Update: New Rules for the Treatment of a Divorcing Spouse's Third Party Trust Interests in Divorce

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This updates important developments since the publication of the authors' article on this topic that appeared in the New Hampshire Bar Journal in the Fall of 2015.[i] *It provides some historical context for our equitable division statute, and describes important amendments made to our Trust Code*[ii] *to address some of the uncertainties and issues addressed in the 2015 article. It will also consider some choice of law principles that will apply when a Family Division judge must consider the divisibility of a spouse's interest in a non-New Hampshire trust. The effect of the recent amendments and the application of foreign-governing trust law will often combine with the broad reach of our property settlement statute to require significant differences in the treatment of a divorcing spouse's interests in New Hampshire and non-New Hampshire third party trusts. At the end of this article, the authors will provide as an Appendix a "decision tree" format for analyzing the proper treatment of any given trust interest under the new rules.*

I. <u>Introduction</u>. The authors' 2015 article describes how in determining the divisibility of a divorcing spouse's interests in a third party revocable trust, the presiding Family Division judge is first required to find whether "as a matter of law" the beneficiary spouse's interests constitute "property interests" or "enforceable rights".[iii] That is an exceedingly low threshold; it is now clear under the law of trusts that *all* of a divorcing spouse's beneficial interests in a third party irrevocable trust are property interests and enforceable rights no matter how "vested", "contingent", robust or attenuated they might be. If that were not the case, the beneficiary would have no legal means to hold the trustee accountable in the performance of the trustee's fiduciary duties and no trust relationship would exist. Our property settlement statute includes in the divisible marital estate "all property, tangible and intangible"[iv]. Therefore, all of a spouse's beneficial interests must be included in the divorcing parties' marital estate unless some controlling authority, other than provisions of our or any other state's property settlement statute, dictates that they are not.

For trusts governed by New Hampshire law, in addition to the discretionary trust interests discussed in the 2015 article as being excluded from the marital estate under Trust Code §8-814(b), as confirmed by *Goodlander*, now *all* mandatory current and remainder trust interests in New Hampshire trusts are excluded under amended Trust Code §5-502(d) and (e)(1) if they are protected by a spendthrift provision. Those provisions of our Trust Code apply *only* to trusts that are governed by New Hampshire law. All interests in a non-New Hampshire third-party irrevocable trust held by a spouse who is a party to a New Hampshire divorce action are therefore divisible property interests and enforceable rights unless the governing law state has a trust law statute or case that indicates that any one or more of such interests would be excluded from the marital estate if the divorce action was being tried in the governing law state.

II. <u>The Critical Distinction Between "All Property" and "Dual Classification" Regimes Defining Marital Property Rights In the Common Law Property States</u>. To understand why that is true, it is first important to recognize that there are three broad categories of marital

property rights regimes in the United States. Nine states have "community property" regimes. The remaining states, including New Hampshire, are considered "common law property", or "equitable division" systems.

Historically, the community property states have considered marriage to create an economic partnership between the parties. Property acquired by either party prior to the marriage or by gift or inheritance during the marriage is considered that party's "separate property". Property acquired during the marriage is considered as part of the "community", with each spouse owning an equitable fifty percent share, irrespective of titling and the extent to which the title holding spouse furnished consideration for the acquisition of that community property. If the parties divorce, family law judges in community property states must classify all property as either separate or community. All separate property is awarded to the title holding spouse. Community property is divided equally between the spouses.

By contrast, before significant reforms were made in many common law property states, property divisions in many of those states were primarily based on title holding. This tended to disproportionately recognize the contributions of the bread winner spouse and undercompensate the less tangible contributions to the marital partnership of the spouse who might maintain the household and raise any children of the marriage. The inherent inequity in defining marital property rights primarily based on title was less controversial in the common law property states when divorce was less frequent and was granted only on fault grounds. However, the enactment of the "no-fault" statutes, and the resulting increase in the incidence of divorce during the 1960s, cast a harsher light on the problem. This prompted many state legislatures in the common law property states to begin to experiment with "equitable division" statutes that attempted to incorporate the marital economic partnership theory of the community property system.

Recognizing this trend, in 1971 the National Commission of Commissioners of Uniform State Laws promulgated the Uniform Marriage and Divorce Act (the "UMDA"). The UMDA was offered as a model equitable division system for adoption in common law property states.

The overall theme of the UMDA has been summarized as follows:

> The recommendations made in the text are designed to permit the courts to recognize what those members of families would recognize – that husband and wife are partners in an enterprise which produces income (the husband's wages), maintains a household and nurtures children (the wife's tasks as housewife and mother).[v]

Section 307 of the UMDA offered two alternatives to adopting states to reflect this partnership principle. Alternative A, which was "recommended generally for adoption", effectively creates a community of all of the property belonging to either or both spouses, however and whenever acquired and regardless of title.[vi] Upon divorce, the court would divide the community property between the spouses, not "equally" but "equitably" in accordance with specified factors.

Alternative B "was included because a number of Commissioners from [some] states represented that their jurisdictions would not wish to substitute, for their own systems, the great hodgepodge of assets created by Alternative A".[vii] Alternative B therefore retains the distinction between the spouses' separate and marital properties, limiting division upon dissolution to marital assets. It also departs from the true partnership principles of the community property system in that it calls for a division in "just" rather than "equal" portions.[viii] As under Alternative A, a court operating under an Alternative B-type system considers the "contribution of each spouse to acquisition of the marital property, including contribution of a spouse as homemaker".[ix] States adopting the Alternative B approach are said to be "dual classification" states.[x] Those adopting Alternative A are "all property" (sometimes referred to as "kitchen sink") jurisdictions.

While very few states adopted the UMDA lock, stock and barrel, the principles embodied in Alternatives A and B sparked a wave of reform of the property division statutes in the common law property states. Our current property settlement statute was enacted in 1992. It incorporates the all property system that is loosely drawn from UMDA Alternative A. New Hampshire is one of fourteen common law property states that have adopted the all property regime. The vast majority of the other common law property states have chosen dual classification systems based on UMDA Alternative B.

III. <u>All Trust Interests in A New Hampshire Divorce Action Are Property Interests or Enforceable Rights under *Chamberlin*</u>. It bears repeating that the *Chamberlin* framework requires a threshold determination that "as a matter of law" the beneficiary spouse's interests constitute "property" interests or enforceable rights. The presiding judge will then have broad discretion to value the interest in question, if that is possible, and apply the fifteen factors of RSA 458:16-a, II in allocating the interests between the spouses.

Section IV, Paragraph 3. of the authors' 2015 article discusses this analytical framework. But it does not address whether any or all trust interests other than powers of appointment and discretionary trust interests satisfy the *Chamberlin* standard and are therefore within the "intangible" property category subject to equitable division. This update will fill that void.

To best implement the marital economic partnership theory, our property division statute intentionally sets a low bar for finding a property interest or enforceable right by its use of the words "all tangible and intangible property." The New Hampshire Supreme Court has broadly found that divisible intangible property to include unvested pension benefits, stock options, and the like, irrespective of the extent to which the spouse's interest might be speculative, contingent or uncertain.[xi] Those cases make it clear that the court has found in the language of RSA 458:16-a, I a mandate on the part of the legislature to give Family Division judges the broadest possible latitude - - indeed, based on *Chamberlin*, the obligation - - to conclude that any given interest held by a divorcing spouse is as a divisible property interest or enforceable right. Because each trustee serves in a fiduciary capacity, <u>all</u> equitable interests held by a divorcing spouse in irrevocable trusts, including current and remainder interests, are property interests or enforceable rights irrespective of how remote or speculative their eventual vesting in possession might be, unless some governing common or statutory law expressly says that they are not.[xii]

Flaherty was decided before *Chamberlin*. The *Chamberlin* court[xiii] overruled prior precedents that suggested that lower courts had discretion to exclude unvested interests from the marital estate. The *Flaherty* court's consideration of the nature of Mr. Flaherty's interest as vested or contingent is *dicta* that was not outcome determinative. To conclude otherwise would ignore *Flaherty's* discussion of the Massachusetts *Davidson* and *Laurincella* cases.[xiv] *Flaherty* cites approvingly the following quote from the Massachusetts Appeals Court decision in *Davidson*:

> We do not think that either the uncertainty of value or the inalienability of [the remainder interest in question], in themselves, are sufficient to preclude consideration of the interest as subject to division.[xv]

The Justices went further noting that *Davidson* "…rejected 'the notion that the content of the estates of divorcing parties ought to be determined by the wooden application of technical rules of the law of property."[xvi]

If valuation or the uncertainty of vesting in possession is a concern, the Supreme Court has directed presiding Family Division judges to resolve those issues by either: (i) awarding the contingent interest in question to the beneficiary spouse based on a formula by actuarial calculations and awarding other assets of equivalent value to the non-beneficiary spouse if the interests can be valued with reasonable confidence; or (ii) when that is not possible, dividing the interest between the spouses subject to a deferred distribution order, as the court approved in *Flaherty*.

IV. <u>Laws of the Trust's Governing Law State Apply to Determine if Trust Interests are Includable in the Marital Estate</u>. The public policy behind the wholesale changes that the legislature made to our Trust Code in enacting the Trust Modernization and Competitiveness Act of 2006 was to make New Hampshire an attractive jurisdiction for both New Hampshire and non-New Hampshire resident trust settlors.[xvii] Part of that effort has been to provide settlors greater assurances that their trust assets will not be subject to division to third party non-beneficiaries' creditors' claims and marital property rights than those available to them unless their home-states' more "regressive" trust law regimes.

This creates a tension between two competing public policy objectives: (i) the policy reflected in our property settlement statute and its common law gloss that favors an expansive application of the economic partnership theory of marital property rights in the divorce context, and (ii) that reflected in our Trust Code that favors trust settlors' desires to insulate their beneficiaries' trust interests from division to third party claimants, including divorcing non-beneficiary in-laws. The changes made to the pertinent provisions of our Trust Code concerning interests in discretionary and spendthrift trusts resolve this tension in favor of the later policy. Those provisions, combined with the *Flaherty* choice of law analysis, also create an interesting new framework for determining the divisibility of a spouse's trust interests that may produce dramatically different results depending on the settlor's choice of governing law.

A. New Hampshire Trusts. The presiding judge would have no authority to include any interests in spendthrift or discretionary trusts in the parties' marital estate. Remainder interests and mandatory interests (*i.e.*, mandatory income and unitrust interests) would be divisible in the marital estate only if not protected by a spendthrift provision.

B. Non-New Hampshire Trusts. The Trust Code provisions have no application for trust interests that are governed by the law of another state, *e.g.* Massachusetts.[xviii] *Flaherty* makes clear that choice of law principles require that the effect of the trust agreements' spendthrift provision must first be determined by applying Massachusetts law. Under Massachusetts law, a spendthrift clause is not a bar to including the interest in the martial estate, as evidenced by recent Massachusetts appellate cases *Levitan v. Rosen*, 95 Mass. App. Ct. 248 (2019) (Massachusetts Appellate Court) and *Pfannenstiehl v. Pfannenstiehl*, 475 Mass. 105 (2016) (Massachusetts Supreme Judicial Court), as well as our Supreme Court in *Flaherty, supra*, 138 N.H. at 341(*citing Davidson v. Davidson*, 19 Mass. App. Ct. 364, 371-72, 474 N.E. 2d 1137, 1144 (1985)). Unless the trust interests in a non-New Hampshire trust are protected by a spendthrift provision and the governing law state has a statute or case that indicates that the such interest is protected, such trust interests are property or an enforceable right and will property be included in the marital estate.

ENDNOTES:

[i] *Trusts and Divorce – Good, Bad and Ugly: New Rules for the Treatment of a Spouse's Discretionary Trust Interests and Powers of Appointment in Divorce Under UTC Article 5 and Goodlander*, 55 N.H. Bar. Jour. 20 (Fall, 2015) (hereinafter cited as "*Trusts and Divorce*").

[ii] All references herein to the "Trust Code" will refer to the provisions of RSA Chapter 564-B, the "New Hampshire Trust Code". At the time the 2015 article was published, the title of Chapter 564-B was the "Uniform Trust Code", or the "UTC". References made in that article as to Trust Code were therefore to the "UTC". In 2017, the General Court revised the Chapter title to the "New Hampshire Trust Code" to reflect the substantial changes made since the adoption of the UTC in 2014, and to distinguish New Hampshire from "UTC" states that have not made substantial changes to their versions of the UTC.

[iii] *See Chamberlin v. Chamberlin*, 116 N.H. 368, 372 (N.H. 2009).

[iv] RSA 458:16-a.I.

[v] Levy, *Uniform Marriage and Divorce Legislation: A Preliminary Analysis*, §B-1, note 205, at FN-62 n. 357 (gender references are Mr. Levy's, not the authors').

[vi] UMDA §307, 9A U.L.A. at 144 (Commissioners' Comment 1973).

[vii] *Id.*, 9A U.L.A. at 144.

[viii] *Id.*, 9A U.L.A. at 143.

[ix] *Id.* §307(1) (Alternative B), 9A U.L.A. at 143.

[x] *See generally*, Douglas and Garvey, *Division of the Premarital Trust or Inheritance*, New Hampshire Bar Jour. 58 (Summer, 2004).

[xi] The Court considered the divisibility of a party's unvested stock options in *In the Matter of Valence and Valence*, 147 N.H. 663 (2002), holding that a portion of husband's unvested stock options were properly included in marital estate and divisible based on time-based formula despite the possibility that they may never vest or have any future value. The equitable division would occur "if and when" the options vest because the Court found that they had no present value. *See also Blanchard v. Blanchard*, 133 N.H. 427 (1990), involving military pension benefits, where the Court noted that, although the nature of a pension can make valuation impossible in some cases, "in such cases, where it is nevertheless clear that the pension in question has some significant value, the problem of valuation can be avoided, and the risk of uncertainty evenly placed upon the parties, by a decree providing that upon maturity of the pension rights the recipient pay a portion of each payment received to his or her former spouse." *Id.* at 131, quoting *Hodgins v. Hodgins*, 126 N.H. at 715-16. In *Hodgins v. Hodgins*, 126 N.H. 711, 715 (1985), the Supreme Court held that if the actual and contingent values of a pension can be ascertained, the presiding family division judge should do so, and divide the pension amount accordingly. If the amounts cannot be ascertained in a meaningful way, the judge should apply what is now well-known among family law practitioners as "the *Hodgins* formula". *Id.* at 716. That formula is intended to help Family Division Judges "avoid the problem of valuation". *Id. See also In re: White*, 148 N.H. 531, 535 (2002) ("*Hodgins* is a default absent the possibility of determining the actual and contingent value of a pension…"). The rationale behind the use of the formula is "to ensure that the risks of uncertainty are evenly placed upon the parties". *Rothbart v. Rothbart*, 141 N.H. 71, 76 (1996).

[xii] *See generally* N.H. RSA 8-814(a). ("[n]otwithstanding the breath of discretion granted to a trustee in the terms of the trust, including the use of such terms as "absolute", "sole", or "uncontrolled", the trustee shall exercise a discretionary power in good faith and in accordance of the terms and purposes of the trust and the interests of the beneficiaries"); RSA 564-B:10-10-1001(a) ("[a] violation by a trustee of a duty the trustee owes to a beneficiary is a breach of trust"), and (b) (prescribing beneficiaries' remedies for breaches of trust); Restatement of Property §6, cmt. a.; Restatement (Second) of Trusts §2 cmt. f.; Kevin O. Milliard, *Rights of a Trust Beneficiary's Creditors Under the Uniform Trust Code*, 34 ACTEC L.J. 58.72 (2008) (the equitable interest of a beneficiary of a discretionary trust is more than a mere expectancy, it is an interest in property) (authorities cited therein).

[xiii] *See Chamberlin*, note 3, *supra*, 116 N.H. at 372.

[xiv] *Flaherty v. Flaherty*, 138 N.H. 337, 341 (N.H. 1994).

[xv] *Id., citing Davidson v. Davidson*, 19 Mass. App. Ct. 364, 371-72, 474 N.E. 2d 1137, 1144 (1985).

[xvi] *Flaherty*, *supra*, 138 N. H. at 342, *citing Davidson*, *supra*, 19 Mass. App. Ct. at 371, 474 N.E. 2d at 1144.

[xvii] *See* Arruda and Ardinger, *The Policy and Provisions of the Trust Modernization and Competitiveness Act of 2006*, 46 N.H. Bar Jour. 16 (August, 2006). *See also* Burke, Brassard, Sanborn and Shields, *The New Hampshire Trust Advantage: Why the Granite State Rocks When It Comes to Administering Trusts*, 43 Estate Planning 3, 4-8 (describing benefits of New Hampshire asset protection trusts)

[xviii] *See* RSA 564-B:1-102 (**Scope**: the provisions of the Trust Code apply only to New Hampshire trusts).

Appendix to *New Rules for the Treatment of a Divorcing Spouse's Third Party Trust Interests in Divorce*

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DECISION TREE FOR ANALYZING THE DIVISIBILITY OF DIVORCING SPOUSE'S THIRD PARTY TRUST INTERESTS

What law governs the trust's validity and construction?

1. If New Hampshire law governs:

    a. Does the trust agreement contain a spendthrift restriction? If "yes", then all of the spouse/beneficiary's interests are protected, regardless of whether vested or contingent, Trust Code §5-502(e)(1), except for assets held in the trust over which the spouse has a general power of appointment, but even interests subject to spendthrift protections can be considered as a "division factor" under RSA:16-a II, particularly if high degree of vesting possibility/certainty (remainder interests vesting on death of elderly parent, mandatory income/annuity trust interest).

    b. If no spendthrift protection, does the vesting of the spouse/beneficiary's interest depend on the exercise of a third party trustee's exercise of discretion? If "yes" then discretionary interest is protected, Trust Code §8-814(b) and *Goodlander*.

    c. If no spendthrift protection, and interest is non-discretionary in nature, is the spouse/beneficiary's interest a property interest or enforceable right? Answer is always "yes", and only question relates to valuation. If eventual vesting and possession is too remote or speculative to be valued, court has equitable power to issue deferred distribution order.

2. If the laws of other states/jurisdictions govern trust's validity/construction:

    a. Does Trust Agreement include a spendthrift provision? If you retain a local expert who opines that the answer is "yes", and the expert also opines that the governing law states' common or statutory law does not extend "exception creditor" status to non-beneficiary spouses in whole or in part (*e.g.*, Massachusetts), then interest is divisible based on *Flaherty* choice/conflicts of law analysis.

    b. Is there any other feature of the law of trusts (not the law of marital property rights) of the governing law state that would afford protection to the spouse/beneficiary's interest similar to spendthrift trust protection? If "yes", consider retaining trust law expert in governing law state to opine on that issue.