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LETTER TO THE EDITOR

Discretionary Trusts Merely Support Trusts?

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, Krugliak, Wilkins, Griffiths & Dougherty Co. L.P., Canton, Ohio

Douglas W. Stein, a member of the Michigan Uniform Trust Committee (UTC), and Mark Merric, the authors of "A Threat to All SNTs," wish to thank Richard E. Davis for his comments in *Trusts and Estates* December 2004 issue. Unfortunately, his letter to the editor as well as arelated article in the Probate Law Journal of Ohio provide almost no legal support for his positions that are contradicted by common law, many times 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. In addition, Davis's reference to SNTs 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 consultation with 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. However, Davis's letter implies that he may have changed his professional opinion. Davis 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 special needs trust (without supplemental needs language) is derived from. The distinction is that a discretionary trust limits the courts standard of judicial review to the trustee (1) acting dishonestly (i.e., stealing from the trust); (2) with an improper motive (i.e., 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). Due to 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, both 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 has also identified and is studying the issue. While the authors agree that the proposed solutions by Ohio, North Carolina, South Carolina, and Virginia are a step in the right direction, these solutions fall far short from approaching the benefits available under most states' common law.

Davis inaccurately describes the law and our article. Davis alleges that UTC Section 504 does not abolish the common law principles of discretionary trusts. While only partially true, Davis misstates the authors' 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 a trustee be reasonable even if the distribution standard is in the trustee's absolute and sole discretion. As thoroughly analyzed 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 that are directly on point with SNT trusts that interpret the "good faith" standard with the standard of reasonableness. However, in support of his own position, in a different article[3], Davis 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 where 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 other article that Davis co-authored, 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 Davis's 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.

Further, our concern appears to be shared by Richard Covey, Senior Counsel at Carter Ledyard, & Milburn, LLP, New York, NY and Dan Hastings, Counsel at Skadden, Arps, Slate, Meagher & Flom, LLP, New York, NY 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 cases[5], an Iowa line of cases[6], a similar line of cases in Pennsylvania[7], 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 the *Kreitzer* line of cases. There are two issues: (1) is there 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 statement when he claims 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 persons whose very life depends on certainty in legal interpretations. Section 50, comment (d) of the Restatement Third provides that if a standard is omitted, the court will still 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 recipient[11] 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. Kitzer.*[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 the Medicaid recipient has an interest in a purely discretionary trust because they can force a distribution from the trust under reasonableness standard. Since a discretionary trust is converted into a support trust under the UTC and Restatement Third, those assets should be considered an "available resource" to the Medicaid recipient and thus render them ineligible for Medicaid.[17] For example, in California, a discretionary trust set up 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 SSI benefits. This may be better addressed in an 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 Commisioners on Uniform State Laws "NCCUSL" convention finally addressed whether a creditor could attach a sole trustee's beneficial interest in a trust. Also, in January after several articles including the SNT article 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 multitude of problems that are created by the UTC. We hope that a scholarly dialogue bringing to light the many issues posed by the UTC results in a well reasoned clear trust law, including legal citations supporting the authors' positions.

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{The following paragraphs were not part of the Trust and Estate's publication in February 2005. These paragraphs were added after reading another grave miscite in a different article co-authored by Ric Davis attempting to defend the UTC as related to

SNTs.[19] Mark Merric and Carl Stevens had previously responded to these miscites and erroneous conclusions in a letter dated December 10, 2004 to members of the Colorado Trusts and Estates Section}

One of the large decreases in asset protection that is created by the UTC is deviating from common law by allowing exception creditors to attach at the trust level. The second article Mr. Davis co-authored states:

> "According to general common law principles, a discretionary interest held in trust can be attached by the beneficiary's creditors. To be sure, attachment is fruitless effort because, as we know, no one , not even the beneficiary, can force the exercise of discretion by the trustee (absent fraud, abuse, or bad faith). Accordingly, attachment yields little benefit to the creditor. However, such creditor is in a post to receive any distributions the trustee decides to make."

The authors would respectfully disagree with Mr. Davis as to the impact of creditor attachment. Although the creditor cannot force a distribution by this attachment under UTC §501, since UTC § 501 provides that an exception creditor (and possibly any creditor) can attach all "present or future distributions to or for the benefit of the beneficiary" the trust is frozen and the grantor's intent to protect a beneficiary from improvident behavior is seriously compromised. In this respect, most of the asset protection features of the trust have been lost.

The authors must also respectfully disagree with Mr. Davis's classification of a creditor attaching at the trust level as "general common law principles." The complete quote stated above and repeated here is "According to general common law principles, a discretionary interest held in trust can be attached by the beneficiary's creditors." First, the issue of attachment or garnishment at the trust level was not the holding of *Colorado State Hospital v.First Interstate Bank of Denver,* 743 P.2d 449 (Colo. App. 1987) and the trustee was the prevailing party on appeal. Second, the case quote that "Creditors of a beneficiary can reach his interest in trust by levying directly upon the subject matter of the trust or by garnishing the trustee," cites to the *Restatement (Second) of Trusts Section 147.* The court in *Colorado State Hospital,* left out the critical prepositional phrase in its quote from *Section 147.* The complete quote reads:

> *Except as stated in Sections 149-162*, creditors of the beneficiary of a trust can *by appropriate proceedings* reach his interest and thereby subject it to the satisfaction of their claims against him.

Sections 149-162 of the *Restatement Second* exclude the following types of trusts from this rule: (1) spendthrift trusts; (2) trusts for support; (3) and discretionary trusts. Therefore, the reference in the case does not apply to most trusts, and in this respect the reference is almost completely irrelevant for analysis.

Third, Colorado case law as well as the strong majority view on point holds the exact opposite of the position taken by the Davis/Kent article. "Spendthrift provisions being recognized in this state, *Snyder v. O'Conner,* supra., funds under the control of a trustee subject to such provisions cannot be garnished." *Brasser v. Hutchison,* 549 P.2d 801 (Colo.

App. 1976) (a creditor could not force or attach a mandatory income interest under a marital trust); Also see analogous authority *In re Guinn*, 93 P.3d 568 (Colo. App. 2004).

Fourth, by not allowing a creditor to attach at the trust level, Colorado follows the strong majority rule. *In the Matter of: Bass v. Denney*, 171 F.3d 1016 (5th Cir. 1999) ("A universal cannon of Anglo-American trust law proclaims that when the trustee's powers of distribution are wholly discretionary the beneficiary has no ownership interest in the trust or its assets . . . ; *In re Shurley*, 115 F.3d 333 (5th Cir. 1997) (No part of a spendthrift trust or estate can be taken on execution or garnishment by creditors of the beneficiary.") Please also see Westlaw key note 189 K 32 where almost all of the cases cited support under the most frequently cited case listing support the rule that a creditor cannot garnish the funds at the trust level. This again points out the problem when one cites the Restatement Third as authority. The Reporter's notes do not disclose when the Restatement Third chose to follow a distinctly minority view, one which contradicts the Restatement Second, Colorado law, and common law in general.

It should be noted that Mr. Davis's co-author is from Colorado and hence the Colorado references above.

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[1] Section 50, comment c.

[2] See *Dwight v. Dwight*, 761 N.E.2d 964 (Mass. 2001). For an example in Mr. Davis's home-state of Ohio, and others, *see 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; *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, Ric 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, 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. Department of Public Welfare*, 825 A.2d 763 (Pa. 2003); *Shaak v. Pennsylvania Department of Public Welfare*, 747 A.2d 883 (Pa. 2000); *Estate of Rosenberg v. Department 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.

[19] Kent and Davis, *The Uniform Trust Code and Supplemental Needs Trusts*, Probate Law Journal of Ohio, January/February 2005.