Entering the 'legal twilight zone': a lesson in trust law

By Stefanie J. Lipson

Forty-eight year old Florida billionaire John Goodman (owner of the International Polo Club Palm Beach, not Roseanne's TV husband) recently shocked courts and bloggers alike with the headline-grabbing adoption of his 42-year-old girlfriend, Heather Hutchins, making Hutchins his eldest (and creepiest) of three children. But if this doesn't give you the heebie-jeebies, here's betting the reason he did so will.

Goodman is currently facing charges of criminal manslaughter while intoxicated and a wrongful death civil action for causing the death of 23-year-old Scott Wilson, who drowned when his car overturned and plunged into a canal after being struck by Goodman's Bentley in February 2010. Goodman could forfeit a significant portion of his net worth should the jury find against him and award punitive damages in the wrongful death case. But even if Wilson's family wins a massive judgment against Goodman, they can't take from what he doesn't own — and "what he doesn't own," says Florida Circuit Judge Glenn Kelley (who is presiding over the wrongful death suit against Goodman), includes a $100 million irrevocable trust, created in 1991, for the benefit of Goodman's "children."

Observers have speculated that Goodman — knowing that his money may soon become the Wilsons' money once their lawsuit is finished — adopted Hutchins as a way to indirectly access a fortune, which the Wilsons cannot. In other words, Goodman's maneuver seemingly isn't so much about making Hutchins a wealthy woman as it is about keeping himself a wealthy man. The head-spinning development caused even Judge Kelley to observe that the court was entering a "legal twilight zone." So what is really going on here?

In the face of the potential liability from the Wilson civil suit, any attempt by Goodman to directly transfer his wealth to Hutchins would probably be seen as a fraudulent transfer and an attempt to thwart his creditors, with the likely result that the transaction would be unwound and Hutchins none the richer. But by adopting Hutchins and therefore cutting her in on his kids' trust, Goodman isn't transferring his wealth to her: He is giving her a share of money that already belongs to his kids.

When the irrevocable trust was established in 1991, Goodman purportedly funded it with $1.5 million, a gift he would (and should) have paid gift tax on. Having completed the gift and paid the gift tax on the 1991 gift, the assets of the trust (and however much they would grow to, no matter how many hundreds of millions) no longer belonged to Goodman — they belong to the trust and are managed by the trustee for the exclusive benefit of the trust beneficiaries — Goodman's children. Consequently, the money in that trust would not be accessible to Goodman's creditors.

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The creative, if untraditional and creepy, adoption of Hutchins puts her squarely within this class of trust beneficiaries, allowing her to share in this fortune that is sheltered from the wrongful death claim. (And since we assume that Hutchins is likely to share with her beloved and generous boyfriend, Goodman remains in good position to enjoy that share as well.)

Although this result is pretty unsatisfying under the circumstances, it is entirely consistent with established trust law. Because Goodman is not a beneficiary of the trust, cannot receive distributions from or borrow from the trust, and does not personally control the trust assets, trust law does not treat the assets of the trust as belonging to Goodman. Likewise, federal tax law respects the sanctity of the trust (provided that Goodman continues to respect the formality of the trust arrangement as well) and will not impose an estate or gift tax on the trust assets when they are distributed to the trust beneficiaries (according to news reports, when each child attains age 35, an age Hutchins has already surpassed) — saving the Goodman family millions of dollars in federal transfer taxes.

Normally this all operates in pretty uncontroversial fashion ... a girlfriend adopted as a child to get backdoor access to a children's trust isn't exactly something you see every day. But while the Wilsons, like most other observers, find the results in this case pretty appalling, we in the trust world simply call this, and its tax result, good planning.

Litigation

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Associated Press

John Goodman, center, shown with attorneys Mark Shapiro, left, and Guy Fronstin, is released from the Palm Beach County Jail in West Palm Beach, Fla. after posting bail on charges of vehicular homicide and manslaughter while intoxicated.

For those who are offended and find the result unfair, consider this: If today, I give you $5 and you take that $5 and invest in the next version of Apple stock (Facebook IPO, anyone?), and 20 years from now that $5 has grown into $500 million, I could not claim that any portion of the $500 million is mine (nor could my creditors). All of it belongs to you. Likewise, since the money no longer belongs to me, and I have not retained control or given the $5 gift to you with strings attached, the Internal Revenue Service cannot impose a transfer tax on your newfound $500 million wealth when I die. Sounds fair, right? The same principles apply in trust law.

When Goodman relinquished control of his $1.5 million to the trustee in 1991, he made a gift to the beneficiaries of the trust at that time. And, since he personally is neither a beneficiary nor the trustee of the trust, he gave up the right to share in the appreciation of the trust assets and gave up the right to control the trust funds, including deciding who is a beneficiary and how much they get. Hence, the money in the trust is no longer Goodman's wealth, as far as trust law and the IRS are concerned.

So despite the icky feelings this case raises in people, trust law is working exactly as intended. Can you really blame the drafters of the law for forgetting to include a "Millionaire Debtor Adopts Girlfriend as Daughter" exception?

But Goodman hasn't gotten off completely scot-free. One of the factors for determining punitive damages awards in civil lawsuits is the wealth of the defendant. After Goodman's adoption of Hutchins hit the headlines, the Wilsons asked Judge Kelley to allow the jury to consider Goodman's children's trust in determining his wealth, and therefore the appropriate quantity of damages in the case. While Judge Kelley initially denied their request, he subsequently reversed his own ruling in light of the adoption, ordering that the jury be allowed to consider the value of Goodman's children's trust.

That said, it is unclear how big of a penalty that really is for Goodman. Even if the jury is permitted to consider the children's trust in valuing Goodman's wealth, it still does not follow that the Wilsons could actually access the money in that trust once it comes time to collect from Goodman. In fact, if the trust assets were used to satisfy a judgment, Goodman's biological children could have a claim to invalidate the use of the trust funds for this purpose. While the jury's right to consider the value of the trust assets might result in an even larger judgment than they would have otherwise brought in, the judgment likely would have been pretty major in any event. All in all? Probably not a big difference to Goodman at the end of the day.

But before you give up on the legal system altogether, here's a treat: the IRS might be able to step in and create some real consequences. Goodman's chutzpah and Judge Kelley's decision, not to mention the media attention, may be just enough fodder for the IRS to take the position that the assets of the trust — all $100 million of them — should be subject to federal estate tax on Goodman's death, because Goodman has retained control over the trust assets in such a manner as if he never gave them up to begin with.

Fueling this potential estate tax trap? Goodman's creative maneuvering, which has essentially modified the trust beneficiaries after the fact (many trusts would limit the definition of "child" to someone who is naturally born or adopted before turning 18), Goodman's installation of Hutchins as an overseer and controller of the trust by contractual arrangement, and a little fact which people have noticed about Goodman and Hutchins having a decidedly more ... intimate relationship than the average adoptive father and child. The result? Just a few extra (tens of) millions of dollars in estate tax on Goodman's death.

Here's betting even the most stanch tax conservative won't be too upset about that one.

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