Navigating Trust and Estate Issues in Divorce Litigation

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The practice of an estate and trust lawyer may routinely intersect with family and divorce law. In drafting estate planning documents, one of your client's goals might be to protect assets from their descendants' creditors, including (potential) ex-spouses, or even from their own future ex-spouse. Or, you might represent a trustee of a trust with a beneficiary in the midst of, or contemplating, divorce proceedings. A solid understanding of how family law courts treat a divorcing spouse's interest in a trust is the foundation to a trust and estate lawyer's representation in these circumstances.

I. Family Law Court Treatment of Trusts in a Property Division.

The starting point for an Illinois family law court's consideration of trust property in divorce proceedings is the Illinois Marriage and Dissolution of Marriage Act. Specifically, Section 503 requires that the court divide the property owned by the divorcing spouses in just proportions. To do so the court must classify and value the property owned by the divorcing spouses as "marital property" and "non-martial" property.

A. 750 ILCS 5/503: Disposition of Property and Debts.

Marital Property presumptively means all property acquired by the divorcing spouses subsequent to a marriage. Non-Marital Property of one spouse means:

(1) property acquired by gift, legacy or descent . . .;

(2) property acquired in exchange for property acquired before the marriage;

(3) property acquired by a spouse after a judgment of legal separation;

(4) property excluded by valid agreement of the parties, including a premarital agreement or postnuptial agreement;

(5) any judgment or property obtained by judgment awarded to a spouse from the other spouse, except . . . when a spouse is required to sue the other spouse in order to obtain insurance coverage or otherwise recover from a third-party and the recovery is directly related to amounts advanced by the marital estate . . .;

(6) property acquired before the marriage, except as it relates to retirement plans that may have both marital and non-marital characteristics;

(6.5) all property acquired by a spouse for the sole use of non-marital property as collateral for a loan that then is used to acquire property during the marriage; to the extent that marital estate repays any portion of the loan, it shall be considered a contribution from the marital estate to the non-marital estate subject to reimbursement;

(7) the increase in value of non-marital property, irrespective of whether the increase results from a contribution of marital property, non-marital property, the personal effort of a spouse, or otherwise, subject to the right of reimbursement . . .; and

(8) income from property acquired by a method listed in paragraphs (1) through (7) . . . if the income is not attributable to the personal effort of a spouse.

750 ILCS 5/503(a).

B. Property that is Neither Marital nor Non-Marital Property.

Sometimes a divorcing spouse may have an interest in property that is not owned by such spouse, as is the case of an irrevocable trust. Such property may be considered to be not the property of either spouse and, thus, not subject to division by the family law court in a divorce proceeding. Nonetheless, Section 503 requires that property be divided in "just proportions" and instructs the court to consider certain statutory factors, including the "relevant economic circumstances of each spouse" and the "opportunity of each spouse for future acquisition of

capital assets and income." 750 ILCS 5/503(d). Accordingly, a court may consider a spouse's interest in an irrevocable trust in apportioning the martial estate. *In re Marriage of Holman*, 122 Ill. App. 3d 1001, 1010-11 (2d Dist. 1984).

1. Vested Interests, Contingent Interests, and "Mere Expectancies."

"Property" has been defined as "a word of the very broadest import, connoting any tangible or intangible res which might be made the subject of ownership." *In re Marriage of Goldstein*, 97 Ill. App. 3d 1023, 1026 (1st Dist. 1981). However, in order to be within the meaning of the § 503, "the res must be in the nature of a present property interest, rather than a mere expectancy interest." *In re Marriage of Weinstein*, 128 Ill. App. 3d 234, 244 (1st Dist. 1984). "An expectancy interest is the 'interest of a person who merely foresees that he might receive a future beneficence, such as the interest of an heir apparent * * * or of a beneficiary designated by a living insured who has a right to change the beneficiary.'" *In re Marriage of Centioli*, 335 Ill. App. 3d 650, 656 (1st Dist. 2002) (quoting *Weinstein*, 128 Ill. App. 3d at 244).

A vested interest in a trust can be considered a present property interest subject to valuation and division as non-marital property. *In re Marriage of Asta*, 2016 IL App (2d) 150160, ¶ 16 ("[s]ection 503(a)(1) may apply where a spouse receives property as his or her share of a trust"). *See also In re Marriage of Tatham*, 173 Ill. App. 3d 1072, 1080 (5th Dist. 1988) (beneficial interest in father's trust was equivalent to a "gift" as that term appears in the statute, so the beneficial interest was properly awarded as non-marital property). On the other hand, "[p]otential inheritances, just as expected degrees or licenses, are not property which can be valued and awarded to a spouse, although they can be a given some consideration in determining property distribution." *In re Marriage of Eddy*, 210 Ill. App. 3d 450, 460 (1st Dist. 1991).

Although not subject to valuation and division, Illinois courts have held that "some consideration" may be given to potential future inheritances in determining property distribution. *See, e.g., In re Marriage of Schmidt*, 242 Ill. App. 3d 961, 968 (4th Dist. 1993) ("[p]otential inheritances are not property which can be valued and awarded to a spouse, although they can be given some consideration in determining property distribution"). Accordingly, a divorcing spouse's contingent or future interest in an irrevocable trust is not property subject to division by the family law court. But, the court can give "some consideration" to such interest in deciding how to divide the marital estate in just proportions.

2. Self-Settled Trusts.

An owner has an absolute right to dispose of his property during his marriage in any manner he sees fit, even if the purpose is to defeat his spouse's statutory marital interests in the property conveyed. *Johnson v. La Grange State Bank*, 73 Ill. 2d 342, 357 (1978). Accordingly, if one spouse creates an irrevocable trust and contributes assets to such trust, it may not be divided as a part of the marital estate by the family law court.

a. Illusory Trusts.

But, where the trust is illusory or colorable – one "which appears absolute on its face but due to some secret or tacit understanding between the transferor and the transferee the transfer is, in fact, not a transfer because the parties intended that ownership be retained by the transferor" – the trust is subject to division as a part of the marital estate. *Johnson*, 73 Ill. 2d at 359. Trusts that contain certain ties or connections may demonstrate that a party retains sufficient control of the trust to make the transfer of assets illusory or colorable. *In re Marriage of Romano*, 2012 IL App (2d) 091339, ¶ 101. And, courts have recognized that self-settled trusts may indicate a greater level of control, unless the trust agreement limits that control (e.g., allowing revocation of trust

agreement provisions only by consent of multiple beneficiaries). *In re Marriage of Tietz*, 238 Ill. App. 3d 965, 972-73 (4th Dist. 1992).

Examples of facts where a court might find that the grantor retained control over a trust such that it is illusory or colorable are:

- The trust protector is close friend and evidence of following spouse's direction;
- The trustee follows the spouse's direction;
- Routine access to funds is given to the spouse;
- The marital lifestyle includes living off of distributions from the trust.

The court's analysis in *In re Marriage of LaRocque*, 2018 IL App (2d) 160973, is illustrative of a situation where the court ruled that irrevocable trusts created by spouses during the marriage were not illusory or colorable and were not included in the division of the marital estate. In *LaRocque*:

- The parties were married in 1985. 2018 IL App (2d) 160973, at ¶ 3.
- In the mid-2000s, H started creating a comprehensive estate plan and H and W established numerous irrevocable trusts. *Id*., at ¶ 6.
- W signed documents related to the trusts but denied any knowledge of the estate plan details. *Id*.
    - W claimed that H was "divorce planning" by reducing the marital estate through estate-planning techniques. *Id*.
    - H argued that the property contributed to the trusts was an irrevocable gift from him or W and thus outside of the marital estate. *Id*., at ¶ 7.
    - H supported his argument with affidavits of the tax benefits of the estate planning for their children. *Id*., at ¶¶ 8-13.
    - W argued the trusts were illusory and without donative intent – most transfers during irretrievable breakdown, trustees were people related to H in some way. *Id*., at ¶ 15.
- Trial court ruled trusts were "separate legal entities" and that "neither party has a property interest in those trusts" and excluded the trusts from both marital and non-marital estates. *Id*., at ¶ 18.
- Appellate Court affirmed because W produced no evidence to show that the trusts were illusory or that H's friends and family trustees breached fiduciary duties. *Id*., at ¶¶ 49, 55.

- W relied mostly on her affidavit that she did not read the trust documents, which is not a defense. *Id*., at ¶ 52.
- However, the court did not preclude argument by W that H committed dissipation by depleting the marital estate. *Id*., at ¶ 56.

II. Family Law Court Treatment of Trusts in an Award of Support and Maintenance.

A. 750 ILCS 5/504 and 750 ILCS 5/505: Support and Maintenance.

Under Section 504, the court may grant a maintenance award for either spouse in amounts and for periods of time as the court deems just without regard to marital misconduct and the maintenance may be paid from the income or property of the other spouse. 750 ILCS 5/504. Under Section 505, the court may order either or both parents owing a duty of support to a child to pay an amount reasonable and necessary for support. 750 ILCS 5/505. Sections 504 and 505 set forth factors to be considered by the court in determining that amount of maintenance and support to be awarded.

Because the court is instructed to consider all income of the spouses for purposes of maintenance and support, income received from trust distributions can be considered in some circumstances. For child support purposes, "income" is "to include gains and benefits that enhance a noncustodial parent's wealth and facilitate that parent's ability to support a child or children." *In re Marriage of Plowman*, 2018 IL App (4th) 170665, ¶ 21 (citations and internal quotation marks omitted). Although "[s]uch gains and benefits are normally linked to employment or self-employment, investments, royalties, and gifts", "[o]ur courts have found the definition of income to be broad enough to include . . . distributions from a trust. . . ." *Id.* (internal citations and quotation marks omitted)

And, the Illinois Supreme Court has held gifts and loans that one spouse receives from his or her parents may be considered for purposes of setting support payments. *In re Marriage of Rogers*, 213 Ill. 2d 129 (2004). In *Rogers*:

- Upon a motion to modify maintenance, the trial court increased H's support obligation because he received $46k per year in gifts and loans from his parents. 213 Ill. 2d at 132-33.
- H appealed, arguing that the gifts and loans were not income. *Id*. at 135.
- On appeal, the Supreme Court affirmed:
    - The first step in determining support obligations is to define net income, which is "the total of all income from all sources" *Id*. at 133 (citing 750 ILCS 5/503(a)(3)).
    - Section 505 does not separately define "income" so the court applied the ordinary, dictionary definition: "something that comes in as an increment or addition * * *: a gain or recurrent benefit that is usu[ually] measured in money." *Id*. at 136-37 (quoting WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1143 (1986)).
    - Thus, a variety of payments can qualify as "income" for purposes of section 505(a)(3) of the Act even though the payments would not be taxable as income under the Internal Revenue Code. *Id*. at 137.
    - The court found that the IRS code is designed to achieve different purposes than the support statutes and does not govern what is income for support. *Id*.
- The Court held that H's annual gifts from parents were income for purposes of support payments and the fact that there were not subject to taxation is not controlling. *Id*.

But, Illinois courts may also consider the level of control the spouse has over the income and may give consideration to only current income. For example, in *In re Marriage of Tietz*, 238 Ill. App. 3d 965, 972-73 (4th Dist. 1992), the court ruled that in determining maintenance, a court may limit its consideration to only the amount over which the party has direct control. Where a party receives income from a trust but has no direct control over the investments or income-earning potential of the trust, the court may consider only the current income rather than the full interest to determine maintenance.

B. Consideration of Spendthrift Trusts in Awards of Support or Maintenance.

The Illinois Trust Code provides that a "'spendthrift provision' means a term of a trust that restrains both voluntary and involuntary transfer of a beneficiary's interest." 760 ILCS 3/103(34). In its most basic form, a spendthrift trust is one that limits a beneficiary's ability to access the trust. The trustee is in control of managing the property. Thus, the beneficiary of the trust is not in control of the property and normally his or her creditors cannot reach those assets.

Although generally a creditor cannot reach assets of a spendthrift trust to satisfy a judgment, the Illinois Trust Code makes an exception for child support obligations providing that "[a] spendthrift provision is unenforceable against: (1) a beneficiary's child, spouse, or former spouse who has a judgment or court order against the beneficiary for child support obligations owed by the beneficiary." 760 ILCS 3/503(b)(1). *See also In re Support of Matt*, 105 Ill. 2d 330, 334 (1985) ("it is the public policy of Illinois to ensure that support judgments are enforced by all available means").

But, note that this exception does not apply to maintenance awards to an ex-spouse – only child support obligations. Rather, the historical rule that a spouse may not enforce a maintenance award against a spendthrift trust applies. *Keller v. Keller*, 284 Ill. App. 198 (1st Dist. 1936) (a spouse may enforce a claim for maintenance or child support against the income of a spendthrift trust unless the trust instrument discloses an intention that such claim may not be enforced in that manner); *Dinwiddie v. Baumberger*, 18 Ill. App. 3d 933 (1st Dist. 1974) (where an employer establishes a spendthrift trust for the exclusive benefit of its employees, the income cannot be withheld to satisfy a claim for alimony arrearage).

However, Illinois courts have long held that self-settled trusts are invalid as a spendthrift trust. *In re Simon*, 170 B.R. 999, 1002 (Bankr. S.D. Ill. 1994). *See also In re Marriage of*

Chapman, 297 Ill. App. 3d 611, 620 (1st Dist. 1998) (The court may convert the money in a self-settled trust into a § 503(g) trust for the payment of future child support).

III. Considerations for Creating and Administering Trusts.

Courts routinely scrutinize the precise terms of a trust instrument in determining the extent to which trust assets will be considered in a divorce proceeding. Thus, it is incumbent upon the estate planning attorney when creating a trust to carefully balance the grantor's goals, one of which may be protection of the assets from claims by an ex-spouse (or potential ex-spouse) of a beneficiary.

A. Standards for Discretion and Distribution.

One of the most important considerations, if not the most important consideration, impacting how a third party trust will be treated in divorce proceedings is the standard of distribution. In divorce proceedings, the standard of distribution is of paramount importance because it not only defines the rights of the beneficiary to compel distributions from the trust, but also the rights of a beneficiary's creditors to compel distributions from the trust.

1. Pure Discretionary Trusts.

A pure discretionary trust grants the trustee "sole" or "absolute" discretion to make distributions for "best interests" or "any purpose." A pure discretionary standard of distribution provides the highest level of protection against claims by a (soon-to-be) ex-spouse. Under a pure discretionary trust, whether the beneficiary receives assets depends on the sole discretion of the trustees. Because the beneficiary of a discretionary trust has no enforceable right to assets from the trust (unless the trustee is in breach of duty), the (soon-to-be) ex-spouse also should not be able to reach the assets.

2. Support Trusts.

A support trust requires the trustee to make distributions for "support" or some other ascertainable standard. Because the beneficiary of a support trust has an enforceable right to certain assets from the trust, the assets may be considered in a property division and/or an award for child support or alimony to the (soon-to-be) ex-spouse. Moreover, in some jurisdictions the (soon-to-be) ex-spouse may be considered "an exception creditor" and permitted to attach trust assets or otherwise compel a direct distribution of trust assets to satisfy a judgment.

3. Hybrid Trusts.

A hybrid trust grants the trustee discretion to make distributions but provides guidance to the trustee as to the purposes for which discretionary distributions may be made. For example, a hybrid distribution standard might provide:

> The trustee may distribute so much, all or none of the net income and principal of the trust as the trustee, in his or her sole discretion, deems necessary for beneficiary's health, education, maintenance or support.

This blurring of the lines between a discretionary trust and a support trust (although it may satisfy other objectives of the settlor) may impact claims on the assets by a (soon-to-be) ex-spouse.

B. Spendthrift Protections.

Spendthrift provisions, providing that a beneficial interest in a trust shall not be transferrable by the beneficiary or subject to claims of the beneficiary's creditors, are enforceable in most jurisdictions and may increase the odds that a trust will remain beyond the reach of a (soon-to-be) ex-spouse of a divorcing beneficiary. However, a spendthrift provision does not provide protection where the beneficiary has certain rights or powers that are the equivalent of ownership, such as an entitlement to an immediate distribution or a general power of appointment. RESTATEMENT (THIRD) OF TRUSTS § 58 cmt. b(1) (2003). Further, the Restatement

specifically provides for exceptions for certain creditors: "The interest of a beneficiary in a valid spendthrift trust can be reached in satisfaction of an enforceable claim against the beneficiary for [] support of a child, spouse, or former spouse." *Id*., at § 59(a). Similarly, the Illinois Trust Code specifically provides a spendthrift provision is unenforceable against "a beneficiary's child, spouse, or former spouse who has a judgment or court order against the beneficiary for child support obligations owed by the beneficiary." 760 ILCS 3/503(b)(1).

C. Historical Pattern of Distributions.

Courts also may consider the manner and method of administration of a trust in determining whether, and to what extent, assets of a third-party trust are considered in divorce proceedings. If a trustee makes regular distributions to a beneficiary, even though the trust is purely discretionary, the court may take the historical pattern of distributions into consideration in determining alimony or child support. For example, in *In re Marriage of Rogers*, 213 Ill. 2d 129, 132-33, 136-37 (2004), the trial court increased the husband's support obligations because he received $46,000 per year in gifts and loans from his parents. In *D.L. v. G.L.*, 811 N.E.2d 1013, 1024 (Mass. App. Ct. 2004), the husband's discretionary interest in a trust was treated "as a stream of income for the payment of alimony and child support," because "income from the trust has historically been distributed to the husband on a consistent basis."

However, withholding distributions does not necessarily "save" a support trust from consideration in an alimony or child support calculation. In *Dwight v. Dwight*, 756 N.E.2d 17, 19, 21 (Mass. App. Ct. 2001), the court determined an alimony award based, in part, upon potential distributions from a support trust despite the fact that historically support distributions had not been from the trust. The *Dwight* court reasoned that based upon the terms of the trust agreement, the beneficiary "had access to additional funds if he needed or wanted them" so they could be considered in determining an alimony award. *Id*.

IV. Representing the Fiduciary in Divorce Proceedings of a Beneficiary or Grantor.

Another common situation in which a trust and estate lawyer might encounter a cross-section with a family law court is representation of a trustee or other fiduciary in a divorce proceeding where the divorcing spouse is a beneficiary, potential beneficiary or grantor of a trust.

A. Third Party Claims Against the Fiduciary in the Divorce Proceedings.

In some cases family law courts have allowed, or even required, the parties to join the fiduciary of a trust for the benefit of (or created by) a divorcing spouse in the divorce proceedings.

For example, in *In re Marriage of Peshek*, 89 Ill. App. 3d 959, 965-66 (1st Dist. 1980), the Illinois Appellate Court held that the trial court should have permitted one divorcing spouse to file a third party claim against the trustee of a trust that was alleged to be holding marital property. The *Peshek* Court analyzed whether the trial court was authorized to bring in the trustee as a third party defendant "to probe the validity of the trust during the dissolution proceeding." *Id*. at 964-65. The *Peshek* court noted that "[t]he Illinois Marriage and Dissolution of Marriage Act makes no provision for the filing of a third party action during a dissolution proceeding to determine the parties' rights in alleged marital property held by a third person" but that the right to file third party actions in a dissolution proceeding had been recognized by case law where an alleged asset was held in trust. *Id*. at 965-66.

The Illinois Appellate Court relied on a Colorado case, *In re Marriage of Kaladic*, 589 P.2d 502 (Colo. App. 1978):

> [In *Kaladic*] the wife placed a large sum of money into an irrevocable, discretionary spendthrift trust prior to the filing of a suit for dissolution and made herself the sole income beneficiary. Her attorney was made the trustee of this trust. The court held that it was necessary to look at the trust to determine whether it contained any marital property. It determined that it contained both marital and

> nonmarital funds and, therefore, required conveyance of a portion of the trust assets to the husband as part of his portion of the marital property. The trial court acknowledged that it had the right to bring in the attorney-trustee as a third party defendant, and that, indeed such an act would be necessary to obtain jurisdiction over the trustee.

Peshek, 89 Ill. App. 3d at 965.

The Illinois Appellate Court agreed with the court in *Kaladic* that a third party holding alleged marital property should be brought into the dissolution proceeding by a third party complaint and proper summons. *Peshek*, 89 Ill. App. 3d at 965. The Illinois Appellate Court also noted that the trial court had authority to adjudicate a third party action under the Civil Practice Act. *Id*.

And, other state courts have ruled similarly. For example, in *Nicks v. Nicks*, 774 S.E.2d 365 (N.C. Ct. App. 2015), the court held that "when a third party holds legal title to property which is claimed to be marital property, that third party is a necessary party to the equitable distribution proceeding, with their participation limited to the issue of the ownership of that property." *Id*. at 372-73 (citation and internal quotation marks omitted). Further, in *Klabacka v. Nelson*, 394 P.3d 940, 946 (Nev. 2017), the court held that the divorce court had jurisdiction over all of the trust-related claims, including those breach of fiduciary duty claims.

B. Discovery Issued to a Fiduciary in Divorce Proceedings.

Given that interests in third-party settled discretionary trusts may be considered for purposes of calculating alimony, child support, or in awarding the division of marital property, it follows that records related to such trusts may be the subject of a discovery subpoena to a fiduciary in a divorce proceeding of a divorcing beneficiary. This raises a host of concerns, including duties the fiduciary owes to other potential beneficiaries of the same trusts and privacy concerns of living parents and other potential beneficiaries.

Illinois courts routinely require the divorce litigant to tie discovery requests to the statutory factors for dividing property and determining support obligations found in Sections 503, 504, and 505. 750 ILCS 5/503, 504, 505. Further, some states specifically dealt with the discovery issues by statute. For example, a Vermont statute provides:

> (A) The court may consider the parties' lifestyle and decisions made during the marriage and any other competent evidence as related to their expectations of gifts or an inheritance. The court shall not speculate as to the value of an inheritance or make a finding as to its value unless there is competent evidence of such value.
>
> (B) A party's interest in an inheritance that has not yet vested and is capable of modification or divestment shall not be included in the marital estate.
>
> (C) *Notwithstanding any other provision of this subdivision (8), a person who is not a party to the divorce shall not be subject to any subpoena to provide documentation or to give testimony about:*
>
> (i) *his or her assets, income, or net worth, unless it relates to a party's interest in an instrument that is vested and not capable of modification or divestment; or*
>
> (ii) *his or her revocable estate planning instruments, including interests that pass at death by operation of law or by contract, unless a party's interest in an instrument is vested and not capable of modification or divestment.*
>
> (D) *This subdivision (8) shall not be construed to limit the testimony given by the parties themselves or what can be obtained through discovery of the parties.*

Vt. Stat. Ann. tit. 15, § 751(b)(8) (emphases added).