an interest in the property which could be transferred to another, or sold on execution, or devised by will or is not to be considered a chose in action. In other cases it has been emphasized that the power to revoke does not invalidate the trust because the title passes from the settlor to the trustee at the time of the conveyance;[6] or until the power is exercised the interest remains vested as though no such power had been reserved;[7] or the power to revoke, unexercised, is a "dead thing."[8] Whatever the reason, it is quite

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[1] 95 Ky. 512, 26 S.W 540 (1894).

1 PERRY, TRUSTS AND TRUSTEES sec. 96 (7th ed. 1929); 3 SCOTT ON TRUSTS sec. 330.12 (1939); See Note, 92 A.L.R. 282 (1934) for collection of cases and annotations.

[3] RESTATEMENT, TRUSTS sec. 330 (0) (1935).

[4] Retaining a power to revoke a voluntary settlement was strongly favored at common law, and if a settlor did not reserve such a power it was open to suspicion of an undue advantage being taken of him. Also at common law, if a person had a power of appointment it was held that his creditors could not reach the property if the power was not exercised, even though the power was a general power of appointment. If, however, the donee of a general power exercised it by appointing to others than his creditors, the creditors might reach the property.

[5] 101 U. S. 225, 25 L. Ed. 908 (1880).

[6] Gall v. Union Nat. Bank of Little Rock, 203 Ark. 1000, 150 S.W 2d 757 (1942); Hill v. Cornwell & Bro. Assignee, 95 Ky. 512, 26 S.W 540 (1894).

[7] National Newark & Essex Banking Co. v. Rosahl, 97 N.J. Eq. 74, 128 A 586 (1925).

[8] In re Dolan s Estate, 279 Pa. 589, 124 A. 176 (1924).

clear that the settlor's power to revoke does not constitute an asset or have such other legal significance as will entitle a creditor to subject it to his claim.

Thus, the creditor normally is forced to attack the conveyance on a collateral ground. He may seek relief on the basis of a fraudulent conveyance contending that the power to revoke retained the instrument is an indication of fraud and this, together with other factors, is sufficient to put the transfer in the category of one hindering, delaying or defrauding creditors.[9]

Relief also may be sought on the theory that the trust settlement is "illusory" or "testamentary."[10] Many times where a settlor reserves to himself a power to revoke the trust, he will also reserve other powers, such as the right to manage the property, to appoint beneficiaries by will, to receive an income for life from the trust *res*, to dispose of the *res* either in whole or in part, or to direct the trustees in administering the trust. If the creditor can prove that the purported conveyance was in fact testamentary and fails to comply with the Statute of Wills, or that there was only a colorable transfer of the property, then he may treat the property as that of the settlor's.[11]

In a few states the difficulty of reaching the trust *res* by the creditor when the settlor merely reserves a power to revoke the trust has been completely remedied by statute.[12] Ohio offers a very good example. The statute there states:

> " the creator of a trust may reserve to himself any use of power, beneficial or in trust, which he might lawfully grant to another, including the power to alter, amend or revoke such trust, and such trust shall be valid as to all persons, except that any beneficial interest reserved to such creator shall be subject to be reached by the creditors of such creator, and except that where the creator of such trust reserves to himself for his own benefit a power of revocation, a court of equity, at the suit of any creditor or creditors of the creator, may compel the exercise of such power of revocation so reserved, to the same extent and under the same conditions that such creator could have exercised the same."[13]

Under a similar statute the Alabama Court has asserted that if a settlor reserves to himself a power to revoke in any conveyance, he is deemed, so far as creditors are concerned, as the absolute owner of the estate so conveyed.[14]

As a practical matter the relief open to the creditor through collateral attack is so meager as to be of little value. Attacking the trust conveyance as being in fraud of creditors too often puts upon the creditor an insurmountable hardship because it may be extremely difficult for him to sustain the burden of proof that the conveyance was made for a fraudulent purpose.[15] Then, too, the conveyance may have been executed at a time when any fraud on the part of the settlor

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[9] *cf.* Stephens v. Detroit Trust Co., 284 Mich. 149, 278 N.W 799 (1938).

[10] No differentiation is made for the purpose of this note between an "illusory" or "testamentary" trust.

[11] Burns v. Turnbull, 266 App. Div. 779, 41 N.Y.S. 2d 448 (1943).

[12] ALA. CODE ANN. tit. 47, sec. 75 (1940); II IND. STAT. ANN. sec. 56-610 (Burns, 1933); N. Y. REAL PROP. LAW sec. 145 (Thompson, 1939); 6 OHIO GEN. CODE ANN. sec. 8617 (1938). The Indiana and N. Y. statutes apply only to realty.

[13] 6 OHIO GEN. CODE ANN. sec. 8617 (1938).

[14] Blackwell v. Harbin, 186 Ala. 531, 65 So. 35 (1914).

[15] Schofield v. Cleveland Trust Co., 135 Ohio St. 328, 21 N.E. 2d 119 (1939).

would be precluded, such as in the *Hill* case[16] where the settlor was in very prosperous circumstances at the time the trust was executed.

Similarly, the creditor who seeks to set aside the transfer in trust as being "illusory" or "testamentary" is faced with considerable practical difficulty. As pointed out in the Restatement of Trusts, the settlor of a trust may reserve to himself any power which he desires with respect to the property, so long as the power so reserved is not illegal. However, the settlor in so doing may effect such a retention of control over the trust that it results in a testamentary disposition and must conform to the Statute of Wills.[17] No definite line of demarcation may be drawn from the cases as to the amount of dominion the settlor may retain in the trust so as to render it "illusory" or "testamentary." Of course, the creditors may reach those benefits so reserved,[18] such as income from the rents and profits or an income from the trust *res*, however, this may be insufficient to satisfy his claim. Further, if the settlor purports to create a trust for others but reserves possession, income, and principal to himself for life, with a power to revoke, in addition to the power of control and management, his position differs in no substantial way from a general owner, and the so-called *cestuis* interest is too nebulous and shadowy to be recognized as an equitable interest.[19] The placing of a colorable legal title in the trustee with the settlor retaining the power to revoke, control, and management over the property may result in a simple agency relation instead of a true trust.[20] Suffice it to say that in dealing with these reserved powers of the settlor, the courts have been extremely liberal in giving validity to the purported trust settlement as an *inter vivos* transfer,[21] and as a practical consequence it may be virtually impossible for a creditor to attack successfully a conveyance in trust from this standpoint.

If we assume that the payment of just debts demands respect both from a moral and legal viewpoint and that every aid, short of debtor oppression, should be given the creditor in the collection of his just claims, it seems unsound to allow the debtor to defeat the creditor s rights by disposing of the property yet reserving in himself the power of revocation. If the law allows the settlor the power to revoke the trust and perhaps to enjoy the benefits of the conveyed property at the same time, it seems logical that the power should be treated as an intangible asset which may be reached by creditors and exercised by them in the satisfaction of their claims. The very fact that the settlor reserves such a power is indicative that he does not wish to release his dominion over the trust.

The reservation of such powers in a conveyance with the vesting of legal title in the trustee and the beneficial interest in the *cestui que trust* seems to result from the historical development of technical principles of trust and property law rather than any regard for a sound policy to protect creditor s rights. Admittedly, the creditor may be criticized for extending credit without other adequate security,

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[16] Hill v. Cornwall & Bros. Assignee, 95 Ky. 512, 26 S.W 540 (1894).

[17] RESTATEMENT, TRUSTS sec. 37 (1935).

[18] Nolan v. Nolan, 218 Pa. 135, 138, 67 A. 52, 53 (1907).

[19] 1 BOGERT, TRUSTS AND TRUSTEES sec. 104 (1935); Goodrich v. City Nat. Bank, 270 Mich. 222, 258 N.W 253 (1935).

[20] Cleveland Trust Co. v. White, 134 Ohio St. 1, 15 N.E. 2d 627 (1938).

[21] 1 BOGERT, TRUSTS AND TRUSTEES sec. 104 (1935). For extreme cases where trusts have been upheld see Kelly v. Parker, 181 Ill. 49, 54 N.E. 615 (1899); Rose v. Rose, 300 Mich. 73, 1 N.W 2d 458 (1942); Cleveland Trust Co. v. White, *supra*.

but should this prejudice the creditor once he seeks to realize on what may be considered an asset? Even though the creditor did or did not have notice that the debtor had made such a conveyance with the power to revoke, once the power is recognized as an asset of the debtor it should properly be subjected to satisfy his indebtedness. The intervention of creditors of the settlor in such an arrangement impairs the traditional rights or relationship existing between the settlor, trustee and beneficiary only to the extent that the beneficiary's interest may now be defeated not only by the wish of the settlor but by creditors of the settlor if subjecting the proceeds of the trust is necessary to the satisfaction of their claims. This does not constitute a serious encroachment upon the cestui's interest since that interest was always held by him subject to a power of later being revoked. However, it is to be noted that the trust, revocable as it is, remains valid as to all other persons.[22]

It is interesting to note that this is essentially the status of the power to revoke in other fields of the law. In *Jones* v. *Clifton*,[23] for instance, a trustee in bankruptcy was seeking to reach the *res* of a trust where the bankrupt settlor had reserved a power of revocation. In refusing to allow the trustee to exercise such power the Court stated that the power to revoke was not such an interest in property which could be transferred or vested in another so as to be executed. However, since this decision the Bankruptcy Act of 1898 was enacted which provided that any powers which may have been exercised for the debtor's own benefit vest in the trustee.[24] Thus, it would appear that a power to revoke would pass to the trustee in bankruptcy so as to allow the trust corpus to be applied in satisfaction of the creditors claims.[25] Also in the field of taxation the courts regard a power of revocation as something more than just a mere power that may later be exercised so as to defeat the conveyance. In *Burnet, Commissioner of Internal Revenue,* v. *Guggenheim*,[26] there was an attempt to levy a gift tax on the donor of a gratuitous trust settlement where the settlor had reserved a power to revoke the trust in whole or in part. The Court, in refusing to uphold the tax, stated that the settlor did not succeed in divesting himself of title by transferring it to others, but the substance of his dominion was the same. In still another case[27] the First Circuit Court of Appeals stated that whenever a settlor of a trust has retained the unfettered power to make such a fundamental alteration as change of beneficaries, the corpus of the trust is includable at death in his gross estate.[28]

In conclusion it may be said that the policy of the courts in failing to recognize the power to revoke a trust conveyance as an asset of the settlor has become to firmly embedded in our jurisprudence as to lend itself primarily to legislative

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[22] The Ohio Statute, note 14 *supra*, expressly states that the reservation of such powers is valid to all persons except creditors of the creator.

[23] See note 6 *supra*.

[24] Sec. 70 a(3), 11 U.S.C.A. sec. 110.

[25] 4 COLLIER, BANKRUPTCY 992 (14th ed. 1942); RESTATEMENT, TRUSTS sec. 330 (o) (1935).

[26] 288 U. S. 280, 77 L. Ed. 748 (1932).

[27] Chickering v. Commissioner of Internal Revenue, 118 F 2d 254 (1941). See 2 BOGERT, TRUSTS AND TRUSTEES sec. 273 (1935).

[28] Note in this case the settlor was only entitled to a change of beneficiaries and not a general power of revocation.

action. By adopting statutes similar to those in the states furnishing such statutory remedy a gap in the law will be closed. As was very aptly put by a New York Court,[29]

> " As to my creditors property is mine that becomes mine for the asking, and no words can make an instrument strong enough to hold it for me, and to keep it from them."

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[29] Ullman v. Cameron, 186 N. Y. 339, 346, 78 N.E. 1074, 1076 (1906).