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ALTERNATIVES TO SPENDTHRIFT TRUSTS IN KENTUCKY

A spendthrift trust creates a right in property held by one person for the benefit of another, and contains valid provisions against alienation of the property right either by the voluntary acts of the beneficiary or by acts of his creditors. The traditional English view is to disallow spendthrift provisions.¹ This position is founded on the belief that to allow a person to enjoy the benefits of property without subjecting it to the payment of his just debts breeds idleness and promotes fraud. The argument usually given is that alienability is an inherent and inseparable incident of an equitable estate, as it is of a legal estate; that after a gift of an equitable estate, a clause forbidding alienation is contradictory and repugnant to the interest granted, and so void. However, the English have modified their strict view materially by the "pay and/or apply" doctrine, which permits a settlor to provide that trust funds or income therefrom may be applied for the benefit of the *cestui que trust* and so not be subject to the claims of his creditors, and the "protective trust" doctrine, discussed *infra*. America, in keeping with the Kantian philosophy of giving efficacy to the human will, has generally upheld the validity of spendthrift trusts. This view has been rationalized as follows: by the creation of a spendthrift trust, the trust property passes to the trustee with all the incidents and attributes of ownership unimpaired, including the power of alienation; the beneficiary takes the whole legal title to the accrued income at the moment it is paid over to him; the power of alienation in advance is not a necessary attribute of such an interest, therefore the restraint of such alienation does not introduce repugnant or inconsistent elements.

Kentucky, by statute, has taken the English view: "Estates of every kind held or possessed in trust are subject to the debts and charges of the beneficiaries thereof the same as if the beneficiaries also owned the similar legal interest in the property."² Since colonial days, this statute, and its Virginia predecessor, have been construed to prohibit restraints on involuntary alienation in spendthrift trusts. Thus a valid spendthrift trust cannot be established in this state.⁴ There are, however, a number of ways to accomplish some of the purposes of a spendthrift trust in Kentucky.

RESTRAINTS ON VOLUNTARY ALIENATION⁵

Trust provisions prohibiting the sale or assignment by the beneficiary of his interest in the trust are not governed by the above-

¹ *Branden v Robinson*, 18 Ves. 429 (1811)

² *Broadway National Bank v Adams*, 133 Mass. 170 (1882)

³ Ky. R. S. sec. 381.180 (1948).

Keith v. First National Bank & Trust Co., 256 Ky 88, 75 S.W 2d 747 (1934), and cases cited therein.

⁵ Fully discussed in *Roberts, Future Property Interests in Kentucky*, 13 Ky. L. J. 186 (1925)

mentioned Ky. R. S. sec. 381.180. This statute, by its terms, is limited in application to the loss of the beneficiary's interest through indebtedness; witness the fact that the statute has never been invoked in an attempt to invalidate a provision prohibiting voluntary alienation. Restraints against voluntary alienation fall into two general categories, as to form: those containing a provision for forfeiture upon an attempted alienation, and those containing no such provision.

Restraints on voluntary alienation with no provision for forfeiture, but meaning merely that any attempted alienation should fail, are void.⁸ The basis for this well established rule is the proposition that a transferee of a beneficiary under a grant containing such restraint obtains absolute ownership of the interest transferred, free from all contingent reversions, during the period of the grant. And it is wholly incompatible with the idea of absolute ownership to impose such a restriction, the result being that the restriction cannot be given effect.

A restraint on voluntary alienation with a provision for forfeiture (i.e., a provision that the interest of the beneficiary in the trust should cease and such interest pass to another) in case of an attempted alienation is valid, if such restraint is, in the court's opinion, reasonable. What restraints are reasonable must be determined by the particular circumstances of each case; there are no fixed limits or standards. The following have been held to be reasonable and valid in Kentucky: restraint for twenty years;⁹ restraint for twenty years after the testator's death;⁹ restraint until the devisee reached thirty-five years of age;¹⁰ restraint during the lifetime of the grantor or of some person other than the grantee;¹¹ provision not to sell or rent the property to persons of African descent for a period of fifty years.¹² It is important to note that the requirement of reasonableness may relate to the purpose or object of the restraint as well as to its duration. The restraint must be reasonable both as to the type of alienation prohibited and as to the period over which the prohibition is to extend.

The above cases involved legal estates in property, but they are nonetheless applicable to the present problem, "Since reasonable restraints are allowed in the case of a legal fee simple, it follows that

⁸ *Knefler v. Shreve*, 78 Ky 297 (1879) GRAY, RESTRAINTS ON ALIENATIONS SECS. 190a-190h (2d ed. 1895)

Steward v Brady, 3 Bush 623, 66 Ky. 623 (1868)

Price v. Virginia Iron, Coal & Coke Co., 171 Ky 523, 188 S.W. 658 (1916).

⁹ *Johnson v. Dumeyer*, 23 Ky L. Rep. 2243, 66 S.W. 1025 (1902).

¹⁰ *Smith v. Isaacs*, 25 Ky. L. Rep. 1727, 78 S.W. 434 (1904)

¹¹ *Turner v. Lewis*, 189 Ky. 837, 226 S.W. 367 (1920), *Polley v. Adkins*, 145 Ky. 370, 140 S.W. 551 (1911), *Frazier v. Combs*, 140 Ky. 77, 130 S.W. 812 (1910)

¹² *Highland Realty Co. v Groves*, 130 Ky. 374, 113 S.W. 420 (1908).

they will more readily be allowed in the case of equitable estates."¹³ Kentucky goes to greater lengths in upholding restraints on the voluntary alienation of legal estates than does any other jurisdiction, and it is to be expected that the Kentucky courts would go even further in restraints on equitable estates, because the rule *stricti juris* may be avoided in the case of equitable interests. For instance, a restraint against the voluntary alienation of a beneficiary's interest in a trust for the life of the beneficiary was held valid in the case of *Murr's Ex'rs v. Howard*.¹⁴ Thus, a direct restraint may validly be imposed upon the voluntary alienation of the beneficial interest in a trust provided that (a) such restraint is accompanied by a provision for forfeiture, and (b) it is a reasonable restraint.

FOREIGN TRUSTS

In order to accomplish for a beneficiary residing in Kentucky the full and complete protection of a spendthrift trust, a trust with the usual spendthrift provisions may be established to be administered in another state, the laws of which state recognize the validity of spendthrift provisions. Ky. R. S. sec. 381.180 does not invalidate any trust from its inception, but merely voids spendthrift provisions when their validity is brought in issue.¹⁵ As this statute can be invoked only in relation to the administration of a trust, it can apply only to trusts which are administered in Kentucky. The validity of any provision imposing a restraint on alienation is a problem of trust administration; and, like all problems of trust administration, is governed by the law of the place of administration or "seat" of the trust.¹⁶

Where land is held in trust, the place of administration is the jurisdiction wherein the land is located; therefore, the law which governs the administration of a trust of realty is the law of the situs of the *res*.¹⁷ Thus in order to provide a spendthrift trust in foreign land for the benefit of a Kentucky resident, it is necessary for the trust to attach to land situated in a state that will enforce a spendthrift trust.

In determining the place of administration of a trust of personalty, "The intention of the settlor should prevail if there is a real connection between the selected jurisdiction and the transaction,"¹⁸ according to a recent Kentucky Court of Appeals decision. In that case, the settlor's intention, the domicile of the trustee, the location of the *res* and the place where the trust business was to be trans-

¹³ Roberts, *supra* note 5, at 197.

¹⁴ 178 Ky. 51, 198 S.W. 551 (1917).

¹⁵ See Note 4 *supra*.

¹⁶ 2 BEALE, CONFLICT OF LAWS sec. 297.2 (1935)

¹⁷ RESTATEMENT, CONFLICT OF LAWS sec. 243 (1934) GOODRICH, CONFLICT OF LAWS 398 (2d ed. 1938)

¹⁸ Kitchen v. N. Y. Trust Co., 292 Ky. 706, 711, 168 S.W. 2d 5, 7 (1943).

acted (all relating to New York) divested Kentucky of jurisdiction over the administration of such trust. Although a spendthrift trust was not involved in that case, it is highly indicative of the position the Kentucky courts will probably take on this particular issue, since all problems of trust administration have a common basis and should be treated similarly. A New York case¹⁹ is authority for the validity of a spendthrift trust administered in that state for the benefit of a resident of a state which disallows spendthrift provisions. This case indicates that such a spendthrift trust would be upheld by the courts of New York.

A foreign spendthrift trust is the ideal substitute for a spendthrift trust in Kentucky: all of the results of a valid spendthrift trust are fully effected thereby the only objection being the inconvenience of distance which is normally experienced when persons in different states carry on business with one another. Standing alone, this possibility makes Ky. R. S. sec. 381.180 wholly ineffective as applied to one who deliberately sets out to avoid the statute.

DISCRETIONARY TRUSTS

"Where the trustee has the discretionary power to withhold from the beneficiary all payments or beneficial use the interest of the beneficiary may not be subjected to his debts."²⁰ Such a discretionary trust affords the same protection against alienation, both voluntary and involuntary, as does a valid spendthrift trust. It may provide even greater protection against involuntary alienation, in view of the fact that courts hold that certain claims transcend the provisions of a spendthrift trust.

The theory upholding the inalienability of an interest in a discretionary trust is that creditors and transferees of a beneficiary obtain only the interest which the beneficiary had in the trust *res*; if the beneficiary has no enforceable interest in the trust, those who claim through him can assert no valid claim to the trust property. This points out the chief difference, legalistically between a spendthrift trust and a discretionary trust, viz., a beneficiary of the former may enforce his interest in the trust, whereas a beneficiary of the latter may not. This fact may make a discretionary trust undesirable in many instances, inasmuch as the trustee has absolute power to withhold all benefits from the *cestui que trust*, or, at the other extreme, to deplete the trust fund by disbursing all the benefits available for distribution. The practical difficulty with a discretionary trust is, of course, the choice of a suitable trustee.

Discretionary trusts are subjected to special consideration in the Internal Revenue Code. Sec. 167, as applied to a discretionary trust

¹⁹ Keeny v Morse, 71 App. Div 104, 75 N.Y. Supp. 728 (1902), *affirming* 34 Misc. 114, 69 N.Y.S. 535 (1901)

²⁰ Department of Public Welfare, Commonwealth of Kentucky v. Meek, 264 Ky 771, 773, 95 S.W. 2d 599, 601 (1926)

in which the beneficiary's interest is inalienable, makes it essential that the trustee not be authorized to exercise his discretion in favor of the settlor, otherwise all income accruing to the trust or given to any beneficiary becomes taxable as income of the settlor.

PROVISIONS FOR FORFEITURE UPON INVOLUNTARY ALIENATION

In *Bull v. Kentucky National Bank*,²¹ a testator devised real property in trust to pay the rents to his son for life, with a provision that if a court of last resort should hold that the rents were subject to the son's debts the trustee should thereupon pay them to the son's wife for her separate use. A creditor of the son sued to recover such rents. The court held that the defeasance in the terms of the trust was valid, and the creditors were entitled to none of the rents which accrued after the rendition of the decree.

The result of a trust with a provision for forfeiture is to defeat the creditors and transferees of the beneficiary upon the happening of the event; it affords no protection for the beneficiary, he is wholly divested of his interest in the trust upon an attempted alienation. From the beneficiary's point of view, a trust with a provision for forfeiture is little better than an ordinary trust which is governed by Ky R. S. sec. 381.180.

To date, there is no decision which would prevent a settlor from reserving a reversionary interest in such a trust to himself; thus, upon an attempted alienation by the beneficiary, the settlor would reacquire the trust property. Thereupon the settlor could create the trust once more; but there can be no duty imposed upon the settlor to so re-establish the trust.

TRUSTS FOR SUPPORT

"There are yet other cases which hold that an income given in trust for the cestui's support, cannot be reached by creditors and thus diverted from the purpose for which it has been set apart, unless the creditor who seeks to subject it to his claim can show that the amount provided is more than adequate for the suitable maintenance of the beneficiary."²²

In a trust for support, it is the nature of the beneficiary's interest which prevents alienation, rather than any restraints imposed. His interest is limited by the particular purpose set out in the terms of the trust. He cannot compel payment except for his support. For this reason, a creditor or transferee cannot compel the trustee to pay anything, although there is a possibility of recovery from a trust for support by one who has furnished support to the beneficiary.

²¹ 90 Ky 452, 14 S.W 425, 12 Ky L. Rep. 536, 12 L.R.A. 37 (1890).

²² *Hackett's Trustee v Hackett*, 146 Ky. 408, 412, 142 S.W 673, 675 (1912)

Earlier cases; however, held that a trust for support would not effect inalienability unless made discretionary.²³

PERSONAL TRUSTS—NON-ATTACHABLE INTERESTS

In the case of *Alexander and Co. v. Owens*,²⁴ land was conveyed in trust for the sole and separate use of a married woman during her life, with a provision that she and her children should occupy the land as a home. It was held that the property could not be charged for the debts of the beneficiary (although contracted for necessities) nor could the profits of the land, that might be necessary for her support, be so subjected.

This decision was based on the proposition that the only interest which the beneficiary had in the trust property was the right to use it as a home. This interest was viewed by the court as being personal to the beneficiary, and of such a nature that no other person could avail himself of it. The decision appears to be sound, because in no other way could the purpose of the settlor be achieved, which purpose should be given effect, since it directly contravened no rule of law and was socially desirable.

The scope of personal trusts is necessarily narrow: there are very few interests which the court would declare inalienable because of their personal nature. Although such trusts are thus limited in application by their subject matter, they are, however, not negligible. Often the type of interest involved in a spendthrift trust will be personal and non-attachable.

BLENDED TRUSTS—INSEPARABLE INTERESTS

Where a trust is created for two or more beneficiaries, and the interest of one beneficiary is inseparable from that of the others, none of them can voluntarily alienate his interest nor can creditors reach it.²⁵ In such blended trusts no definite portion of the entire beneficial interest can be attributed to any one beneficiary therefore his interest cannot be alienated since it is indefinite and unascertainable. Where the beneficial interest of one is capable of being separated from the interests of others it is alienable.²⁶

A blended trust usually is effected by establishing a trust for the benefit of certain named persons without designating the proportionate share of each one. In *Hackett's Trustee v. Hackett*,²⁷ however, a grant in trust was executed for the benefit of the settlor's nephew, "his wife and infant children residing with him equally"²⁸

²³ *Ratliff's Ex'rs. v. Com.*, 139 Ky. 533, 101 S.W. 978 (1907) *Hopper v. Eastern Ky. Asylum*, 27 Ky. L. Rep. 649, 85 S.W. 1187 (1905)

²⁴ 4 Ky. L. Rep. 621, 11 Ky. Opin. 898 (1883)

²⁵ *Russell v. Meyers, Trustee*, 202 Ky. 593, 260 S.W. 377 (1924)

²⁶ *Rudd v. Hagan*, 86 Ky. 159, 5 S.W. 416 (1887)

²⁷ 146 Ky. 408, 142 S.W. 673 (1912).

²⁸ *Id.* at 409, 142 S.W. at 673.

the court held the interest of the nephew to be inseparable and not liable for his debts. This case has been criticised in view of the word "equally" in the limitation.²⁹

This type of conveyance is often combined with a personal trust, for the reason that in a blended trust standing alone the court may hold the interests of the beneficiaries to be divisible into equal shares and therefore alienable. When this combination is made, it is often difficult to ascertain the true basis for a decision holding the interest inalienable. This holding is invariably made when an inseparable interest is combined with a non-attachable interest, and both factors are mentioned by the court.³⁰

OTHER ALTERNATIVES

The following are suggested as additional devices which achieve some of the results of a spendthrift trust. There is no authority in Kentucky for their use, but neither have they been expressly disallowed by decision or statute.

Solvency as a Condition Precedent—A trust may be established with an express provision that the beneficiary is not to receive his interest in the trust until he becomes financially solvent. The objection to this provision is that the beneficiary's trustee in bankruptcy should be able to reach the interest of the beneficiary in the trust. However, such provisions have been upheld in a majority of the jurisdictions where their validity has been tested. The United States Supreme Court has held that the Federal Bankruptcy Act presents no obstacle to such trusts.³¹

Protective Trusts have been adopted in England by statute,³² and are recommended by Bogert for use in Kentucky.³³ A protective trust is, essentially an ordinary trust with a provision that upon an attempted alienation of the beneficiary's interest, voluntary or involuntary, the ordinary trust shall terminate and a discretionary trust for the support of the beneficiary or of the beneficiary and his heirs shall be created.

Insurance Trusts—The statutes of a number of states provide that the proceeds of an insurance policy may be left with the insurance company to pay installments to the beneficiary, and that such payments may be made inalienable.³⁴ By the principles outlined

²⁹ GRISWOLD, SPENDTHRIFT TRUSTS sec. 186, n. 16 (1936)

³⁰ Stephens v Bishop, 3 Ky Opin. 351 (1869).

³¹ Hull v Farmer's Loan & Trust Co., 245 U.S. 313, 38 Sup. Ct. 103, 62 L.Ed. 312 (1917)

³² Trustee Act, 1925, 15 Geo. V c. 19, sec. 33.

³³ BOGERT, TRUSTS AND TRUSTEES sec. 226 (1935)

³⁴ IND. STAT. sec. 39-704 (Burns 1933) MISS. ANN. CODE sec. 5682 (1942) 6 Mo. STAT. ANN. secs. 5752, 5772, 6011 (1934), OHIO GEN. CODE sec. 9398-1 (1934) TENN. CODE ANN. sec. 6398 (Williams 1934), fraternal benefit insurance only.

above dealing with foreign trusts, these statutes of other states may be invoked to provide spendthrift trust protection for a Kentucky resident.

CONCLUSION

Despite the wording of Ky R. S. sec. 381.180, it is not true that estates of every kind held or possessed in trust are subject to the debts of the beneficiaries thereof, because a valid spendthrift trust may be administered in another state for the benefit of a Kentucky resident, and such trust is governed wholly by the foreign laws. Thus an accepted principle of the conflict of laws precludes Kentucky from cutting off its citizens from the protection of spendthrift trusts, so long as it is surrounded by states having a different social policy.

The result of the Kentucky decisions is to make the statute only partially effective even when applied to trusts administered within the state. Ky R. S. sec. 381.180 cannot be given the latitude required by its terms without doing violence to principles which have long been well established in our law. For example, to hold "every trust" liable for the debts of the beneficiary violates the rule that in order to subject the property of a debtor to the claims of his creditors, the debtor must have an interest in the property which he can enforce.

The Kentucky cases show some disinclination to follow the statutory policy against spendthrift trusts. This position may be justified in view of the fact that the legislature has not clarified its policy. Whatever may have been the serious objections to spendthrift trusts in early times, it is apparent that they do not exist now.

On the contrary, a policy is currently gaining favor which not only upholds spendthrift trusts, but makes them a favorite of the law. To a great extent spendthrift trusts serve a purpose similar to that of charitable trusts: both perform services which might otherwise fall upon the state. A spendthrift trust may provide for a person who might otherwise become indigent and a charge of the state in the absence of such provision. There is, therefore, good reason for not only enforcing spendthrift trusts but also extending to them the favored treatment afforded charitable trusts. The experience of states which enforce spendthrift provisions is that the desirable results achieved far out-weigh the undesirable ones which are possible if the spendthrift trust device is abused.³⁵

The Kentucky rule should be changed, both because it is ineffective, and because even if given effect, it reaches an undesirable result. This change should be made by the legislature and not by the courts. The statutes of other states furnish examples of desirable substitutes for the Kentucky rule. These statutes, in general, provide for either (a) limited recognition of spendthrift trusts, i.e., enforcing

³⁵ Costigan, *Spendthrift Trusts Reexamined*, 22 CALIF. L.REV. 471 (1934).

spendthrift provisions as to payments not exceeding a specified amount, or (b) full recognition of spendthrift trusts with certain claims excepted, such as claims against the beneficiary for support of dependents or for alimony

APPENDIX

In furtherance of the views expressed in this note and as a preliminary step in putting them into effect, the following is a proposed statute for the authorization and regulation of spendthrift trusts in Kentucky. This proposed statute is designed to enforce the desirable elements of spendthrift trusts while eliminating most of their evils by proper regulation.

Subject to the provisions of the following sections of this act, a trust instrument may provide specifically that the interest of any beneficiary in the income of the trust shall not be subject to voluntary or involuntary alienation by the beneficiary. A trust in which the interest of the beneficiary is subject to restraints on alienation, as provided in this act, may be called a "spendthrift trust."

Notwithstanding a specific provision in the terms of a trust restraining the alienation of the interest of the beneficiary, a transferee or creditor of the beneficiary shall be entitled to reach the interest of the beneficiary in satisfaction of his claim to the following extent:

(1) All income due or to accrue in the future to the beneficiary in excess of \$3600 per annum shall be subject to attachment by a creditor of the beneficiary and shall be freely alienable by the beneficiary

(2) All income due or to accrue in the future to the beneficiary in excess of \$1800 per annum shall be subject to the following claims:

- (a) claims by dependents of the beneficiary for support;
- (b) claims for alimony against the beneficiary;
- (c) claims for debts incurred by the beneficiary through his fraudulent misrepresentations to creditors that his interest in the trust was alienable;
- (d) tort claims for which the beneficiary is liable;
- (e) claims for necessities furnished the beneficiary;
- (f) claims for state and federal taxes;
- (g) any judgment based upon the above claims.

Where the beneficiary of any spendthrift trust is also the beneficiary under any other spendthrift or similar trust created or administered either within or without this state, the aggregate income payable under all such trusts to the beneficiary shall be considered together for the purpose of determining the rights of creditors and transferees under this act.

Where the interest of the beneficiary attaches to any trust which has previously been held to effect inalienability of such interest, any sums which are

actually paid to or for the beneficiary from such trusts shall be considered for the purpose of determining the rights of creditors and transferees under this act.

The right of any beneficiary of a trust to receive the principal of the trust or any part of it, presently or in the future, shall be freely alienable and subject to the claims of his creditors, notwithstanding any provision to the contrary in the terms of the trust.

It is not essential to the validity of a provision restraining voluntary alienation that it be accompanied by a provision restraining involuntary alienation; also, a provision restraining involuntary alienation may be enforced although the terms of the trust contain no provision restraining voluntary alienation. The presence of one such provision expressly shall not be construed as implying the presence of the other.

Nothing in this Act shall be construed as authorizing a person to create a spendthrift trust for his own benefit. Nor may a valid spendthrift trust be created for the benefit of a person who pays a substantial consideration in exchange for the creation of the trust. The interest of any beneficiary who is also the settlor or who has paid substantial consideration for the creation of the trust shall be freely alienable and subject to the claims of his creditors.

Nothing in this Act shall be construed as effecting the exemptions from debt now or hereafter accorded by law to any kind of property or interest in property and such property or interest in property in trust shall be exempt from debt to the same extent as if free from trust.

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