

DELAWARE BUSINESS COURT INSIDER

COMMENTARY

Court Upholds Garnishment of Beneficiary's Interest in Distributions From a Del. Statutory Trust

In *Protech Minerals v. Dugout Team*, No. 288, 2021, 2022 WL 4004606 (Del. Sept. 2, 2022), the Delaware Supreme Court affirmed that trust distributions are personal property subject to garnishment. The court declined to consider whether the result would be different if the trust were a spendthrift trust.

By Barry M. Klayman and Mark E. Felger | October 12, 2022 at 09:00 AM



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Are distributions from a Delaware statutory trust to beneficial owners subject to garnishment by a creditor? In *Protech Minerals v. Dugout Team*, No. 288, 2021, 2022 WL 4004606 (Del. Sept. 2, 2022), the Delaware Supreme Court affirmed that trust distributions are personal property subject to garnishment. The court declined to consider whether the result would be different if the trust were a spendthrift trust.

A Delaware statutory trust is a legal entity created to hold title to income producing properties. It is sometimes referred to as an unincorporated business trust. A Delaware statutory trust is created by a written instrument—whether referred to as a trust agreement, declaration of trust or otherwise—under which either property (real, tangible and intangible) is held, managed, administered, invested and/or operated; or business or professional activities for profit are carried on by one or more trustees for the benefit of the trustor who holds a beneficial interest in the trust property.

The Delaware Statutory Trust Act, 12 Del. C. Section 3801 et seq., provides that a statutory trust is a separate legal entity and that the personal liability of its beneficial owners is limited in a similar fashion as stockholders in a Delaware corporation. The act places limits on the rights of creditors of the beneficial owners. Section 3805(b) provides, “No creditor of the beneficial owner shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the statutory trust.” However, Section 3805(c) states, “A beneficial owner’s beneficial interest in the statutory trust is personal property notwithstanding the nature of the property of the trust.”

The *Protech* case involved a creditor of a beneficial owner of Texas Healthcare Portfolio DST, a Delaware statutory trust. The trust owned health care-related real estate and improvements in Texas. The trust agreement provided that no interest could be assigned pledged, encumbered or transferred without the prior consent of the trustee; no person other than the trustee and the Investors would have any legal or equitable right, remedy or claim under the agreement; and none of the provisions of the agreement were for the benefit of or enforceable by any creditor of any Investor.

One such investor was appellant Protech Minerals, Inc., which was a beneficial owner of 8.3333% of the trust and entitled to monthly distributions from the trust. Appellee Dugout Team, LLC, obtained a judgment against Protech in the U.S. District Court for the Western District of Washington and recorded the judgment in Delaware. Dugout served a writ on the trust to attach

property belonging to Protech in the possession of the trust, and the trust froze all distribution payments payable to Protech pending further court order. Dugout then served a writ of garnishment on the trust that specifically sought attachment of the monthly distributions to Protech by the trust.

Protech moved in Delaware Superior Court to quash the garnishment, arguing that the distributions from the trust were exempt from attachment under Delaware law. It contended that under Section 3802(a) of the Statutory Trust Act, a statutory trust may be sued only for debts or obligations contracted or incurred by the trustees or other authorized persons. Since the judgment was against Protech and not against the trust or trustee, the trust was not subject to attachment and execution for Protech's obligation. Protech also cited Section 3805(b), limiting the rights of creditors of beneficial owners with respect to property of a statutory trust. Dugout opposed the motion to quash, arguing that Section 3805(b) only protected trust property from creditors, but that distributions owed to a trust beneficiary were personal property of the beneficiary, not the trust. Therefore, the monthly distributions payable to Protech were subject to garnishment. The Superior Court agreed and denied the motion to quash, and Protech appealed.

The Delaware Supreme Court first addressed Dugout's argument that the appeal was moot and that Protech did not have standing to pursue the appeal because the Trust had been converted to a limited partnership and a stipulation between the trust and Dugout operated as a charging order against the limited partnership. The stipulation provided that the trust would turn over all of the distributions to Dugout's law firm to hold in escrow pending the outcome of the appeal. The stipulation stated that it would apply to all future distributions in the same manner as a charging order without the need for Dugout to obtain a charging order. However, the stipulation was never approved by the Superior Court, which refused to act on it because of the pending appeal. The Supreme Court held that the stipulation, as an agreement between the trust and the creditor, was not the equivalent of the entry of a charging order by the court since the Superior Court declined to approve the stipulation, and therefore the appeal was not mooted.

Dugout also argued that Protech lacked standing to pursue the appeal because it no longer held a beneficial interest in the trust due to the trust's conversion to a limited partnership. Again, the Supreme Court disagreed. Because Protech had an interest in the distributions prior to the conversion of the trust to a limited partnership, it still had standing to prosecute the appeal.

On the merits, the Supreme Court held that the distributions were personal property under the Delaware Statutory Trust Act and were subject to garnishment by Protech's creditor. While trust property could not be reached by the creditor of a beneficiary under Section 3805(b), the distributions could be. The act differentiates between trust property subject to Section 3805(b) and personal property belonging to a beneficial owner of the trust. Protech's beneficial interest in the trust included the income or distributions to which it was entitled, and thus under Section 3805(c), the distributions were personal property and not trust property. The court affirmed the Superior Court's holding that Protech's distributions were subject to garnishment by its creditor.

Protech also argued that even if the distributions were personal property, Delaware's spendthrift trust provision, 12 Del. C. Section 3536, barred garnishment by creditors. However, Protech did not make that argument in the Superior Court. Because Protech did not argue or present any evidence in the court below that the trust agreement contained a spendthrift trust provision, it failed to preserve that argument on appeal and the argument was waived.

As noted in the legislative synopsis to the Delaware Statutory Trust Act, business trusts are the favored form of entity for money market mutual funds and for real estate investment trusts and other investment entities involved in the securitization of debt. The passage of the Statutory Trust Act eliminated many of the uncertainties associated with common law business trusts. Nevertheless, there is a dearth of case law interpreting the act. The *Protech* case thus serves an important function in helping to define the relationship between a trust, a beneficiary of the trust, and a creditor of the beneficiary.

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