The Power of Discretion: An Introduction to Creditor Rights and Disability Planning Under the Michigan Trust Code

By Douglas Chalgian

Introduction

The rights of creditor’s to collect against assets held in trust are expressed in Part 5 of the Michigan Trust Code (the “MTC”). The objective of this article will be to summarize those rules and explain how they are organized. This will include a discussion of how these rules relate to the use of so-called “special needs” trusts.

A. The Organization of Part 5

Many key terms used in Part 5 of the MTC are defined in Part 1 of the MTC. Specifically, Section 7103 includes the definitions of an “Ascertaintable Standard,” a “Discretionary Trust Provision,” a “Spendthrift Provision,” and a “Support Provision,” among other terms.

Part 5 is comprised of only eight, relatively short, sections. These can be characterized as follows:

7501: Introduction
7503: Creditor’s Rights with respect to the Beneficiary of a Support Trust.
7504: Super Creditors.
7505: Creditor’s Rights with respect to the Beneficiary of a Discretionary Trust.
7506: Creditor’s Rights with respect to the Settlor of Revocable and Irrevocable Trusts.
7507: Creditor’s Rights with respect to the Beneficiary of a Trust that provides for Mandatory Distributions.
7508: Creditor’s Rights with respect to Creditors of the Trustee

B. The Matrix: Creditor Rights and Beneficial Interests

In terms of the ability of a creditor to reach assets held in trust for a beneficiary-debtor, Part 5 of the MTC establishes a matrix pursuant to which the rights of the creditor are a function of both the nature of the beneficial interest and the nature of the creditor.

According to this matrix, beneficial interests come in three varieties: (1) a right to a mandatory distribution, (2) a right to support under the terms of a support provision, and (3) a beneficial interest subject to a discretionary trust provision. Meanwhile, creditors come in two varieties: (1) so-called “super creditors” and (2) everyone else.

(1) Types of Creditors

As indicted above, an important distinction is made between super creditors and all other creditors.

(a) Super Creditors

The term “super creditors” is not used or defined by the MTC. This term simply provides a shortcut for referencing the grouping of creditors identified in section 7504. These creditors are:

(i) Persons entitled to alimony payments from the beneficiary.
(ii) Persons entitled to child support payments from the beneficiary.
(iii) Persons who have supplied services that enhance, preserve, or protect a beneficiary’s interest in the trust, and who have a judgment for same.
(iv) The state of Michigan.
(v) The United States Government.

When a super creditor exists and is subject to the rules establishing the situations in which super creditors may enforce their claims, as addressed below, section 7504 (2) provides that a court:

...shall order a trustee to satisfy all or part of a judgment...only out of all or part of distributions
of income or principal as they become due.

(b) Other Creditors

Types of creditors not specifically identified in section 7504 are provided no additional rights. Their power to collect with respect to a specific beneficial interest is discussed below.

(2) Types of Beneficiaries

Taking the most protective arrangement first, and working backwards:

(a) Beneficiary of a Discretionary Trust

Michigan law has always provided, and under the MTC will continue to provide, a high level of protection to assets held for the benefit of a beneficiary subject to a discretionary standard with respect to creditors of that beneficiary.

Section 7505 of the MTC states:

*The transferee or creditor of the beneficiary of a discretionary trust provision does not have a right to any amount of trust income or principal that may be distributed only in the exercise of the trustee’s discretion, and trust property is not subject to the enforcement of a judgment until income or principal, or both, is distributed directly to the trust beneficiary."

Or, said another way, a creditor of a beneficiary of a discretionary trust cannot reach assets that are held in trust for the beneficiary, and may only be satisfied if and when distributions are actually made from trust property directly into the hands of the trust beneficiary.

Note that 7505 does not make an exception for the so-called “super creditors” of 7504, and further, 7504(3) clarifies that the super creditor exceptions are not applicable to beneficial interests in discretionary trusts.

What might be new, or at least clearer, under the MTC is how to construe those trusts where discretionary language seems to be mixed with language of support or some other ascertainable standard. Section 7103(d) says that a trust provision establishing a distributional standard is a “discretionary trust provision:"

*…regardless of whether the terms of the trust provide a standard for the exercise of the trustee’s discretion…."

This interpretation is fortified with a clarifying statement in the definition of a “support trust.” Section 7103(k) states that even if a trust provision provides language that appears to be support language (health, education, maintenance, and support), if there is also language of discretion, such a provision will be treated as a discretionary provision. It states:

*“A provision in a trust that provides a trustee has discretion whether to distribute income or principal or both for these purposes or to select from among a class of beneficiaries to receive distributions pursuant to the trust provision is not a support provision, but rather is a discretionary trust provision.”*

Further, the definition of a “discretionary trust provision” clarifies that the creditor protections afforded beneficiaries of discretionary trusts are applied even when the nature of the trustee discretion is something less than full discretion over whether or not to make distributions to the beneficiary. Section 7103(d) identifies five specific acts of discretion that would qualify the beneficial interests as a discretionary interest, only one of which is the traditional: discretion to decide whether or not to make distributions.

(i) Special Needs Trusts

For attorneys who plan for clients with disabilities, and more specifically, clients who are receiving or are expected to receive needs-based government benefits such as Supplemental Security Income and Medicaid, the use of discretionary trusts has long been an important tool. So-called “special needs trusts” come in two varieties: (1) “self-settled special needs trusts (where the person seeking to receive the government benefits owns the property that will be held in trust for their benefit), and (2) third-party special needs trusts (where one person, typically a parent or grandparent, wants to leave a gift to another person who qualifies for these government benefits
but wants to make sure that the gift can be used to enhance their quality of life without interfering with their ability to continue to receive assistance through these government programs).

Self-settled special needs trusts are a creature of federal statute. Specifically, 42 USC §1396(p)(d)4. While it is important that these trusts are in fact discretionary trusts, the reason they work (that is, the reason someone can put their own money in them and then apply for these benefits) is that this statute says so. To be afforded the protection of these laws, trusts must comply with other requirements of the statute, the specifics of which are outside the scope of this article.

On the other hand, third-party special needs trusts are a function of state law. The reason someone can leave property in trust for the benefit of a person receiving needs-based government assistance, and not cause them to become ineligible for those government benefits, is because Michigan law provides that even a government creditor is not entitled to reach assets held in a discretionary trust for that debtor’s benefit. Accordingly, Part 5 of the MTC was intentionally drafted to allow people to be able to use third-party special needs trusts to plan for loved ones with disabilities.

(b) Beneficiary of a Support Trust

Section 7103(k) defines a “support provision” as:

…a provision in a trust that provides the trustee shall distribute income or principal or both for the health, education, support, or maintenance of a trust beneficiary, or language of similar import. A provision in a trust that provides a trustee has discretion whether to distribute income or principal or both for these purposes or to select from among a class of beneficiaries to receive distributions pursuant to the trust provision is not a support provision, but rather is a discretionary trust provision.

As discussed above, section 7504 allows super creditors to collect from distributions from a support trust “as they become due.” Section 7503 establishes the ability of other creditors to reach the interest of a beneficiary where that interest is subject to a support provision:

(a) The interest of a trust beneficiary that is subject to a support provision may not be transferred and the trust property is not subject to the enforcement of a judgment until income or principal, or both, is distributed directly to the trust beneficiary. After a distribution to a trust beneficiary whose interest is subject to a support provision, the income and principal distributed are subject to the enforcement of a judgment only to the extent that the income or principal, or both, is not necessary for the health, education, support, or maintenance of the trust beneficiary.

(b) The use or enjoyment of trust property by a trust beneficiary whose interest is subject to a support provision may not be transferred and is not subject to the enforcement of a judgment against the trust beneficiary.

In other words, to collect against an interest in a support trust, a creditor other than a super creditor must (1) have a judgment, (2) can then only collect from property distributed directly to the hands of the beneficiary, and (3) then only to the extent that the distributed property is not needed for that beneficiary’s health, education, maintenance, and support. What’s more, if the trust allows trust property to remain in trust for the use and enjoyment of the beneficiary, the property remains immune to collection.

(c) Beneficiary Entitled to Mandatory Distributions

The ability of trust beneficiaries to avoid creditors comes to an end at such time, including upon termination of the trust, that the trust provides that the property is required to be distributed to the beneficiary. Section 7507 states:

Whether or not a trust contains a spendthrift provision, a creditor or assigns of a trust beneficiary may reach a mandatory distribution of income or principal, including a distribution upon termination of the trust, if the trustee has not made the distribution to the trust beneficiary within a reasonable time after the designated distribution date.
D. Spendthrift Provisions

Separate and apart from the issue of the nature of the beneficial interest is the issue of whether the beneficiary’s interest is subject to a spendthrift provision, and the impact such provisions have on creditor rights.

The term “spendthrift provision” is defined in section 7103(j). It means:

...a term of a trust that restrains either the voluntary or involuntary transfer of a trust beneficiary’s interest.

The relevance of a spendthrift provision is set forth in section 7502. Specifically, in addition to precluding a beneficiary from being able to transfer their beneficial interest in a trust, section 7502(3) provides that with respect to creditors other than super creditors, and excluding self-settled trusts, a judgment creditor of a beneficiary whose interest is subject to a spendthrift provision may only reach trust property when it is “distributed directly to the trust beneficiary.”

E. Distributions to Third Parties for the Benefit of a Beneficiary.

It is important to recognize that throughout Part 5 of the MTC, even where creditors are not otherwise precluded from enforcing a judgment against the beneficiary’s interest, they are limited to reaching property that is distributed directly to the beneficiary. What this means is that property that is distributed to third parties to pay for things that benefit the beneficiary are not reachable by these creditors. Also as discussed with respect to the support trust provisions, assets that remain in trust for the use and enjoyment of the beneficiary are likewise outside the reach of the beneficiary’s creditors. What this suggests is that drafting provisions that allow the trustee flexibility in terms of how to provide for a beneficiary’s needs may provide a higher level of protection from that beneficiary’s creditors.

F. Creditors of the Settlor

The MTC was not intended to cause Michigan to become a state that is friendly to so-called “self-settled asset protection trusts,” and that has not occurred. Section 7506 provides that the assets in a revocable trust held for the benefit of a settlor/beneficiary remain exposed to that settlor’s creditors, and they must be used to satisfy the creditors upon the death of the settlor as has always been the law. Further, assets placed in an irrevocable trust for the benefit of the settlor/beneficiary remain available to satisfy creditors of the beneficiary, to the extent of the lesser of: the claim of the creditor or the maximum amount of trust property that could be distributed to or for the benefit of the settlor (excluding amounts that may be needed to pay the settlor’s taxes during his/her lifetime).

(1) The Self-Settled Asset Protection Predeceased Spouse Trust

That said, there is a curious exception to rule that under the MTC Michigan does not allow for self-settled asset protection trusts. Section 7506(4) provides that:

(4) An individual who creates a trust shall not be considered a settlor with regard to the individual’s retained beneficial interest in the trust that follows the termination of the individual’s spouse’s prior beneficial interest in the trust if all of the following apply:

a. The individual creates, or has created, the trust for the benefit of the individual’s spouse.

b. The trust is treated as qualified terminable interest property under section 2523(f) of the internal revenue code, 26 USC 2523.

c. The individual retains a beneficial interest in the trust income, trust principal, or both, which beneficial interest follows the termination of the individual’s spouse’s prior beneficial interest in the trust.

In other words, if you know your spouse is dying, and if you set up a qualified terminable interest property (QTIP) trust for said spouse, and you retain a beneficial interest in the property following his/her death, the property in trust for your benefit after your spouse dies will be subject to the rules for creditor rights as if you were a beneficiary and not the settlor of the trust. This means
then that in this limited situation, you could establish a self-settled asset protection trust that provides for your needs but cannot be reached by your creditors.

**Conclusion**

“Asset Protection” is a popular concept in estate planning today, and something some clients seem to take an interest in. Accordingly, planners should recognize that while the MTC does not significantly alter the existing law regarding the rights of creditors to assets held in trust, the clarity which the new code provides makes planning for these objectives more straightforward and reliable. The MTC should help attorneys better explain creditor rights issues to clients and to draft so-called “asset protection” provisions into their trusts with more confidence.

With respect to asset protection for beneficiaries, the key tools for such planning would involve: (1) selecting the appropriate beneficial standard (discretion, support, etc.), (2) considering language which would allow the trustee to retain assets in trust for benefit of beneficiary, and/or (3) to make distributions from trust to third parties for the benefit of beneficiaries, as well as (4) the possibility of including provisions that allow a trustee and/or a trust protector to convert one type of beneficial interest into another type of interest.

Although hardly the Mecca for self-settled asset protection trusts, the MTC establishes at least two situations where planners may begin to see possibilities for protection of a settlor’s assets through self-settled trusts: (1) self-settled trusts for payment of taxes and (2) self-settled QTIP retained interests trusts.

**Notes**

1. This matrix is not new to Michigan trust law. Part Five of the MTC is largely a codification of Michigan case law dealing with creditor rights and specifically those rules as first announced by the Michigan Supreme Court in *Miller v Department of Mental Health*, 432 Mich 426, 442 NW2d 617 (1989).

2. For a more complete understanding of the creation and administration of Special Needs Trusts in Michigan, see Chapter 7 of the ICLE publication, *Advising the Older and Disabled Client*, a new rewrite of which was recently released and which was prepared by Attorney Amy R. Tripp. Also see the materials prepared by Attorney Sebastian V. Grassi and presented at the 2009 Heckerling Institute in Orlando, Florida, and see Mr. Grassi’s article, “A Special Needs Child Requires Special Attention,” Vol 34 *Estate Planning* (Dec, 2007).

3. In addition, transfers to irrevocable trusts would also be subject to review by creditors in light of Michigan’s laws related to fraud, and more specifically, transfers in fraud of creditors.

4. This change brings Michigan property law into line with tax law in that both now treat the spouse for whom the trust was established as the transferor when the interest in the trust reverts to the donor spouse after the donee spouse’s death.

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