THE SPOTLIGHT

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WEALTH PLANNING, ADMINISTRATION, AND DISPUTES GROUP

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The Spotlight is the result of ongoing collaboration between our national trial practice and estate planning groups, with the goal of providing a forum to discuss the latest news and other issues impacting the trusts and estates community. Whether you are a trustee, beneficiary, trust officer, attorney, financial advisor, or other professional in this area, we hope that you will find this newsletter interesting, informative, and perhaps at times even a bit entertaining.

As leaders and teachers in the field of wealth planning and administration, our attorneys have built a reputation for excellence in meeting the needs of individuals and organizations from basic to complex testamentary planning. We counsel individuals and business owners in all aspects of estate planning and business succession, providing them with peace of mind and reassurance that their legacy is in the best of hands.

Furthermore, should a conflict arise, our wealth disputes attorneys are well positioned to resolve the matter with thoughtfulness, creativity, and compassion. Our national reputation for litigation excellence includes wins in the fiduciary arena for trustees and fiduciaries, personal representatives, beneficiaries, guardians, and conservators. Whether litigating fiduciary matters, inheritance issues, or contested charitable donations, we help clients cut through confusion to find a path to resolution.

Is there a topic affecting your practice that you would like us to discuss in an upcoming issue of the Spotlight? Let us know at SPosthumus@RobinsKaplan.com.

– Denise S. Rahne and Steve A. Brand

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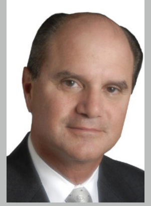

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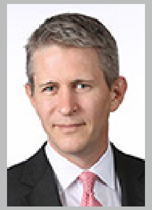

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EXEMPTION OF INHERITED IRAS UNDER CALIFORNIA LAW: THE LEGACY OF *CLARK V. RAMEKER*

BY MICHAEL T. DELANEY AND PETER FOUNDAS

Under federal and state law, an individual retirement account, or IRA, ordinarily may be exempted or excluded from the assets of a bankruptcy estate and, thus, protected from the claims of creditors. What happens, however, to an inherited IRA when an heir to the account files for bankruptcy? Will those funds be entitled to the same protections under federal and state law?

In *Clark v. Rameker*, the U.S. Supreme Court held that an inherited individual retirement account or IRA did not constitute "retirement funds" within the meaning of the Bankruptcy Code and, thus, was not subject to the *federal* exemption provided under section 522(b)(3)(C).[1] 134 S. Ct. 2242 (2014). Subsequent decisions of the lower courts, however, have called into question the applicability of the *Clark* decision in jurisdictions applying state law exemption schemes. *See, e.g.*, *In re Norris*, 550 B.R. 271 (Bankr. D. N.J. 2016). This article addresses the question of whether *Clark* has altered the treatment of inherited IRAs under the California exemption scheme.

CALIFORNIA EXEMPTION OF RETIREMENT ACCOUNTS AND INHERITED IRAS

The commencement of a bankruptcy case births a new legal entity—the bankruptcy estate. The assets of the bankruptcy estate include "all legal or equitable interests of the debtor in property as of the commencement of the [bankruptcy] case[,]" 11 U.S.C. § 541(a), *unless* the property may be exempt under applicable law. Under the Bankruptcy Code, each state may either adopt the exemptions in section 522 or establish its own exemptions. California elected to establish its own exemptions.

Section 703.140(b)(10)(E) of the California Code of Civil Procedure authorizes a bankrupt debtor to exempt the debtor's right to receive "payment under a stock bonus, pension, profit-sharing, annuity, or similar plan or contract on account of illness, disability, death, age, or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor …." Similarly, section 704.115(b) authorizes the exemption of "private retirement plan" funds and revenues. Courts in the Ninth Circuit have held that an IRA qualifies as a "similar plan or contract" for purposes of section 703.140(b)(10)(E) and a "private retirement plan" for purposes of section 704.115, and, as such, may be exempted from a bankruptcy estate. *See In re McKown*, 203 F.3d 1188, 1190 (9th Cir. 2000).

Prior to *Clark*, multiple courts addressed the applicability of sections 703.140(b)(10)(E) and 704.115(b) to inherited IRAs. *See, e.g.*, *In re Greenfield*, 289 B.R. 146, 150 (Bankr. S.D. Cal. 2003); *Diamond v. Trawick (In re Trawick)*, 497 B.R. 572 (Bankr. C.D. Cal. 2013). These courts held that inherited IRAs were not presumptively exempt or *per se* excluded from the California exemptions. To the contrary, the courts evaluated the

[1] For a further discussion of *Clark v. Rameker*, please see *Bankruptcy and Inherited IRAs: the Impact of Clark v. Rameker* by James P. Menton, Jr. and Kevin D. Meek published in Fall 2016 edition of The Robins Kaplan Spotlight, which is available at the following link: www.robinskaplan.com/resources/newsletters/spotlight/spotlight-fall-2016.

circumstances of the case to determine whether the plain language of the statute was satisfied and whether the goals of bankruptcy were furthered by allowing the exemption. *Ibid.*

Since the issuance of the *Clark* decision, multiple courts have addressed the exemption of inherited IRAs and other retirement accounts—specifically evaluating whether *Clark*'s *per se* exclusion of inherited IRAs from federal exemptions altered the applicability of the California exemptions. *See, e.g., In re Williams*, 556 B.R. 456, 463-464 (Bankr. C.D. Cal. 2016) (inherited pension under section 703.140(b)(10)(E)); *In re Sherr*, unpub., 2016 Bankr. LEXIS 3521 (Bankr. N.D. Cal. Sept. 27, 2016) (inherited IRA under section 704.115). In each case, the courts followed the pre-*Clark* case law—engaging in an analysis of the circumstances presented to determine whether the account qualified for the exemption per the terms of the applicable statute.

For instance, in *Williams*, the debtor asserted an exemption under section 703.140(b)(10)(E) in a survivorship interest in a CalPERS pension earned by the debtor's father and distributions on account of such interest. *See Williams*, 556 B.R. at 463-464. As the pension revenues were the sole source of the debtor's income, the court held that "preserving the debtor's ability to meet her basic needs and ensuring that debtors have a 'fresh start,' support the claimed exemption claimed here." *Ibid, citing In re Cataldo*, 224 B.R. 426, 429 (B.A.P. 9th Cir 1998). Based on its analysis, the *Williams* court overruled the objection and upheld the exemption in the pension.

Similarly, in *Sherr*, the chapter 7 trustee, relying on *Clark*, objected to an exemption claimed in an IRA inherited by the debtor from her father—arguing that the debtor could not exempt the IRA because she did not establish or contribute to the IRA. *Sherr*, 2016 Bankr. LEXIS 3521, at *1. The *Sherr* court overruled the objection and set the matter for an evidentiary hearing to consider the circumstances of the case and determine whether the inherited IRA was reasonably necessary to provide for the support of the debtor in retirement.[2] *Id.* at *3.

CONCLUSION

In sum, the *Clark* decision has not affected the exemption of inherited IRAs under California law or resulted in the adoption of a *per se* rule against the exemption of inherited IRAs or other retirement accounts. As before *Clark*, California courts evaluate the exemption of inherited IRAs and retirement accounts on a case-by-case basis to determine whether the retirement accounts are "reasonably necessary" for the support of the debtor in retirement and, therefore, necessary to provide the "fresh start" envisioned under the Bankruptcy Code.

[2] Shortly after the court's decision, the chapter 7 trustee and the debtor reached a settlement resolving the matter, and, as a result, no evidentiary hearing was held.

SOUTH DAKOTA DAPTS: PROTECT YOUR CAKE AND EAT IT, TOO

BY BRENDAN V. JOHNSON AND ERICA A. RAMSEY

One of the most frequent requests estate planning attorneys receive is how to guard one's hard-earned savings in the event of litigation, divorce, or bankruptcy. Often, the best plans for protecting personal assets can be simple, such as funding a trust for children or grandchildren. These types of trusts—naming third parties as beneficiaries — are common vehicles for asset protection, because they transfer assets to others. By doing so, however these assets become unavailable for future personal use. For those of us who want to protect assets but also need them available for use in the future, a self-settled Domestic Asset Protection Trust ("DAPT") could be the answer.

South Dakota, known for having progressive trust laws, is one of the handful of states that allow self-settled trusts as a form of creditor protection, and South Dakota's DAPT statutes are ranked among the top in the nation. https://www.oshins.com/state-rankings-charts.

How does a DAPT offer asset protection? The general rule long has been that a trust creator's creditors could reach trust assets if the creator retained rights to those assets. Under a DAPT, the trust creator (or "settlor") turns over decision-making power for distributions to one or more trustees — meaning the settlor does not control the funds, and the funds remain out of reach to the settlor's creditors. Ultimately, DAPTs give the settlor greater protection of a trust while allowing the settlor to retain the ultimate benefit of receiving distributions as a beneficiary.

Under South Dakota law, a beneficiary's discretionary interests, limited powers of appointment, and remainder interests are not property rights and cannot be garnished by creditors. SDCL 55-1-26, 55-1-28. Since a DAPT is a spendthrift trust (where the trustee has full authority as to how trust funds are spent), assets placed in a DAPT are protected against most creditors, including child support or alimony payments (unless the award was prior to the transfer to the DAPT) or divorcing spouses (again, for any transfers made prior to the marriage). SDCL 55-16-15. As in all other states, however, fraudulent transfers will be set aside. SDCL 55-16-9, 55-16-10. The takeaway? Setting up a DAPT will not protect assets against existing creditors, but it can be a useful tool for proactively protecting assets before any problems arise.

What qualifies as a self-settled DAPT in South Dakota? First, the trust must be irrevocable, contain a spendthrift clause, and expressly incorporate South Dakota law. SDCL 55-16-2. At least one trustee must be a state resident or institution. SDCL 55-16-3; 55-3-41. The South Dakota trustee must meaningfully participate in the administration of the trust, and some or all of the trust property should be located in the state. SDCL 55-3-39. Most important, as their actions relate to asset protection, the trustee(s) must have absolute discretion over distributions, although the settlor can retain a measure of control over certain investment decisions. *See* SDCL 55-16-2(a) – (j).

Additional layers of protection can be added to the trust as well. DAPT trust property may be titled to a corporate entity such as an LLC or LP, leaving a charging order as a creditor's sole remedy, which simply grants the creditor a right to a future distribution but does not allow the creditor any means to foreclose on the debtor's interest or otherwise force a distribution. SDCL 47-34A-504(e); 48-7A-504(e). Appointing a trustee organization as the sole member of the LLC will maximize protection, because South Dakota law does not distinguish treatment of single-member LLCs.

What assets can be used to fund a DAPT? The answer varies on a case-by-case basis, but assets may include property such as cash, securities, intellectual property, business inventory, or real estate. Ultimately, because the settlor is a permissible discretionary beneficiary, funds should be considered a long-term investment and should not be depended upon for everyday expenses. Depending on the trust structure, assets may be kept within a settlor's estate, which can allow the settlor to establish a self-settled trust without utilizing a gift tax exemption.

If properly structured, DAPTs can do much to protect a settlor's assets from creditors while allowing the settlor to use his or her own funds for retirement or other expected needs through future distributions. Those of us searching for a comprehensive personal asset protection plan should keep DAPTs in mind as a powerful tool.

CALIFORNIA SUPREME COURT DECISION LIMITS PROTECTIONS FOR SPENDTHRIFT TRUSTS

BY KEVIN D. MEEK AND ZACHARY A. COHEN

When a beneficiary of a spendthrift trust files for bankruptcy, a question arises as to the extent to which the beneficiary's interest in the trust is included in his or her bankruptcy estate and thus may be administered by a bankruptcy trustee. This answer is often determined by state law. Although beneficial interests in spendthrift trusts are a type of property that are not included in a bankruptcy estate pursuant to 11 U.S.C. § 541(c)(2), bankruptcy trustees have long relied upon California Probate Code § 15306.5(f) to assert that bankruptcy trustees, in their position as hypothetical lien creditors pursuant to 11 U.S.C. § 544, may receive up to 25 percent of the debtor/beneficiary's expected future payments in a spendthrift trust.

In the decision *Carmack v. Reynolds*, 2 Cal. 5th 844 (Cal. 2017), the California Supreme Court held that California law does *not* limit a bankruptcy trustee to 25 percent of distributions from a spendthrift trust but also includes any past amounts that are "due and payable" under the terms of the trust. In *Carmack*, the debtor was a beneficiary of a spendthrift trust.

After the beneficiary filed for Chapter 7 bankruptcy, the bankruptcy trustee sought to satisfy the claims of the beneficiary's creditors by including the beneficiary's interest in the trust as an asset of his bankruptcy estate, including all distributions that were due and payable to the beneficiary at the time the beneficiary filed for bankruptcy. The bankruptcy court, applying the Ninth Circuit's holding in *Neuton*, held that the bankruptcy trustee was entitled to reach *only* 25 percent of the beneficiary's interest in the trust. The Bankruptcy Appellate Panel for the Ninth Circuit affirmed the bankruptcy court's ruling. The trustee then appealed to the Ninth Circuit Court of Appeals, which asked the California Supreme Court to clarify whether California Probate Code § 15306.5 caps a bankruptcy trustee's access to a spendthrift trust at 25 percent of the beneficiary's interest where the trust pays entirely from principal.

The California Supreme Court's analysis centered on several sections of the California Probate Code. Cal. Probate Code § 15301(b) provides that, once an amount in principal has become "due and payable" to the beneficiary under the trust, a judgment creditor may petition to the court to make an order directing the trustee to satisfy the money judgment out of that principal amount. Cal. Probate Code § 15302 provides that where the trust specifies that a distribution is for the beneficiary's support or education, the amount that the beneficiary actually needs for such purposes may not be reached by creditors until in the hands of the beneficiary. Cal. Probate Code § 15306.5 simultaneously provides that any judgment creditor can petition the court to order a trustee to satisfy the judgment out of payments to which the beneficiary is entitled, limited to "25% of the payment that otherwise would be made to or for the benefit of the beneficiary." And Cal. Probate Code § 15306.5 allows any creditor to access all of a beneficiary's interest in a spendthrift trust besides the amounts necessary for a beneficiary's education and support. The court examined the complex interplay between these sections.

Having reasoned that the precise language of "due and payable" under section 15301(b) reaches only those amounts *presently set to be paid* to the beneficiary, the court next turned to Cal. Probate Code § 15306.5 and analyzed whether the 25-percent limitation applied to "due and payable" funds. The court determined that if no such distribution is pending or if the distribution is not adequate to satisfy a judgment, a general creditor can petition to access up to 25 percent of future payments *expected* to be made to the beneficiary, unless the trust instrument specifies that those distributions are for the beneficiary's support or education and the beneficiary needs those distributions for either purpose. Then, the court reconciled the 25-percent limitation imposed by Cal. Probate Code § 15306.5 with Cal. Probate Code § 15307, which purports to access all of a beneficiary's interest in a spendthrift trust besides what is necessary for the beneficiary's education and support. The court concluded that section 15307 reflects a drafting error that inadvertently did not address the 25-percent limitation set forth in section 15306.5, and that Cal. Probate Code § 15307 does not expand a creditor's ability to access future payments made to a beneficiary under the terms of a trust beyond the 25-percent limitation. The Ninth Circuit subsequently adopted and applied the California Supreme Court's decision to the debtor's bankruptcy case in *In re Reynolds*, 867 F.3d 1119 (9th Cir. 2017).

THE POTENTIAL IMPACT OF *CARMACK*

The court's ruling in *Carmack* provides that a bankruptcy trustee may access a beneficiary's interest in a trust, despite the existence of a spendthrift clause as follows: (1) the trustee may recover the full amount of any distributions of principal that were presently due and payable to the beneficiary (unless the distributions are for the support or education of the beneficiary), and (2) a trustee may reach up to 25 percent of those payments that are anticipated payments made to, or for the benefit of, the beneficiary. The decision also bolsters the incentive for donors to leave their items in trust for the beneficiary's support or education.

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As an attorney in the Restructuring and Business Bankruptcy Group, Kevin Meek focuses his practice on representing debtors, creditors, Chapter 11 creditor committees, and court-appointed receivers and bankruptcy trustees with regard to insolvencies, business bankruptcy planning, litigation, state and federal receiverships, and Commercial Law disputes. His litigation practice includes: prosecuting fraudulent transfer actions, prosecuting preferential transfer actions, defending against non-dischargeability and revocation of discharge claims, and representing clients in claims disputes and asset sales. He is currently the Vice Chair of the Bankruptcy Section of the Beverly Hills Bar Association, and serves on the Remedies Section Executive Committee of the Los Angeles County Bar Association. He can be reached at KMeek@RobinsKaplan.com.

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