

Guest Article

■ Irrevocable Trusts and Family Limited Partnerships in Matrimonial Litigation

Irrevocable trusts and family limited partnerships play an important role in estate planning, and they also can figure in matrimonial litigation. In this article, we examine a hypothetical fact pattern that is similar to those that family law attorneys are confronting in litigating high net worth divorces. We also address arguments that can be raised in (a) attempting to set aside transfers of assets to an irrevocable trust, (b) attacking the validity of such a trust, and (c) defending such transfers and the validity of such trusts.

Hypothetical ■ ■ ■ ■

The Parties

In 1980, George and Martha were married. During the marriage, George (a sophisticated businessman) was the breadwinner. Martha, a college graduate, did not work outside the home. Instead, she took care of the parties' children and managed the household. Martha relied on George to handle the parties' financial transactions and decisions.

The Family Trust

In 1990, George engaged the law firm where George's close friend and business lawyer ("Attorney/Friend") was a partner, to draft an agreement to create an irrevocable family trust ("Family Trust"). The instrument was executed by George as Settlor and was to be executed by the two designated Co-Trustees, Martha and the Attorney/Friend. The Family Trust recited in relevant part

that (a) the parties' children were the beneficiaries, (b) the Co-Trustees (acting jointly) had the discretion to make distributions of income and principal to one or more of the children, and (c) George could not amend or revoke the Family Trust or serve as a trustee. The initial corpus of the Family Trust was \$25,000, which George contributed from his earnings during the marriage.

The Family Limited Partnership

At the same time, the Attorney/Friend's law firm created a family limited partnership ("Family Limited Partnership"), in which George had a 20% General Partnership interest and the Family Trust had an 80% Limited Partnership interest. George contributed (from his earnings during the marriage) the sum of \$100,000 as the initial capital of the Family Limited Partnership.

Martha's Execution of the Documents

One morning, just before he left for work, George handed Martha (i) the Family Trust document that she was to execute as Co-Trustee, and (ii) the document creating the Family Limited Partnership that she was to execute on behalf of the Family Trust—acknowledging its 80% limited partnership interest therein. George told Martha that the Family Trust and Family Limited Partnership would be important parts of their estate and tax planning and asked that she execute them. George also told Martha that she could consult with an independent attorney and have him or her review

the documents before she signed them. George watched as Martha took the documents and immediately signed without reading them first.

The Bonus

After the creation of the Family Limited Partnership, George (as General Partner) invested the Family Limited Partnership's funds skillfully. By December 2010, the Family Limited Partnership had grown to \$6,000,000 in liquid assets. As the 80% owner of the Family Limited Partnership, the Family Trust held a substantial majority of all of the property and assets acquired during the marriage.

In December 2010, the Family Limited Partnership paid George a bonus of \$1,000,000. George immediately transferred that \$1,000,000 to a different irrevocable trust ("Father's Trust"), created by George's father in 2000. The Father's Trust named George's Attorney/Friend as Trustee and provided that (a) income and principal could be distributed to one or more of George and his descendants, (b) George could not amend or revoke the trust or serve as trustee, and (c) the Attorney/Friend could amend the Trust for the benefit of one or more of George and his descendants. In December 2012, George filed for divorce.

Analysis ■ ■ ■

A Brief Discussion of the Illinois Case Law on Transfers

Under Illinois law, "an owner of property has an absolute right to dispose of his property during his lifetime in any manner he sees fit." *Payne v. River Forest State Bank & Trust Co.*, 81 Ill. App. 3d 1128, 1130 (1st Dist. 1980). He or she may do so even if the transfer is for the precise purpose of minimizing or defeating the statutory marital interest of his or her spouse in the property transferred or conveyed. *Id.* See also *Wood v. Wood*, 284 Ill. App.3d 718, 723 (4th Dist. 1996).

A trust is valid against the marital rights of a spouse if the settlor spouse had the donative intent to make a conveyance of a present interest in the trust estate. *Johnson v. LaGrange State Bank*, 73 Ill. 2d 342, 361 (1978). If, however, the settlor lacked donative intent, the trust would be merely illusory or colorable and, therefore, tantamount to a fraud. *Id.*

[A]n illusory transfer is one which takes back all that it gives, while a colorable transfer is one which appears absolute on its face but due to some secret or tacit understanding between the transferor and the transferee the transfer is, in fact, not a transfer because the parties intended that ownership be retained by the transferor.

Id. at 359.

"[A] fraud on the marital rights of [a] spouse [is] not fraud in the traditional sense. 'Intent to defraud' must be construed in connection with the words 'illusory' and 'colorable.'" In re *Marriage of Frederick*, 218 Ill. App. 3d 533, 536 (2d Dist. 1991). The Illinois Supreme Court in *Johnson* observed that a "purported transfer whereby the owner does not intend to convey a present interest, but intends to retain ownership, is evidence of an intent to defraud." *Johnson*, 73 Ill. 2d at 359-60. As the court observed in *Payne*, 81 Ill. App. 3d at 1131, citing *Johnson*, 73 Ill. 2d at 360-61:

The fraud, as defined by the supreme court, relates to the absence of present donative intent to transfer an interest in the property, not to the presence of intent to defeat the statutory marital rights of the surviving spouse.

Whether a spouse possessed the requisite donative intent to transfer an interest to a trust must be determined from the particular facts in each case. *Johnson*, 73 Ill. 2d at 364. Accordingly, any determination concerning the fraudulence of a transfer is fact-specific and "depends upon all the circumstances surrounding the transfer." *Frederick*, 218 Ill. App. 3d at 536.

Courts have found the following factors to be *among* those to consider in determining whether the donor possessed the requisite donative intent or whether the transfer was fraudulent:

- The secretive nature (or lack thereof) in which the settlor acted, and what the settlor might have said to others as to his intent in making the apparent gift;
- The value of the settlor's estate and the value of the property left to the other spouse;
- The proximity in time between the transfer and death or dissolution; and
- "[F]inally, all factors which might indicate an intent to defraud" the other spouse of her/his statutory share.

E.g., In re *Estate of Puetz*, 167 Ill. App. 3d 807, 812 (2d Dist. 1988).

Based on these legal principles (and others discussed in this article), each of Martha and George could advance arguments concerning the viability of the Family Trust and the Family Limited Partnership.

Arguments That Martha Could Advance ■ ■ ■

Martha and her divorce attorney are faced with the dilemma that unless Martha is able to assert a right to the assets in the Family Trust, or an interest in the \$1,000,000 bonus George received from the Family Limited Partnership (which he then promptly transferred to the Father's Trust), there will be substantially less marital property for the Court to award Martha at the time of Judgment than would otherwise have been the case.

To avoid this result, Martha could challenge George's transfer of assets to the Family Trust, making the following arguments, based on the factors listed in *Puetz* and other common law principles – including fiduciary duty principles.

1. Secretive Fashion (Puetz #1)

George acted in a secretive fashion because he knew Martha relied on him to look out for her financial interests, yet he failed to insure that full disclosure to Martha was made as to the nature and consequences of the Family Trust and the Family Limited Partnership. It is logical to assume (and Martha might allege) that George's Attorney/Friend explained to George (and George understood) the nature and consequences of the Family Trust and the Family Limited Partnership before those documents were signed, including the fact that as General Partner, George had *de facto* control over the Family Trust's assets. Yet, George did not insure that Martha had an understanding of the nature and consequences of those documents.

These issues also may be framed in terms of fiduciary obligations discussed in Section 5.

2. Inequality of Martha and George's Estates (Puetz #2)

At the time George filed for divorce, the Family Trust contained a substantial majority of the assets and property acquired during the marriage, reducing materially the marital property to be divided between George and Martha. Because George had at all times controlled the Family Limited Partnership as its General Partner (and because the Family Trust's most valuable holding was its 80% interest in the Partnership), Martha could assert that George had always had access to the corpus of the Family Trust arising out of his control over the Family Limited Partnership. This is demonstrated by the \$1,000,000 bonus he paid to himself from the Family Limited Partnership. Accordingly, Martha could argue that the marital estate (to be divided between George and Martha) should include the Family Trust's/Family Limited Partnership's assets; otherwise, George would receive substantially more than Martha would receive upon entry of a Judgment for Dissolution because George has access to the Family Trust's assets through his control over the Family Partnership.

3. Timing (Puetz #3)

The Family Trust was created many years before George filed for divorce. Nevertheless, Martha could argue that George never relinquished effective control over the assets transferred to the Family Trust, for the reasons stated in Section 2 above. She also could argue that George controlled these assets as evidenced by the bonus he paid to himself in December of 2010. Thus, the timing (Martha could argue) is relevant to her position that George always lacked the donative intent to transfer the assets to the Family Trust and only began exercising such control in 2010 shortly before he filed for divorce.

4. Other Factors (Puetz #4)

As noted in Sections 2 and 3, in December 2010, George (a) exercised his power (as General Partner) to pay himself a \$1,000,000 bonus from the Partnership; and (b) in turn, transferred that money to the Father's Trust—thus giving George's Attorney/Friend (as Trustee of the Father's Trust) power to amend that Trust for George's benefit. Martha could argue that these are equitable "factors which might indicate an intent to defraud" and further demonstrate that George lacked the requisite donative intent when he created the Family Trust and that his alleged transfers of assets to the Family Trust were "colorable."

In short, Martha could assert that because of George's role as General Partner of the Family Limited Partnership and the "tacit understanding" between George (as transferor) and Attorney/Friend (as a transferee), he in effect took back the assets he transferred to the Family Trust. Put simply, George and his Attorney/Friend understood that George in effect could invade the Family Trust's assets through his role as General Partner of the Family Trust and his relationship with his Attorney/Friend who is the Co-Trustee of the Family Trust and as Trustee of the Father's Trust. See *Hoffman v. Hoffman*, 94 Ill.2d 205, 221 (1983) (husband's transfer of property collusively with intent to regain the property can be voided).

5. Breach of Fiduciary Duty

The facts on which the foregoing *Puetz* arguments are based also may give rise to a claim that George breached his fiduciary duty to Martha by arranging to have the Family Trust agreement and the Family Limited Partnership agreement prepared and executed by her without providing her with full disclosure of the ramifications of these documents. Although a marital relationship does not create a fiduciary duty as a matter of law, Martha could argue that the fact that George took on the role of handling finances and that she completely trusted him to do so created a fiduciary relationship between them and the duties associated therewith. See *Wold v. Wold*, 43 Ill. App. 3d 773, 778 (2d Dist. 1976).

Cases that could be urged in support of George's alleged breach of his fiduciary duty include *Kurtz v. Solomon*, 275 Ill. App. 3d 643, 652 (1st Dist. 1995) (fiduciary relationship imposes general duty to refrain from seeking "selfish benefit" during the relationship), and *Prueter v. Bork*, 105 Ill. App. 3d 1003, 1007 (1st Dist. 1981) (documents presumptively invalid unless defendants could prove that plaintiff had full knowledge of the trust terms when executing them). Martha also could point to language in *Carr v. CIGNA Securities, Inc.*, 95 F. 3d 544, 548 (7th Cir. 1996), to the effect that a fiduciary relationship may in some cases excuse a principal's failure to read a document.

Further, should a fiduciary duty be established, Martha could argue that George had a duty to disclose to her, before she signed the documents, all of the potential issues that could arise from the transfer. See *Prueter*, 105 Ill. App. 3d at 1006 (fiduciary must show he/she made a full disclosure of all relevant information to principal and that principal had competent and independent representation before completing transaction). She could then assert that had these matters been disclosed, she would not have executed the Family Trust and Family Limited Partnership documents.

Additionally, Martha could argue, in her capacity as a Co-Trustee of the Family Trust, that George – as General Partner of the Family Limited Partnership – breached his fiduciary duty to the Family Trust (which owned an 80% Limited Partnership interest in the Partnership) by taking Family Limited Partnership funds and arranging immediately to transfer them to the Father’s Trust. See *Labovitz v. Dolan*, 189 Ill. App. 3d 403, 412 (1st Dist. 1989) (discretion granted to general partner is subject to fiduciary duty of good faith and loyalty to other partners).

6. Dissipation

Finally, Martha could allege that when George received the \$1,000,000 bonus from the Family Limited Partnership and immediately transferred that sum to the Father’s Trust (which, as noted above, gave the Attorney/Friend the power to amend that trust to benefit George), the marriage was undergoing an irretrievable breakdown – hence George was guilty of dissipation, which should be redressed in allocating the remaining marital property.

Arguments that George Could Advance ■ ■ ■

George and his divorce attorney could make the following arguments in response:

1. Secretive Fashion (Puetz #1)

George could assert that there was nothing “secretive” about the creation of the Family Trust, which named Martha as Co-Trustee. Martha, a college graduate, could have read the agreements creating the Family Trust and the Family Limited Partnership. Further, George could argue that he told Martha that she could consult with an independent attorney as to the nature and consequences of the documents before signing them, but Martha declined to do so. Cf. *Matter of Estate of Wessels*, 203 Ill. App. 3d 1080, 1087 (3d Dist. 1990) (independent legal advice concerning a questioned transaction, when given to the trusting party of a fiduciary relationship, is significant evidence tending to rebut the presumption that the transaction was fraudulent or the result of undue influence).

2. Inequality of Martha’s and George’s Estates (Puetz #2)

Although the Family Trust contained a substantial majority of the assets and property acquired during the marriage, George could argue that he was the owner of the property that he contributed to the Family Trust and, as such, he had the right and power in 1990, under *Payne*, 81 Ill. App. 3d at 1130, to transfer the assets to the Family Trust. Further, George could assert that he no longer owns the assets transferred to the Family Trust and he has no power to amend or revoke the Family Trust or to serve as a trustee. Thus, he could assert that there is no inequality between his estate and Martha’s estate. As far as the Family Limited Partnership is concerned, George’s general partnership interest therein is marital property and the value thereof is subject to equitable division.

3. Timing (Puetz #3)

The Family Trust was established in 1990 – 23 years before George filed for divorce. Thus, George could argue that the timing of these transactions weighs in his favor.

4. Other Factors (Puetz #4)

George could argue that if the divorce court were to entertain the claim that the Family Trust was illusory or colorable, it would be interfering with the equitable rights of the beneficiaries of that Trust (the parties’ adult children). Accordingly, George could argue that the Family Trust, the Attorney/Friend, as Co-Trustee of the Family Trust, and the parties’ children, who are beneficiaries of the Family Trust, would have to be brought into the divorce case as necessary parties thereto. See 735 ILCS 5/2-405. Thus, George could force Martha to sue their children.

Further, George could assert that the \$1,000,000 bonus he received in December 2011 was fair, given the huge increase in the Family Limited Partnership’s value attributable to his efforts and in light of the fact that he had received no compensation from the Family Limited Partnership’s inception in 1990 for managing the Family Limited Partnership.

5. Breach of Fiduciary Duty

George could argue that he was not Martha’s fiduciary. A fiduciary duty does not arise by marriage alone. See *Pollard v. Pollard*, 12 Ill. 2d 441, 446 (1957). George could assert that the facts do not support a duty here. Martha was a college graduate and was clearly able to read the documents George provided to her. Further, George recommended that Martha consult with an independent attorney as to the nature and consequences of the Family Trust agreement and the Family Limited Partnership agreement before she signed them. Martha, however, failed to consult an independent attorney and willingly signed the documents without reading them. George could assert that even if he were a fiduciary, he did not breach his duties under these circumstances. See *Carr*, 95 F. 3d at 548 (court affirmed the dismissal of a breach of fiduciary claim where the plaintiff had only “breezed through” the documents before signing them).

6. Dissipation

George could argue that the Partnership's transfer of \$1,000,000 to him in December 2010 was before the irretrievable breakdown of the marriage, so there was no dissipation.

Conclusion ■ ■ ■

It is likely that attempts to attack irrevocable trusts and attempts to lodge breach of fiduciary duty claims will become increasingly more commonplace in high net worth family law litigation. As they do, the law in this area is likely to develop further. Presently, it is easier to articulate arguments that divorce counsel can advance than to predict how a trial judge would rule on any particular factual situation.

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