
Mennen v. Wilmington Trust Company, George Jeffrey Mennen and Owen J. Roberts as Trustees

C.A. No. 8432

Master LeGrow (Del. Ch. January 17, 2014) (Master's Draft Report)

Introduction

Master LeGrow of the Delaware Court of Chancery (the "Court") issued a draft report (the "Draft Report") granting a defendant's motion for summary judgment upholding the enforceability of a spendthrift clause under Delaware's spendthrift statute, Section 3536 of Title 12 of the Delaware Code ("Section 3536"). The Draft Report is notable because it is a strong confirmation of the protections available to beneficiaries of third-party spendthrift trusts under Section 3536 and the Court refused to create a public policy exception to Section 3536 for a tort claimant who was a family member of the plaintiffs and who allegedly persistently engaged in a course of conduct that breached his fiduciary duties resulting in millions of dollars of damages for plaintiffs.

Background

On November 25, 1970 George S. Mennen (the "Settlor") created four trusts, one for each of his children and their issue (collectively the "1970 Trusts"). One of the 1970 Trusts (the "Trust") was created for the Settlor's son, John H. Mennen ("John") and one of the 1970 Trusts ("Jeff's Trust") was created for the Settlor's son, George Jeff Mennen ("Jeff"). In March 2013, the beneficiaries ("Beneficiaries") of the Trust filed a complaint against Wilmington Trust Company ("WTC"), the corporate trustee of the Trust, and Jeff, the individual trustee of the Trust (Jeff and WTC are collectively the "Co-Trustees"). The Beneficiaries alleged that the Co-Trustees of the Trust breached their fiduciary duties and claimed damages exceeding \$100 million. Under the terms of the Trust, Jeff has the power, as individual co-trustee, to direct the corporate co-trustee to exercise certain investment powers. The individual trustee of Jeff's Trust, Owen Roberts ("Owen"), was also named as a defendant.

The crux of the allegations made by the Beneficiaries were that the Co-Trustees of the Trust breached their fiduciary duties related to a series of poor investment decisions made by Jeff, as the individual trustee of the Trust. In particular, the Beneficiaries claimed that Jeff utilized assets of the Trust to invest in and make loans to several start-up companies ("Jeff's Investments"), including several that Jeff served as a board member on, and because Jeff's Investments drained the value of the Trust to nearly zero, Jeff's Investments were imprudent and self-interested. Jeff had no authority to invest the assets of Jeff's Trust and, as a whole, the investment of Jeff's Trust had been successful. The Beneficiaries alleged that if their claims against Jeff as Co-Trustee of the Trust are successful, equity would require that the assets of Jeff's Trust should be available to satisfy any judgment against Jeff.

Owen moved for summary judgment on the basis that, even if the Beneficiaries prevailed against Jeff at trial, the spendthrift provision in Jeff's Trust and Section 3536 of Title 12 of the Delaware Code precluded those assets from being subject to the claims of the Beneficiaries' judgment creditors.

The Beneficiaries argued alternatively that (i) the spendthrift provision is not enforceable against them because they are not “creditors” for purposes of the spendthrift provision or for purposes of Section 3536, or (ii) if the spendthrift provision and Section 3536 applies to them, then Delaware should recognize a public policy exception for tort claimants who are “persistent wrongdoers” that would allow them to recover from Jeff’s Trust, or (iii) they should be able to impound Jeff’s interest in Jeff’s Trust because the 1970 Trusts are essentially sub-trusts of a larger trust created by the Settlor. Master LeGrow held that the trustee of Jeff’s Trust was entitled to summary judgment because none of the theories advanced by the Beneficiaries presented a legal argument entitling them to defeat the spendthrift provision in Jeff’s Trust if their claims against Jeff at trial were ultimately successful.

Analysis

The Court began its analysis by recognizing that the merit of the Beneficiaries’ claims turned on the application of Subsection (a) of Section 3536, which provides that creditors of beneficiaries only have rights with respect to a beneficiary’s interest in the trust as granted in the express terms of the trust instrument or by Delaware law. The import of Subsection (a) of Section 3536 is that a spendthrift provision in a trust instrument will be enforceable subject only to the statutory limitations provided for in Section 3536. To circumvent the application of Section 3536, the Beneficiaries argued that they are not “creditors” for purposes of Section 3536 and, even if they are, the common law regarding spendthrift trusts and public policy in Delaware should permit the Beneficiaries to access the assets in Jeff’s Trust under the factual circumstances of this case.

The Beneficiaries are “Creditors” Under Section 3536

The Court disagreed with the first contention of the Beneficiaries and concluded that they would be “creditors” under Section 3536 if they obtained a judgment against Jeff at trial. The essence of the Beneficiaries unsuccessful argument was that they were a special class of tort claimants entitled to pierce Jeff’s Trust because of the “especially egregious and specific” allegations against Jeff. To summarize the Beneficiaries argument, they contended, that “family member victims of fiduciary misconduct are entitled to pierce the spendthrift trust of the faithless fiduciary co-family member to satisfy a judgment in equity.”

The Court noted that Delaware courts have been asked to discuss the rights of tort claimants against third-party spendthrift trusts in the past. In the Delaware Supreme Court ruling in Garretson v. Garretson¹, the Supreme Court held that a wife, seeking maintenance and support from her husband, is not a “creditor” within the meaning of Section 3536 because such action was merely compelling performance of a duty of support imposed on the spouse and was not an action to collect on a debt. Central to the Supreme Court’s holding was the nearly universally recognized policy that a beneficiary of a spendthrift trust should not be permitted to enjoy his interest in the trust while neglecting to support his dependents. Master LeGrow read Garretson as creating a narrow exception for familial support obligations that cannot be extended to create other exceptions to Section 3536. The limited application of Garretson was confirmed in two later cases, namely Gibson v. Speegle² and Parsons v. Mumford³, where the Court held that, in general, a tort claimant is a “creditor” for purposes of Section 3536. Notably, the Court in both Gibson and Parsons rejected recognizing a public policy exception in the case of a creditor of the beneficiary of a third-party spendthrift trust where the beneficiary was alleged to have committed as a tort with respect to the creditor.

The Beneficiaries argued that the rationale of Garretson should be extended and their case should be an exception to the principles of Section 3536 and the tort claimant rulings in Gibson and Parsons. According to the Beneficiaries, the fact that their claim was made against the trust of a family member of the Beneficiaries who committed alleged fiduciary misconduct with respect to the Trust warranted that they not be treated as “creditors” for purposes of Section 3536.

1 302 A.2d 737 (Del. 1973).

2 C.A. No. 124 (Del. Ch. May 30, 1984).

3 1989 WL 63899 (Del. Ch. June 14, 1989).

The Court rejected this argument for two principal reasons. First, the exception recognized in Garretson was of a totally different nature than the claims made by the Beneficiary. In Garretson, the beneficiary of a third-party spendthrift trust owed a support obligation to his spouse and dependents, which he had a legal duty to pay separate from any judgment entered by a court. Here, if the Beneficiaries succeeded against Jeff at trial they would hold a judgment liability, a debt similar to any other successful tort claim. Second, the only similarity the Beneficiaries identified between their case and Garretson was that it involved disputes between family members. The Court implied that this similarity was legally insignificant for the Beneficiaries to avoid being treated as “creditors” under Section 3536.

No Common Law or Public Policy Exception Support the Beneficiaries’ Claims

The Court also rejected the Beneficiaries’ contention that a limited variety of tort claimants, as “involuntary creditors”, should be recognized as a common law or public policy exception to Section 3536. The Court noted that this exact argument was considered and rejected for the tort claimants in Gibson and Parsons. The Court further reasoned that, although Section 3536 did not replace the common law regarding spendthrift trusts in Delaware, the Beneficiaries were unable to identify a common law exception that applies in that case. Absent such an exception, the Court reasoned that the General Assembly, in enacting Section 3536, did not give the Court carte blanche authority to develop new, non-statutory exceptions to Section 3536 as fairness and justice might dictate in the absence of an ambiguous statute.

The Beneficiaries claimed that Delaware law should recognize a “persistent wrongdoer” exception of the kind identified in the Restatement (Third) of Trusts (the “Restatement”). More specifically, the Beneficiaries pointed out that a comment to Section 59 of the Restatement provides authority for the piercing of a third-party spendthrift trust where there is a “nature or pattern of tortious conduct by a beneficiary ... especially one whose willful or fraudulent conduct or persistently reckless behavior causes serious harm to others”⁴, such as the alleged fiduciary misconduct exhibited by Jeff with respect to the investment of Trust assets.

The Court rejected the Beneficiaries’ argument for two reasons. First, the Court noted that the Restatement did not identify a single case adopting this type of exception. Second, and more importantly, the Court noted that again the Beneficiaries failed to identify any authority recognizing this exception in Delaware. Although the Court admitted that the Beneficiaries’ argument was “compelling from the standpoint of fairness”, recognizing a common law exception in this case would be “inconsistent with the role of the judiciary” when Section 3536 is an unambiguous statute.

The Beneficiaries Are Not Entitled to Pierce Jeff’s Trust Based on Impoundment

Finally, the Court rejected the Beneficiaries’ argument that they should be able to impound Jeff’s Trust. The theory of impoundment applies when the trustee of a trust who is also a beneficiary of that same trust commits a breach of trust that harms the other beneficiaries. The Beneficiaries argued that the Trust and Jeff’s Trust were essentially sub-trusts of a larger trust created by the Settlor in 1970 and, accordingly, Jeff’s alleged wrongdoing with respect to the Trust permitted them to impound his interest in Jeff’s Trust.

In rejecting the Beneficiaries’ argument, the Court concluded that, even if impoundment was a remedy available under Delaware law, it applies only where the trustee and wronged beneficiaries share an interest in the same trust. The Beneficiaries’ argument that the 1970 Trusts were really sub-trusts because they were created on the same day by the same settlor and easily could have been drafted as sub-trusts under the same trust was not persuasive to the Court because the Beneficiaries could point to no case that espoused this theory.

⁴ Restatement (Third) of Trusts, § 59, cmt a(2) (2003).

Moreover, the Court reasoned that, even assuming that the theory was available in this case, the nature of Jeff's Trust would require the Court to order relief expressly forbidden by Section 3536. Central to this holding was that Jeff was not the only current beneficiary of Jeff's Trust and was not entitled to any specific distribution from Jeff's Trust. Because the trustees of Jeff's Trust had discretionary authority to sprinkle income and principal of the Trust between one or more of the beneficiaries as the trustee deems appropriate, there was no relief to which the Beneficiaries were entitled that is permissible under Section 3536. The Beneficiaries' proposed relief (that the trustees are enjoined from making distributions to Jeff until he satisfies his obligations to the Beneficiaries and require distributions to immediately be sent to the Beneficiaries) was, in the Court's view, clearly prohibited by Section 3536.

Conclusion

Exceptions to the Draft Report were delayed pending the resolution of the trial against Jeff, as the individual trustee of the Trust, so the Draft Report is subject to a Master's Final Report and/or other de novo review by the Court. However, the Draft Report is significant in its own right.

First, the Draft Report provides significant insight into the application of Section 3536. Under the Court's reading of the statute, Section 3536(a) applies to third-party spendthrift trusts unless a specific exception can be identified under Delaware law. Even where, as here, the allegations against a fiduciary are particularly egregious and damages caused by the fiduciary are substantial, the Court appears unwilling to undermine Section 3536 unless a specific exception in Delaware common law can be identified.

Second, the Court affirmed the limited application of Garretson and in doing so provided helpful analysis as to the rationale of the holding in Garretson, Parsons, and Gibson. Importantly, the Draft Report read Garretson narrowly, emphasizing that the claim in Garretson was a support obligation that existed outside of a judgment in litigation. The Court concluded that Garretson did not extend beyond familial support obligations, and furthermore, Garretson only addressed a beneficiary's interest that is an identifiable share, such as an income interest or a right to receive distributions pursuant to a standard, and not a discretionary interest. The essence of what the Court held was that the claims of the Beneficiaries, though compelling from a standpoint of fairness and justice, were simply tort claims and, accordingly, fell within the umbrella of the Parsons and Gibson.

➤ Morris Nichols Trusts, Estates and Tax Group



TODD A. FLUBACHER
PARTNER

(302) 351-9374 T
(302) 425-4698 F
tflubacher@mnat.com



THOMAS R. PULSIFER
PARTNER

(302) 351-9226 T
(302) 425-4682 F
tpulsifer@mnat.com



KIMBERLY GILL MCKINNON
SPECIAL COUNSEL

(302) 351-9102 T
(302) 425-3094 F
kmckinnon@mnat.com



KENNETH F. HUNT
ASSOCIATE

(302) 351-9185 T
(302) 425-3092 F
kfhunt@mnat.com

**MORRIS
NICHOLS**
**ARSHT &
TUNNELL**

mnat.com   (302) 658-9200
1201 North Market Street, 16th Floor
P.O. Box 1347
Wilmington, DE 19899-1347

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