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MAR 30 2005
UNITED STATES
BANKRUPTCY COURT
FOR THE DISTRICT OF ARIZONA

UNITED STATES BANKRUPTCY COURT

IN AND FOR THE DISTRICT OF ARIZONA

In Re: **JESSICA RAE THORLEY** **Debtor.**	**Chapter 13 Proceedings** **Case No. 2:03-bk-20939-CGC** **UNDER ADVISEMENT DECISION RE: VALIDITY OF SPENDTHRIFT TRUST CLAUSE**

I. Introduction

In dispute is the validity of the spendthrift provision in the trust in which Debtor has a beneficial interest. The Chapter 13 Trustee argues that the Debtor must include her beneficial interest in the trust in her Chapter 13 Plan because the trust does not contain a valid spendthrift provision. Debtor argues that the spendthrift provision is valid and therefore properly excluded from her bankruptcy estate. For the following reasons, the Court finds Debtor's interest in the trust properly excluded from her bankruptcy estate.

II. Facts

The parties do not dispute the relevant facts. On September 27, 1988, Edmund Dale Thorley and Mabel McLane Thorley ("Settlors") created a trust ("Trust"). After the death of Mabel Thorley, surviving Settlor Edmund Thorley executed a First Amendment to the Trust Agreement ("Trust Amendment"). The Trust Amendment provides that after the death of Edmund Thorley, the Trust will terminate when the youngest of the named great-grandchildren reaches the age of thirty, at which point the Trust income and principal shall be distributed to the surviving named beneficiaries.[1] Debtor Jessica Rae Thorley is the youngest named great-grandchild and will turn thirty on August 31, 2009. The Trust Amendment also provides that the death of any of the named beneficiaries

[1] Both Settlors are now deceased and the Trust is managed by a corporate trustee.

terminates their interest in the Trust.[2]

On November 26, 2003, Debtor filed for Chapter 13 bankruptcy and filed her Plan on December 23, 2003. The Plan provided that Debtor would make payments of $210 a month for 55 months. The Plan payments pay Debtor's priority claims and secured creditors in full and pay $1,927 to unsecured creditors, whose claims total $14,758 – approximately a 13% return. Debtor did not include her interest in the Trust in the Plan, but the Trustee's Plan Recommendation required Debtor to amend her schedules to reflect this beneficial interest. The Trustee projected that Debtor's interest in the Trust will amount to more than $100,000 when the Trust terminates in 2009.

At the Plan Confirmation hearing, the Trustee argued that Debtor must include her interest in the Trust in her bankruptcy estate. Debtor responded that her interest in the Trust is excluded from her bankruptcy estate because the Trust contains a valid spendthrift provision. The disputed Spendthrift Provision reads as follows:

> The interests of beneficiaries in principal or income shall not be subject to the claims of any creditor, any spouse for alimony or support, or others, or to legal process, and may not be voluntarily or involuntarily alienated or encumbered. This provision shall not limit the exercise of any power of appointment.

This Court noted at the hearing that if the Spendthrift Provision is valid under Arizona law, it is not property of the bankruptcy estate under 11 U.S.C. section 541. The Court asked the parties to provide supplemental briefs addressing only the issue of the Spendthrift Provision's validity. That having been done, the matter is now under advisement.

III. Decision

Arizona law recognizes the validity of spendthrift trusts. Arizona Revised Statute ("A.R.S.") §§ 14-7701, 14-7702. A spendthrift trust restrains the voluntary or involuntary transfer of a beneficiary's interest in income or principal and under the terms of such a trust, a "beneficiary's interest in income [or principal] under the trust shall not be transferred and is not subject to enforcement of a money judgment until paid to the beneficiary." *Id.* A spendthrift provision is

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[2] The Trust Amendment names seven beneficiaries, but the death of one has left six surviving beneficiaries. Thus, Debtor's share of the Trust is currently one-sixth.

invalid if the settlor is also the beneficiary, or if the sole beneficiary is the sole trustee. A.R..S. §§ 14-7705 and 14-7706. Section 541(c)(2) of the Bankruptcy Code, in turn, provides that "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title." *In re Coumbe* 304 B.R. 378, 382 (9th Cir. B.A.P. 2003). Thus, "a beneficial interest that is subject to a valid spendthrift restraint cannot be attached by judgment creditors of the beneficiary, nor does it become an asset of the beneficiary's bankruptcy estate under § 541 of the Bankruptcy Code." Restatement 3d of Trusts, § 58.

The Spendthrift Provision in the Trust satisfies A.R.S. §§ 14-7701 and 14-7702 because it clearly restricts the voluntary or involuntary transfer of the beneficiary's right to income and principal to creditors until paid to the beneficiary. Debtor has no present control over her Trust interest and is not entitled to any Trust income until her thirtieth birthday on August 31, 2009, which date falls outside of the Plan. Pursuant to the Trust's terms, she also has no power of appointment because her interest in the Trust evaporates upon her death and her share gets redistributed to the surviving beneficiaries. Further, the Spendthrift Provision is valid because the Debtor is not the settlor and does not act as trustee. Thus, the Spendthrift Provision does not fall into either exception that would invalidate the provision under Arizona law..

Despite the limited exceptions under the Arizona spendthrift statutes, the Trustee asks this Court to invalidate the Spendthrift Provision for two additional reasons. The Trustee first argues that the power of appointment language in the Spendthrift Provision[3] invalidates its inalienability because it reserves a power of appointment for the Debtor. For support, the Trustee relies solely on *In re Gilroy*, 235 B.R. 512 (Bankr. D. Mass. 1999), a case interpreting Illinois law. The Trustee argues that in *Gilroy*, the court invalidated a spendthrift provision because "the reservation of the power of appointment afforded the Debtor/beneficiary unrestricted access to the corpus." 235 B.R. at 518.

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[3] The Final sentence reads: "This provision shall not limit the exercise of any power of appointment."

The Trustees' argument is unpersuasive for two reasons. First, the decision in *Gilroy* is non-binding and not controlling because the *Gilroy* court applied Illinois state law and this presents a question of Arizona state law. Second, *Gilroy* is factually distinct from the case at hand because the debtor in *Gilroy* was both the sole beneficiary and sole trustee. Under Arizona law, this fact alone would invalidate the spendthrift provision. A.R.S. § 14-7706(B). The trust at issue in *Gilroy* also gave the debtor/beneficiary a general power of appointment, while in the case at hand, Debtor has no similar, presently exercisable power of appointment. In fact, Debtor does not have any power of appointment under the Trust Amendment because Debtor's interest terminates if she fails to survive the Trust.

The Trustee also argues that the non-discretionary nature of the Trust distributions invalidate the Spendthrift Provision. In other words, the Trustee asks the Court to invalidate the Spendthrift Provision simply because the Trust terms require the corporate trustee to distribute the Trust income and principal to the beneficiaries on the Debtor's thirtieth birthday. However, the Arizona spendthrift statutes do not impose the requirement that a trustee *must* have discretion over distributions in order for the spendthrift provision to be valid. To support his position, the Trustee relies *In re Pugh*, 274 B.R. 883 (Bankr. D. Ariz. 2002). While *Pugh* interprets Arizona law, the Trustee misapplies *Pugh* to this case. In *Pugh*, the debtor/beneficiary was a co-trustee of a trust with his sister. However, he named his sister as co-trustee without her knowledge or consent. He managed the trust and withdrew funds from the trust on numerous occasions at his discretion and without his sister's knowledge. The Court concluded that the sister's lack of knowledge prevented her from acting as a co-trustee. Thus, the Court invalidated the spendthrift provision because it debtor/beneficiary was acting as the sole trustee. The Trustee interprets *Pugh* to mean that a trustee must have discretion when distributing funds from a trust. *Pugh* does not *require* that a trust instrument give a trustee discretion to make distributions, but rather that *if* a trust instrument does give a trustee that discretion, then the trustee must have some knowledge base in order to exercise that discretion.

III. Conclusion

For the foregoing reasons, the Court finds that the Spendthrift Provision is valid. It is ordered

excluding the Debtor's beneficial interest in the Trust from her bankruptcy estate and Confirming the Chapter 13 Plan. Counsel for Debtor is to lodge a form of order consistent with this decision for the Court's signature.

So ordered.

DATED: March 30, 2005

CHARLES G. CASE II
United States Bankruptcy Judge

COPY of the foregoing mailed and/or via facsimile
this 31 day of March 2005, to:

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