

Estate Planning & Elder law

Piercing the Trust Veil: How Foolish Beneficiaries Can Compromise Foolproof Trusts

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A metallic silver Aston Martin screeches to a halt in your visitor's parking spot. Thirty-eight years old, impeccably dressed and arrogant, your client steps out, slams the car door and enters the building for an appointment with you. Years ago your firm counseled his parents on the formation of their software company. As the company started to grow, you, as a young partner, used your considerable tax expertise to transfer 98 percent of that company into a multigenerational family trust for the benefit of their son and issue. Through years of hard work by your client's parents, and through their technical brilliance, the company flourished. In their later years, mom and dad decided to sell the software company and eventually accepted a bid for \$75 million. Their young son's trust ended up with most of that sum, after income taxes, based on your creative and detailed planning many years ago.

A driving force behind mom and dad's decision to sell the software company was their concern that their young son did not possess the financial "disci-

pline" to maintain the company's viability. They followed the same thought process in designing the trust. The trust prohibits the wealthy young man from serving as a trustee. The trust also contains a spendthrift clause and a fully discretionary distribution standard (and does not contain a support standard of distribution or a mandatory distribution requirement), thus avoiding the creation of any property rights susceptible to creditor attack. Dad's trusted brother, Uncle Harry, was appointed trustee.

Your young client was not the settlor of the trust; he never did (nor will) gratuitously transfer assets to the trust. The law of fraudulent transfers, which courts use to unwind conveyances made with actual or constructive intent to evade creditors, is inapplicable because your client did not transfer assets into the trust. The theory of piercing the trust veil, which courts use to penetrate trusts for which trust settlors exert overbearing influence and/or use to commit frauds against others, is inapplicable because your client is not the settlor of the trust. In sum, your young client's trust cannot be accessed by his creditors. This trust is foolproof...or is it?

Unfortunately, your client's lavish lifestyle and abusive treatment of his trust may now catch up with him, for a liberalized doctrine of piercing the trust veil, one that looks beyond set-

tlors toward any beneficiary with abusive control over a trust, may be taking shape in courts of equity. This developing and controversial theory is carving out a new avenue by which creditors may be able to attack the interests of nonsettlor beneficiaries.

Courts co-opted the doctrine of piercing the trust veil from corporate law, where a corporation's protective shield can be pierced, and the assets of its shareholder can be attached, if a creditor of the corporation can prove: (1) the shareholder exercised such control over the corporation that it became a mere instrumentality, or "alter ego," of that shareholder; (2) the shareholder used that control to commit a fraud or wrong; and (3) that fraud or wrong caused injury to another party, namely the plaintiff or creditor in an action. In the trust context, the theory allows courts to access trust assets to satisfy claims against a settlor if the following can be proven: (1) the settlor exercised such control over the trust that it became a mere instrumentality, or "alter ego," of that individual; (2) the settlor used that control to commit a fraud or wrong; and (3) that fraud or wrong caused injury to another party, namely the plaintiff or creditor in an action. An example of such a case is *In re Maghazeh*, 310 B.R. 5 (Bkrptcy. E.D. N.Y. 2004).

In the trust context, however, courts may choose to forgo the requirement that the abusive party be a settlor of the trust since such a requirement may not serve any legitimate rationale. A trustee of a fully discretionary trust may have theoretical control via the terms of a

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trust instrument, but beneficiaries can, in certain instances, exert such dominant control and influence over a trust that courts may be willing to ignore the long-standing maxims of creditor protection for beneficiaries, particularly where trust assets are substantial and the details of trust management are less than clear. At the extreme, a court could destroy any creditor protection that a beneficiary may enjoy in relation to his trust's assets. In fact, the authors of this article have been retained to "right" trusts determined by court judgment and otherwise, to have de facto beneficiary control, including multinational trusts with hundreds of millions of dollars in diverse asset holdings. The authors have witnessed situations where experienced international corporate trustees had become "absentee landlord," allowing beneficiaries to do what they please for fear of losing trust management (and thus fees).

As it unfolds, this liberalized piercing theory may have far-reaching consequences, allowing courts to pierce trusts that have been established for lawful purposes only later to be abused by nonsettlor, nontrustee beneficiaries. New Jersey courts have yet to clearly move in this direction, but case law in New York reveals the transformation taking shape. In 1995, the New York Supreme Court, Appellate Division, noted in *National Union Fire Ins. Co. of Pittsburgh, Pa. v. Eagle Equipment Trust*, 221 A.D. 2d 212, 212-13 (1st Dep't 1995) (emphasis added):

There is no authority for applying...a theory of "piercing the corporate veil" to disregard the form of a trust, when the trust was not formed for an illegal purpose and there is the requisite separation between beneficiary and trustee. Even if it were permissible to proceed on such a theory, plaintiffs have not alleged facts tending to show that defendant

trust is a "dummy" by which the trustee is carrying on business in a purely personal capacity for purely personal ends.

Though the facts of this particular case were not amenable to expanding the doctrine, the court clearly acknowledged that a "dummy" trust, one in which an individual is using trust assets in a purely personal capacity, would justify the use of a piercing theory to satisfy creditor claims.

Several years later, in 2002, the District Court for the Southern District of New York indeed pierced a trust veil to access a parcel of real property to satisfy the creditors of a nonsettlor, nontrustee beneficiary. The District Court held that the beneficiary, and not the trustee, exercised complete domination and control over that particular trust asset. The District Court noted that the beneficiary lived in the property rent-free, granted a mortgage and easements on the property, and pledged the property as collateral as if it was his own. The Second Circuit eventually overruled the District Court, holding that New York State courts had yet to explicitly expand the doctrine in this manner. Nonetheless, the case reveals the willingness of a court to pierce a trust established for lawful purposes and later abused by nonsettlor, nontrustee beneficiaries. See *In re Vytautas Vebeliunas*, 2002 WL 115656 (S.D.N.Y. 2002).

Courts use a number of factors to determine whether a corporation is the alter ego of a shareholder, including the following: (1) the absence of formalities and records part and parcel to corporate existence, (2) the use of funds for personal rather than corporate use, (3) a lack of business discretion displayed by the dominated corporation, (4) the nonfunctioning of other shareholders, officers or directors, and (5) whether the corporation in question had property used by a dominating shareholder as if it

were his or her own. These same factors may apply in gauging whether a trust is the alter ego of a beneficiary. If there are no formal records of trust transactions, and if a trustee acts as a puppet or absentee landlord, allowing beneficiaries to use trust assets as if their own (without making independent judgments and documenting the same), a court may have justification to pierce the trust and impute ownership to the controlling beneficiary.

Turning back to your client, a few years ago Uncle Harry stepped down and appointed a local noncustodial trust company as successor trustee. This trust company is eager to keep generating fees from this substantial trust over many years. You learn that the client's lifestyle is directly funded by the trust at his direction. Your client used his influence over the trustee to purchase numerous vacation homes that had no prudent objective. The trustee made investments that would seem imprudent and suspect to a responsible trustee, including an investment in a money-losing horse farm of your client's "close friend." The trust operates independent businesses which your client abusively treats as his own entities. The formalities of the entities are not maintained; your client siphons money and merchandise out of the companies and abuses the corporate jet for his personal use. There are clear indications that your client simply tells the trustee how to manage the trust, evidenced by e-mails and correspondence. The trustee complies without any independent investigation or judgment and no documentation thereof.

Not only has your client created potential negative estate tax consequences, he also may have provided a court with an avenue by which to pierce an otherwise lawful trust in the event he personally finds himself in creditor trouble or a contentious divorce. The question thus becomes: faced with these facts, how does a practitioner re-establish the asset protection features of the trust?

Depending on the extent of beneficiary domination and control, one solution may be to decant the assets of the tainted trust into a new or pre-existing trust that does not have problematic issues. By leaving the “baggage” of the former trust and trustee behind, with the passage of time a court may be less driven to pierce the trust veil. Regardless of whether trust assets are managed in a new trust, all interactions between the trust and its

beneficiaries must be formalized and prior inappropriate interactions must be corrected, to the extent feasible. Business entities owned by the trust, especially those where the beneficiary is an officer or employee, must deal at arms length with the beneficiaries. There should be significant and documented participation by the trustee in all aspects of trust administration, evidenced by accurate, detailed books and records of all distributions, loans,

expenses, income and receipts.

It is imperative that trustees maintain the boundary between beneficiaries and trust assets. There certainly may be strong counterarguments that prevent courts from accepting a broad application of piercing in the long run. However, with formal trust administration, the trust, foolproof by design, will remain foolproof in practice, regardless of how foolish its beneficiaries may be. ■