

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF WISCONSIN

In re:

CHAPTER 7

JOHN MICHAEL FLYNN,

Case No. 94-24931-MDM

Debtor.

MEMORANDUM DECISION

Introduction

This matter comes before the court on a motion by the bankruptcy trustee requesting the court to order the trustee of the Flynn Family Trust ("Flynn trustee"), of which the debtor is a settlor and beneficiary, to turnover cash assets equal to the debtor's present interest in the value of the trust. The facts are not in dispute. The parties briefed the legal issues, and the court has reached its decision on the motion.

The court is satisfied that the trust is unambiguous, and no further evidence is needed to construe the trust. The rights of the parties can be determined as a matter of law. For the reasons set forth in this decision, the bankruptcy trustee is entitled to an order directing the Flynn trustee to turnover that portion of the assets of the debtor's share of the Flynn Family Trust that represent the debtor's proportionate contribution to the trust when it was created.

Facts

The Flynn Family Trust was created on July 2, 1991, by the trustee, one of the debtor's brothers, and the settlors, the seven Flynn siblings and their mother. The debtor's father had

died intestate, and his estate included an undivided 1/2 interest in a house, which was and continues to be the debtor's mother's residence, and some cash. The debtor inherited 1/7 of his father's 1/2 interest in the real estate, which he contributed to the trust, and his six siblings did the same. The seven children also contributed equal amounts of cash. The debtor's mother, Ann Flynn, contributed her 1/2 interest in the real estate to the trust, and the terms of the trust gave her the right to live in the house that the trust owns. She has no other beneficial interest in the trust assets. The primary purpose of the trust, as set forth in Article I, is to provide and maintain a residence, rent free, for the debtor's mother, Ann Flynn.

Article II, Section 4, requires the Flynn trustee to hold the share of each of the Flynn children "as a separate trust fund in accordance with the provisions of Article III." Each share has an equal interest in the real estate and an equal interest in other assets held by the trust. Art. II.2.¹ Article II.4. states that "[a]ny real estate shall be apportioned among the individual shares in kind." Thus, the debtor's share includes

¹ "Subject to Ann Flynn's right to occupy the property rent free as hereinbefore provided, the Residence and all beneficial interests therein and rights thereto (including all rights and interests in and to the Residence at such time as Ann Flynn shall permanently cease to reside therein) shall be divided into equal shares so that one share is allotted to each of the Flynn Children. Each such share shall constitute a separate and distinct trust designated with the name of the respective child."

Article II.2.

the 1/14 share of the real estate he contributed to the trust, plus another 1/14 interest in the real estate as his equal share of his mother's contribution, for a total share of 1/7 of the real estate. Article II.3. also states that additional contributions of cash or other assets shall be equal, and these funds are to be used to pay costs of maintaining the residence. Therefore, the debtor's separate share holds an equal 1/7 of the total cash.

The beneficiary of each share has an unrestricted right to withdraw annually the income on his or her share upon demand to the trustee.² Principal and accumulated income from prior years can be withdrawn by the beneficiary upon request to the trustee, subject to two conditions: (1) if it is necessary to sell the real estate to make a required distribution, this can be done only with the consent of Ann Flynn and a majority of the Flynn children, Article VI.1.; and (2) the purpose for the withdrawal must be for a purpose "that, in the judgment of the Trustee,

² "During the lifetime of each of the Flynn Children with whose name a share is designated, all right to such share, including the distribution of income and principal as hereinafter provided in Articles IV and V, shall belong to the child with whose name the share is designated. During such time, any determination whether to receive or accumulate income or to withdraw principal as provided in Article V shall be made solely by the child with whose name the share is designated."

Article III.1.

constitutes an exceptional need on the part of the beneficiary or the beneficiary's family."³

At the present time, it is undisputed that the fair market value of the house is \$135,200, and the value of the total liquid assets is \$58,890.92.

Discussion: What Portion of the
Trust is Included in the Bankruptcy Estate?

The bankruptcy trustee has asked the court to order the Flynn trustee to deliver the cash assets equal to the debtor's present interest in the value of the trust. The bankruptcy trustee argues that the terms of the trust clearly empower the debtor with the present ability to withdraw his interest in the trust, which, according to the bankruptcy trustee, amounts to \$18,070.10 in cash. He arrives at that figure as follows: the

³ "The beneficiary having the right to receive income from any share pursuant to Article III shall have the right to receive such net income annually, or more frequently at the discretion of the Trustee, or to have such income accumulate in such share. If the distribution of income is not requested by any such beneficiary, such income shall be accumulated. The beneficiary having the right to receive income from any share pursuant to Article III shall also have the right to receive, upon request to the Trustee, all or any part of any accumulated income of such share and all or any part of the principal and allocated reserves of such share, provided, however, that to the extent such distribution of principal shall require the sale or liquidation of real estate, consent and approval as required by Article VI shall be necessary, and provided further that the distribution of principal or allocated reserves is for purposes that, in the judgment of the Trustee, constitute an exceptional need on the part of the beneficiary or the beneficiary's family."

Article V.1.

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debtor's interest includes 1/14 of the value of the house (\$9,657.14) and 1/7 of the liquid assets (\$8,412.99), which is, in round numbers, \$18,070.10. This represents the debtor's pro rata contribution to the trust when it was established, plus any income the liquid assets have earned since that time.

The Flynn trustee, on the other hand, argues that the express primary purpose of the trust -- to provide and maintain a residence for the debtor's mother, Ann Flynn -- must be satisfied prior to a distribution of the trust's assets. According to the Flynn trustee, the only purpose for which cash can be distributed from the trust is to pay for expenses of the trust real estate. Distribution of the debtor's share to the bankruptcy trustee would frustrate the purpose of the trust and should not be required.

Spendthrift Provision is
Ineffective as to Debtor's Contribution.

It is axiomatic that a person who is competent to do so (and who has sufficient assets, of course) may establish a trust for the benefit of another person or entity and may condition distributions on practically any terms. Frequently, the settlor would rather provide for the beneficiary than for the beneficiary's creditors or assignees, and a "spendthrift clause" is included in the trust. Wisconsin law recognizes the right of settlors to limit access to trust assets by the creditors of a beneficiary. Wis. Stat. § 701.06(1), (2). The Flynn trust

contains an anti-alienation provision which was clearly intended to provided spendthrift protection.⁴

Generally, a debtor's bankruptcy estate includes all of the debtor's property, "notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law that restricts or conditions transfer of such interest by the debtor." 11 U.S.C. § 541(c)(1)(A). However, trust funds with legally sufficient restraints on transfers and alienation under "applicable nonbankruptcy law," such as an enforceable spendthrift clause, will be excluded from property of the bankruptcy estate of a beneficiary. 11 U.S.C. § 541(c)(2). The debtor in this case is one of the beneficiaries of the Flynn Family Trust.

Section 541(c)(2) requires reference to state law to determine whether "applicable nonbankruptcy law" prevents alienation of the debtor's interest in the trust. Applicable nonbankruptcy law has special rules when a beneficiary of a trust is also a "settlor." Here, the debtor clearly is a "settlor" because of having contributed to assets in the trust, Wis. Stat.

⁴ Article XIV of the Flynn Family Trust provides:

All interests, both in income and in principal, in all trusts created by this instrument are intended for the personal protection and welfare of the beneficiaries thereof; no such interest shall be transferable, voluntarily or involuntarily, by the beneficiary thereof, nor subject to the claims of creditors or of the former spouse or spouse of such beneficiary, except as to those rights specifically provided herein.

§ 701.01(5), and he is identified as such in the first introductory paragraph of the trust. See also BLACK'S LAW DICTIONARY 1373 (6th ed. 1990) (definition of "settlor"); *In re Shurley*, 171 B.R. 779, 778-79 (Bankr. W.D. Tex. 1994); IIA WILLIAM F. FRATCHER & AUSTIN W. SCOTT, SCOTT ON TRUSTS § 156.3 at 179-80 (4th ed. 1987).

Under general common law trust principles, a person cannot create a trust, transfer his/her assets to the trust, and maintain the current benefits of ownership, while insulating those assets from the reach of creditors. See, e.g., *In re Shurley*, 171 B.R. at 779-82; see also David B. Young, "The Pro Tanto Invalidity of Protective Trusts: Partial Self-settlement and Beneficiary Control," 78 Marquette L. Rev. 807 (1995). Wisconsin law is in accord with this general rule. Section 701.06(6), Wis. Stats., pertaining to spendthrift provisions and rights of creditors of settlor/beneficiaries, provides:

SETTLOR AS BENEFICIARY. Notwithstanding any provision in the creating instrument and in addition to the remedies available under subs. (4) and (5) where the settlor is a beneficiary, upon application of a judgment creditor of the settlor, the court may, if the terms of the instrument require or authorize the trustee to make payments of income or principal to or for the benefit of the settlor, order the trustee to satisfy part or all of the judgment out of part or all of the payments of income or principal as they are due, presently or in the future, or which are payable in the trustee's discretion, to the extent in either case of the settlor's proportionate contribution to the trust.

Wis. Stat. § 701.06(6).

Thus, under state law, a judgment creditor is entitled to recover the debtor's proportionate contribution to the trust.

Here, the debtor contributed his 1/7 interest in the trust cash and his 1/14 interest in the trust real estate. The bankruptcy trustee stands in the shoes of a hypothetical judgment creditor and can exercise the same rights in favor of the estate.

11 U.S.C. § 544(a)(1), (2).

The trust provides that the Flynn trustee has no discretion to withhold income, if demanded by the beneficiary, and this current income is clearly under the debtor's control. Articles III.1, V.1. Income not demanded is accumulated at least annually. Article V.1. The beneficiary of each share also has the right to receive accumulated income and principal upon demand, but this right is subject to two conditions. Article V.1.; see n. 3. If sale of the real estate is required to make a distribution, consent of Ann Flynn and a majority of the Flynn children is required. *Id.* Also, the distribution of principal or allocated reserves must be, in the judgment of the Flynn trustee, for an "exceptional need" on the part of the beneficiary or the beneficiary's family. *Id.* While the Flynn trustee's exercise of discretion may affect the beneficiary's ability to receive distributions of principal, the right of a judgment creditor to recover is only limited by the proportion of the beneficiary's contributions to the trust as settlor. Wis. Stat. § 701.06(6); see Article V.1. Since applicable nonbankruptcy law does not insulate the debtor's proportionate contribution to the trust from the reach of his creditors, then his share in

proportion to the original contribution is property of the estate.

Here, the debtor contributed all of the cash in his share, which amounted to \$8,412.96 when the matter was briefed. It is not necessary to compute how much is current income and how much is principal and accumulated income. All liquid assets are property of the estate, because the Flynn trustee's exercise of discretion is irrelevant to the inclusion of the cash contribution. 11 U.S.C. § 541(c); Wis. Stat. § 701.06(6).

For the same reasons, the 1/14 interest in the real estate that the debtor contributed, a principal asset, is also property of the bankruptcy estate. 11 U.S.C. § 541(c); Wis. Stat. § 701.06(6).

Bankruptcy Trustee Cannot Recover
Debtor's Mother's Contribution to His Share of Trust.

The debtor is the settlor as to 1/14 of the real estate and 1/7 of the cash, but he is not the settlor with respect to any of the real estate contributed to the trust by Ann Flynn. Therefore, the spendthrift clause is effective as to this asset. Not only did he not contribute this portion of the residence, he has no unrestricted right to withdraw it from the trust. Articles V.1., VI.

The Bankruptcy Trustee Cannot Compel Purchase of the
Debtor's Interest in Real Estate by Other Trust Shares.

The debtor's share of the cash in the Flynn Family Trust is in proportion to his contribution of cash to the trust, i.e., 1/7. The bankruptcy trustee argues that the 1/14 interest in

real estate that the debtor also contributed should be distributed to the bankruptcy trustee in cash equal to its value, but he does not want the real estate in kind.

The bankruptcy trustee cannot pick and choose what he wants from shares allocated to the debtor's brothers and sisters. Article II.4. states that "[a]ny real estate shall be apportioned among the individual shares in kind." Article II.2. states that all beneficial interests are to be divided into equal shares, and "[e]ach such share shall constitute a separate and distinct trust designated with the name of the respective child." Cash contributions were also equal, and costs are to be shared equally. Article II.3. This is not what is commonly known as a "sprinkling trust," where the trust holds all assets in a single trust, and the trustee distributes income, and sometimes principal, to the beneficiaries according to their individual needs or some other standard that does not require equal distributions. Here, the trust shares are treated as if they are separate trusts. Although the bankruptcy trustee can compel distribution of the debtor's cash in his trust share, the bankruptcy trustee cannot compel distribution of cash from any of the other beneficiaries' separate shares. The rest of the cash in the trust has been spoken for; it belongs in the shares of the debtor's siblings, and they are the only beneficiaries of their particular shares. The bankruptcy trustee receives what the debtor contributed as settlor, even if the assets are in an inconvenient form. Eventually, the bankruptcy trustee will be

compelled to liquidate any assets he receives, 11 U.S.C. § 704(1), but he has no claim to the other Flynn children's shares. See also 11 U.S.C. § 363(h).

Conclusion

For the reasons stated above, the court will grant the bankruptcy trustee's motion, in part, and order the Flynn trustee to turnover the debtor's proportionate contribution to the trust: his 1/7 interest in the trust cash and his 1/14 interest in the trust real estate. A separate order will be entered accordingly.

Dated at Milwaukee, Wisconsin, January 19, 1996.

BY THE COURT:

_____/s/_____
Honorable Margaret Dee McGarity
United States Bankruptcy Judge