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Discretionary Trusts Merely Support Trusts?

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A response from the authors of "A threat to All SNTs," November 2004 issue, to a letter to the editor from Richard E. Davis, member of Krugliak, Wilkins, Griffiths & Dougherty Co. L.P. in Canton, Ohio Douglas W. Stein, a member of the Michigan Uniform Trust Committee (UTC), and Mark Merric, co-authors of "A Threat to All SNTs," in the November 2004 issue of Trusts & Estates thank Richard E. Davis for his comments in the December 2004 issue of T & E. Unfortunately, his letter to the editor as well as his related article in the Probate Law Journal of Ohio in the Jan./Feb. 2005 issue provide almost no legal support for his positions that are contradicted by common law, by the Third Restatement of Trusts (Restatement Third), and appear to be inconsistent with Davis's own actions as a member of the Ohio UTC review committee. Davis's reference to SNTs also is unhelpful, as he doesn't explain whether he is commenting on a third party SNT with or without special needs language.

It should be noted that, after consulting Mark Merric, Davis led the Ohio elder law committee to unanimously vote against adoption of the proposed Ohio UTC until it incorporated the concept of a "wholly discretionary trust." For a very limited number of trusts in Ohio, the wholly discretionary trust retains the discretionary-support distinction. Now, Davis's letter implies that he may have changed his professional opinion. He asserts that the discretionary-support distinction is "artificial" and "arbitrary." Therefore, the statutory amendment he pioneered maintaining the "wholly discretionary trust" should be unnecessary. However, an e-mail dated Dec. 13, 2004, from estate-planning attorney Dennis Williams to Robert Brucken, chair of the Ohio UTC, stated that the concept of the "wholly discretionary trust" must remain intact if the bar is to seek passage of the Ohio UTC."

The discretionary-support distinction is the common law mechanism from which the corner stone of asset protection of a third party SNT (without supplemental needs language) is derived. The distinction is that a discretionary trust limits the courts standard of judicial review to the trustee (1) acting dishonestly (that is to say stealing from the trust); (2) with an improper motive (that is to say, the reason the trustee will not make distributions to the beneficiary is that the trustee is the remainder beneficiary); or (3) failing to act (that is to say, acting arbitrarily and capriciously). Because of this high standard of judicial review, a beneficiary has no enforceable right or property interest. For a support trust, the review standard was reasonableness, and because a judge could review a trustee's discretion, the beneficiary has an enforceable right to demand a distribution.

In addition to Ohio, the North Carolina, South Carolina, and Virginia UTC review committees have expressed similar concerns and have made efforts to deal with the SNT issue. The Michigan UTC Committee also is studying the issue. While we agree that the proposed solutions by Ohio, North Carolina, South Carolina and Virginia are a step in the right direction, they still fall short from approaching the benefits available under most states' common law.

Davis inaccurately describes the law and our article. He alleges that UTC Section 504 does not abolish the common law principles of discretionary trusts. Davis also misstates our positions, common law and the interplay of the UTC and the Restatement Third. The preamble to the UTC acknowledges the close

coordination it has with the Restatement Third, which states that a discretionary standard is subject to court review for reasonableness.1 In essence, the Restatement Third requires that a trustee be reasonable, even if the distribution standard is in the trustee's absolute and sole discretion. As we explained in our article, by reducing the standard of review traditionally afforded discretionary trusts, the Restatement Third reduces a discretionary trust to a mere support trust, because the trustee must act reasonably or something less than the common law standard discretionary standard when making distributions.2

Davis complains about our reliance on a handful of cases, directly on point with SNT trusts, that interpret the "good faith" standard with the standard of reasonableness. However, Davis in a different article3 incorrectly cites only one case to support his position: In re Estate of McCart, 847 P.2d 184 (Colo. App. 1992) is a classic discretionary trust case in which the trustee did not make distributions to current discretionary beneficiary because the trustee was the remainder beneficiary and wanted the trust assets for himself. The appellate court noted: "The trial court specifically found and concluded that Goss had abused his discretion and acted arbitrarily and capriciously. The improper motives with a clear conflict of interest as trustee seeking to conserve the trust funds for himself and his heirs as remainderman under the trust, and also in breach of his fiduciary responsibilities to act with the utmost good faith and fairness toward a beneficiary."

In the above-mentioned article in the Probate Law Journal of Ohio, "The Uniform Trust Code and Supplemental Need Trusts," that Davis co-authored with Stanley C. Kent, he quoted only the "in breach of his fiduciary responsibilities to act with the utmost good faith and fairness toward a beneficiary, and then he concluded that, because these words were used in combination with a discretionary trust, the review standard of "good faith" was the same as the discretionary common law. Despite Davis's careful selection of phrases to support his position, a cursory review of the case yields the opposite of his conclusion. In re Estate of McCart is nothing more than a classic discretionary trust case with the judicial review standard only for (1) acting dishonestly; (2) acting with an improper motive; or (3) failing to act.

Our concern about SNTs appears to be shared by Richard Covey, senior counsel at Carter Ledyard, & Milburn, LLP in New York and Dan Hastings, counsel at Skadden, Arps, Slate, Meagher & Flom, LLP in New York when they state: "Section 814(a) illustrates the uncertainty that codifying the trust law may create." What do the words "and in accordance with the terms and purposes of the trust and the interests of the beneficiaries" mean? Do they create a stricter limit on the discretion that may be conferred upon a trustee than the common law test sets forth in the above quotation from Scott? It seems likely that courts will use them to do so in particular cases, yet their application to particular facts remains as hard to predict as that of the common law. Has anything been gained by codification?4

As noted in our article, the "good faith" standard only needs to be interpreted as something slightly less than the high discretionary common law threshold for judicial review of (1) improper motive, (2) dishonesty or (3) failure to act, and this results in the beneficiary having a right to force a distribution. If so, the trust assets should constitute an available resource, and most likely disqualify the SNT beneficiary from governmental benefits. The Kreitzer line of cases5 , Iowa line of cases6 , a similar line of cases in Pennsylvania7 , and possibly a recent case in Connecticut hold that whenever a discretionary trust is coupled with any standard, a beneficiary has an enforceable right to a minimal distribution that constitutes an available resource.

Davis wrongly characterizes our position regarding Kreitzer and its progeny. There are two issues: (1) whether there is an available resource and (2) whether a creditor may force a distribution. The UTC codifies the first issue, creating an available resource due to the good faith standard of UTC Section 814(a) and the right of a beneficiary to enforce a standard or remedy. Davis ignores the issue of what happens if a beneficiary has an available resource and is disqualified from receiving Medicaid.

We also respectfully disagree with Davis's claim that the Restatement Third dispenses with the standard of

reasonableness by providing that "judicial intervention is not warranted merely because the court would have differently exercised its discretion."8 The comment further provides that "a court will not interfere with a trustee's exercise of a discretionary power when that exercise is reasonable and not based on an improper interpretation of the terms of the trust."9 The comment continues: "A court will also intervene if it finds the payments made, or not made, to be unreasonable as a means of carrying out the trust provisions." Although the UTC does not modify the Restatement Third, it is to be read in conjunction with the Restatement Third.

Wishful thinking that SNTs containing no standard should be safe from the newly created continuum of discretionary trusts is hardly comfort to the medically needy whose very lives depend on certainty in legal interpretations. Section 50, comment (d) of the Restatement Third provides that if a standard is omitted, the court still will apply a reasonableness or good-faith judgment "based on the extent of the trustee's discretion, the various beneficial interests created, the beneficiaries' circumstances and the relationships to the settlor, and the general purposes of the trust." 10

Also contrary to Davis's assertions, Medicaid is a creditor of any person receiving Medicaid benefits. The state agency administering Medicaid has the right to adopt recovery statutes against the estate of the Medicaid recipient11 and is required to adopt estate recovery laws.12 The estate recovery rules allow the state, under certain federally mandated circumstances, to place a lien against the Medicaid recipient's home.13 In fact, in some states the Medicaid agency need not file a claim outside the normal deadline for claims against the estate.14

Federal law initially failed to define the term "estate recovery" resulting in cases like Citizens Action League v. Kizer.15 But this was rectified in Omnibus Reconciliation Act of 1993, which made it so that an estate includes, at the state's option, any property in which the Medicaid recipient had an interest.16 Under the UTC and Restatement Third, Medicaid recipients have an interest in a purely discretionary trust because they can force a distribution from the trust under reasonableness standard. Because a discretionary trust is converted into a support trust under the UTC and Restatement Third, the assets in it should be considered an "available resource" to the Medicaid recipient and thus render the recipient ineligible for Medicaid.17 For example, in California, a discretionary trust established for support was treated as a mandatory support trust.18 As Medicaid steps into the shoes of the recipient not only at death but also during life, the entire value of a discretionary trust is potentially at risk. If a court imputes income to the recipient from a trust, the state must seek recovery of any amounts improperly paid by the state under OBRA-93.

It is beyond question that, under federal law, the state is a creditor of a Medicaid recipient both during life and after death. On the other hand, Davis introduces an interesting issue of whether the UTC also threatens supplemental security income (SSI) benefits. This may be better addressed in another article. Because criticism of the UTC became more vocal, UTC reviewing committees are beginning to address the many problems with the UTC and its interplay with the new law created and minority positions adopted by the Restatement Third. In fact, after our concerns were voiced, the August 2004 National Conference of Commissioners on Uniform State Laws "NCCUSL" convention finally addressed whether a creditor could attach a sole trustee's beneficial interest in a trust. In January, after several articles including our on the SNT were published, NCCUSL again made modifications to Sections 501 and 506 to address a couple of issues we raised. We are honored that both the state UTC committees and NCCUSL are beginning to address the problems created by the UTC. We hope that continued, scholarly dialogue results in a well-reasoned, clear trust law.

1.Section 50, comment c.

2.See Dwight v. Dwight, 761 N.E.2d 964 (Mass. 2001). For an example in Davis's home state of Ohio, and others, see Bureau of Support in the Dept of Mental Hygiene and Correction v. Kreitzer, 243 N.E.2d 83 (Ohio 1968); Matter of Gantz, 1986 WL 12960; Samson v. Bertok, 1986 WL 14819 (the creditor did not recover

because it was not a governmental claim); Matter of Trust of Stum, 1987 WL 26246; Schierer v. Ostafin, 1999 WL 493940; In re Carol Miller, 432 Mich 426 (1989), holding property in a wholly discretionary trust is not considered a countable asset because beneficiary has no ascertainable interest in the trust and cannot force a distribution.

3.Suzanne Walsh, Richard E. Davis, Stanton Kent, and Alan Newman, "What Is the Status of Creditors Under the Uniform Trust Code?" Estate Planning Journal, February 2004.

4.Richard Covey and Dan Hastings, Practical Drafting (U.S. Trust's quarterly publication), October 2003.

5. Bureau of Support in the Department of Mental Hygiene and Correction v. Kreitzer, 243 N.E.2d 83 (Ohio 1968); Matter of Gantz, 1986 WL 12960; Samson v. Bertok, 1986 WL 14819 (the creditor did not recover because it was not a governmental claim); Matter of Trust of Stum, 1987 WL 26246; Schierer v. Ostafin, 1999 WL 493940 (the creditor did not recover because it was not a governmental claim). In Metz v. Ohio Dept. of Human Services, 762 N.E. 2d 1032 (Ohio Ct.App. 2001).

6.Strojek v. Hardin County Board of Supervisors, 602 N.W. 2d 566 (Iowa Ct. App. 1999), also see the follow-up unpublished opinion where the Iowa Appellate Court expanded the definition of the distribution language as much broader than "basic needs." Strojek v Hardin County Board of Supervisors, 2002 WL 180377 (Iowa Ct. App. 2002). Also see the unpublished opinion of McCabe v. McKinnon, 2002 WL 31757533 (Iowa Ct. App. 2002).

7. Estate of Taylor v. Dept. of Public Welfare, 825 A.2d 763 (Pa. 2003); Shaak v. Pennsylvania Dept of Public Welfare, 747 A.2d 883 (Pa. 2000); Estate of Rosenberg v. Dept. of Public Welfare, 679 A.2d 767 (Pa.. 1996); Commonwealth Bank and Trust Co., 598 A.2d 1279 (Pa.. 1991)

8. Section 50, comment (b).

9. Restatement (Third) of Trusts, Section 60, comment (a).

10. Restatement (Third) of Trusts, Section 50, comment (d).

11. 42 U.S.C. 1396p(b)(1); West Virginia v. U.S. Dept. of Health and Human Services, 289 F3d 281 (4th Cir., 2002).

12. 42 U.S.C. 1396p(b) (1).

13. 42 U.S.C. 1396p(a)(1).

14.In re Cahill, 131 S.W.2d 859 (Mo. Ct. App. 2004).

15. 887 F.2d 1003 (9th Cir., 1989) holding that assets held in a joint tenancy escape estate recovery because common law did not include joint tenancy property as part of a decedents estate.

16. 42 U.S.C. 1396p(b)(4).

17. See Brenda J. Rediess-Hoosein, "Disabled Beneficiaries Present Unique Estate Planning Problems," Taxation for Accountants, January 1995.

18. Lackman v. Dept. of Mental Hygiene, 156 Cal. Ct. App. 2d 674; Estate of Hinkly v. Blackstock, 195 Cal. Ct. App. 2d 164.