

The Blessing of Pure Discretionary Trusts

Pack v. Osborn (2008), 117 Ohio St. 3d 14

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Third-party settled special needs trusts, if carefully drafted, are safe in Ohio. While at first blush, the Ohio Supreme Court's reversal and remand of *Pack v. Osborn*¹ may have looked like a blow to the efforts of those who strive to protect public benefits for disabled beneficiaries of third-party trusts, a further analysis of the opinion demonstrates that it is quite the opposite. The Supreme Court's decision, on the one hand, warrants little mention, in that it is simply one more of dozens of cases from various jurisdictions, including Ohio, to affirm the nature of a common law pure discretionary trust. On the other hand, it is only slightly hyperbolic to state that the implications of the decision are stunningly breathtaking, in that the case instantly cleared away the conditions that had been brewing a perfect storm.

The holding that a beneficiary cannot compel a distribution from a pure discretionary trust is rock solid, black letter law², so that conclusion by the Court is hardly noteworthy. What is important, however, is the Court's recognition of the fact that the beneficiary's interest under such a trust cannot be treated as a countable resource under R. C. § 5111.151(G)(2) for Medicaid purposes. The substantive and procedural rulings in this case will have a profound impact on those drafting and advocating for beneficiaries of third-party special needs trusts.

The Case

Maebelle W. Osborn had three adult children, Charlotte Osborn, Arthur Osborn, and Loretta Pack. Charlotte was permanently disabled and living with her mother when, on October 7, 1987, Maebelle established a revocable trust for the benefit of herself and all three children. When Maebelle died in late 1991, Charlotte moved to her brother Arthur's home. Maebelle's trust became irrevocable, her daughter Loretta Pack became successor trustee, and the provisions for the benefit of Maebelle's children became those of a pure discretionary trust with no distribution standard of any kind.

By 2004, Charlotte's medical needs had grown beyond her brother's ability to provide for them. At that point trust assets amounted to \$265,000, and the question arose whether Charlotte would qualify for Medicaid assistance given her status as a beneficiary of the trust. That issue was joined by the simultaneous filing, on May 7, 2004, of a Medicaid application by Charlotte, and an action in Licking County Common Pleas Court by trustee Loretta Pack to construe and/or reform the trust's distributional language. The language read as follows:

The Trustee may, until the death of her daughter CHARLOTTE OSBORN, distribute to or expend for the benefit of MAEBELLE W. OSBORN, CHARLOTTE OSBORN, ARTHUR ELWOOD OSBORN and LORETTA PACK so much of the principal and the current accumulated income therefrom, at such time or times and in such amounts and manner as the Trustee, in her sole discretion, shall determine. Any amounts of income which the Trustee shall determine not to distribute to or to expend for the benefit of MAEBELLE W. OSBORN, CHARLOTTE OSBORN, ARTHUR ELWOOD OSBORN and LORSETTA PACK may be accumulated.

In making such distribution [sic] is my intent that my Trustee use income or principal for the benefit of my children only for purposes other than providing food, clothing or shelter that is to be used only to meet supplemental needs over and above those met by entitlement benefits.

The Licking County Department of Job & Family Services concluded that trust assets were available to finance Charlotte's medical needs, and denied the Medicaid application. Charlotte's appeal of that denial was ultimately presented to the Common Pleas Court, along with the trustee's separately filed declaratory judgment action. In June 2005, that Court found the trust assets to be available to Charlotte, declined to modify the terms of the trust, and thus sustained Licking County's Medicaid denial. The decision was appealed and reversed by the Fifth District Court of Appeals on May 8, 2006, on the basis that the law that should have been applied was the law in effect at the time that the revocable trust was drafted.

While the Court of Appeals reached the correct decision, the most troubling aspect of its holding was that the Court apparently felt it necessary to apply prior law to reach its result. That led to speculation that, in the Court's view, the result actually depended upon which law was applied (which it did not). The Licking County decision was based upon three "findings of fact" made by its magistrate, all of which the authors feel were clearly erroneous.³ By ignoring these supposed errors, and instead focusing on which version of the Medicaid trust rule should apply, the appellate decision led observers to worry that Ohio courts might incorrectly interpret R. C. § 5111.151(G)(2) and conclude that a beneficiary's interest under a pure discretionary interest was a countable resource.

The Ohio Supreme Court decided to review the Appeals Court decision on a discretionary basis (Licking County DJFS had appealed), and also because the decision had been certified as being in conflict with decisions of other appellate courts. The parties' arguments were supplemented by briefs of *amicus curiae* Ohio Attorney General Jim Petro supporting the County, and *amicus curiae* Ohio State Bar Association, National Academy of Elder Law Attorneys, and Down Syndrome Association of Central Ohio, supporting Loretta Pack.⁴

The resulting decision, *Pack v. Osborn*⁵, was unsurprising insofar as it held that the Medicaid rules existing at the time of an application govern that application, and that a trust is construed in the context of the law existing at its creation. Observing that "the court of appeals did not determine the nature of the trust in which Charlotte has an equitable interest..." the Court remanded the case for further consideration.⁶

However, the Court did not limit its analysis solely to the issue of the applicable law. Two additional and critical points were established by the Court's decision, one substantive and one procedural. First, the Court specifically found that a pure discretionary trust – one that gives the trustee uncontrolled discretion to distribute income and principal, without a support standard – is not a resource available to a beneficiary under Medicaid rules. Second, the Court approved a trustee's decision to petition a Common Pleas Court to declare whether a trust's distributional language makes trust assets "available" for Medicaid purposes.

The Purely Discretionary Trust - Substantive Ramifications

The Ohio Department of Job & Family Services and its predecessor, Ohio Department of Human Services, had waged an aggressive multi-year battle against third-party settled special needs trusts. The result was a series of decisions⁷ in which the trusts were generally not considered to be resources available to their beneficiaries unless the trust had a distribution standard that referred to the support needs of its beneficiary. During the course of this litigation, the Department made several revisions to its trust rule, seeking to find the bar that would prevent beneficiaries of third-party

settled special needs trust from qualifying for Medicaid. That effort persistently focused on so-called exclusionary clauses (i. e. trust provisions that prohibit the trustee from making distributions that would affect Medicaid eligibility), rather than upon the fact that preemptive federal law simply does not permit states to treat beneficial interests in pure discretionary trusts as countable resources of their beneficiaries.⁸

Because of the frequency of administrative changes and the ferocity of the judicial challenges, which included the infamous dissent of Justice Stratton in *Young v. Ohio Dept. of Human Services*⁹ that such trusts were basically against the public policy of the state of Ohio, Ohio earned the reputation nationally as perhaps the most hostile jurisdiction toward special needs trust planning.

In 2002, the Ohio Department of Job & Family Services promulgated the current version of its trust rule, O.A.C. § 5101:1-39-27.1, which, on its face, appears to treat virtually every third-party settled trust as a countable resource for Medicaid purposes.¹⁰ In 2003, the Ohio legislature codified that rule in R. C. § 5111.151, in large part to prevent further administrative tinkering in this area.¹¹ In 2006, the Ohio legislature enacted the Ohio Trust Code, which included a statutory safe harbor special needs trust in the form of the Wholly Discretionary Trust¹². The codified rule could be seen as slamming the door on third-party settled special needs trusts, while the latter statute granted them special, protected status, thereby setting up the apparent conflict that faced the Court in *Pack v. Osborn*.

The language and interpretation of R. C. § 5111.151 had been an ongoing source of frustration for estate and special needs planners. In particular, R. C. § 5111.151(G)(2) states that, for purposes of Medicaid eligibility, ~~that~~ third-party settled trusts:

...shall be an available resource only if the trust permits the trustee to expend principal, corpus, or assets of the trust for the applicant's or recipient's medical care, care, comfort, maintenance, health, welfare, general well being, or any combination of these purposes.¹³

The Trial Court in *Pack v. Osborn* appeared to adopt an interpretation which viewed as an available resource any third-party trust that does not *prohibit* the trustee from making the above expenditures. Since the Osborn Trust failed to do so, the Trial Court found that the trust could be interpreted to *permit* distributions for the proscribed purposes, thereby failing to meet the statutory requirements and resulting in the trust being countable as a resource of its beneficiary.

At the appellate level, the Fifth District Court found that the controlling law was the Medicaid eligibility rules in effect at the time the trust was executed. Because this ruling was the basis of the Court's reversal of the lower court, the Fifth District's

analysis of the discretionary nature of the trust language did not address the subsequent changes in the law, particularly the promulgation and enactment of O.A.C. § 5101:1-39-27.1 and R. C. § 5111.151.

With the Supreme Court's reversal on the issue of applicable law, the question of the trust's discretionary language was again open for debate and review. Fortunately, in remanding the matter, the Supreme Court also set forth "important principles" for the Appellate Court to follow in its consideration, thereby seemingly, but not expressly, closing the gap in the interpretation of *permits* in the statute. By stating that the assets of pure discretionary trusts are not countable resources of their beneficiaries, the Supreme Court has apparently rejected the notion that the word "permits" in R. C. § 5111.151(G)(2) means "does not prohibit." Because the trustee of a pure discretionary trust clearly has the power to make a distribution for any of the purposes listed in R. C. § 5111.151(G)(2), such a trust obviously "permits" the trustee to make distributions for those purposes. It would seem, therefore, that, the use of "permits" in the statute can mean only one other thing, and that is that the R. C. § 5111.151(G)(2) applies only where the trust contains a distribution standard that references the enumerated items."¹⁴

The Court distinguished support trusts from pure discretionary trusts that contain no distribution standard of any type. In making this differentiation, the Court did not treat differently pure support trusts which grant no discretion, or limited discretion, from support trusts which grant the trustee sole, absolute, or uncontrolled discretion.¹⁵ The Court stated that neither pure discretionary trusts which contain no support standard nor Ohio's new statutory wholly discretionary trust are treated as countable resources for Medicaid purposes because of the beneficiary's inability to compel a distribution.¹⁶ The important point to be gleaned from the Court's decision is that a trust which follows the statutory definition of a wholly discretionary trust under R. C. § 5801.01(Y) ~~and~~ **has** been recognized as a legislatively protected trust that will not impede its beneficiary's eligibility for Medicaid benefits.

Applying the Court's distinction between a support trust and a pure discretionary trust to the Osborn trust, it would appear that it qualifies as a common law pure discretionary trust. Specifically, the language of the Osborn trust provides that the trustee "may" distribute principal and income "at such times and in such amounts and manner" as the trustee in her "sole discretion shall determine." The additional precatory language regarding the settlor's intent that the trustee use the income and principal "only for purposes other than providing food, clothing or shelter" and "only to meet supplemental needs over and above those met by entitlement benefits" should be treated as merely verifying the settlor's intent, and not creating a support standard by which the trustee must consider the beneficiary's needs. It should be noted that, with respect to disabled ~~beneficiary's~~ **beneficiaries** only, a wholly discretionary trust is permitted to contain this very type of precatory language. In light of the Supreme Court's discussion, the Appellate Court came to the right conclusion but

for the wrong reason.

Court Involvement in Trust Interpretation – Procedural Ramifications

The dispute about Charlotte Osborn's Medicaid eligibility had initially proceeded on two tracks. Administratively, Charlotte had applied for, and Licking County had denied, Medicaid assistance. Charlotte appealed¹⁷ and asked that the State Hearing be delayed pending a decision by the Common Pleas Court in the pending action initiated by Trustee Loretta Pack. That request was denied and, when Charlotte did not appear at the State Hearing, she was found to have abandoned her appeal. She then sought an Administrative Review of that result, and the decision was affirmed. Next followed Charlotte's appeal to the Common Pleas Court, which granted her request to stay further proceedings pending resolution of the Trustee's petition pending in the same court.

When the case reached the Supreme Court, *amicus curiae* Ohio Attorney General entered the case and objected to the use of a "two-track" approach. He argued that the Trustee's request for a declaratory judgment subverted administrative decision-making, was an end run around the R. C. § 119.12 appeals process, impaired the Ohio Department of Job & Family Services' ability to fairly administer the Medicaid program, and would have devastating consequences for all Ohio administrative agencies.

The Attorney General urged that matters of trust interpretation, at least as to whether distributional language made the trust a resource for Medicaid purposes, belonged exclusively to the county and state employees administering the program. He argued that the courts' jurisdiction attaches only after a county case worker decision is reviewed administratively, and then a court is limited to determining whether the decision is supported by "reliable, probative, and substantial evidence and is in accordance with law."¹⁸

The Supreme Court addressed the Attorney General's arguments as follows:

As a final matter, the trustee herein sought a declaratory judgment. The trustee sought guidance regarding her duties with respect to the proper administration of the trust, in particular, whether she can be compelled to make distributions to Charlotte.

The ability of a trustee to invoke the jurisdiction of a court is a matter that has been legislatively addressed. According to statute, a trustee may bring a declaratory-judgment action to determine any question arising in the administration of the trust. R. C. § 2721.05(C) and 5802.01(C). Moreover, court involvement with respect to interpretation of a trust's terms in the Medicaid eligibility context has been legislatively sanctioned. R. C. §

5111.151(G)(4)(e), (g), and (h)...

In light of the foregoing, it is difficult to accept the Attorney General's argument in his amicus brief that a trustee's request for interpretation of a trust's terms for purposes of Medicaid eligibility amounts to bypassing the Department of Job and Family Services' administrative Medicaid-eligibility review. **Instead, pursuant to such request, the court interprets the trust, and its interpretation must be used in the Medicaid-eligibility-review process.** It is through this procedure that the nature of the trust is ascertained; i.e., whether the trust is a pure discretionary trust or a discretionary trust with a support standard. [Emphasis added].¹⁹

The Court's conclusions comport with the general proposition that the common law controls questions regarding trust interpretation²⁰, as well as with the Medicaid statute cited by the **Court**. In particular, R. C. § 5111.151(G)(4) provides:

A [third-party settled special needs] trust... shall not be counted as an available resource if at least one of the following circumstances applies:

...(e) If a person obtains a judgment from a court of competent jurisdiction that expressly prevents the trustee from using part or all of the trust for the medical care, care, comfort, maintenance, welfare, or general well being of the applicant or recipient, the trust or that portion of the trust subject to the court order shall not be counted as a resource.

...(g) If an applicant or recipient presents a final judgment from a court demonstrating that the applicant was unsuccessful in a civil action against the trustee to compel payments from the trust, the trust shall not be counted as an available resource.

Thus, the direct, determinative and appropriate role of a Common Pleas Court, where Medicaid eligibility depends upon the availability of assets held in a third-party trust, has been confirmed.

How and when to seek court involvement remains a matter of judgment for a Medicaid applicant. If by its terms the trust is clearly a "pure discretionary" one, should the applicant rely upon the county case worker's recognition of that fact, or should a declaratory judgment action be routinely filed? Will case workers and State Hearing officers, who look no further than Medicaid eligibility rules²¹, feel bound by the Supreme Court's quite clear declaration that "pure" or "wholly" discretionary trusts are not resources available to the applicant? Is the Ohio Supreme Court sufficiently authoritative for purposes of Subparagraphs (e) or (g) of the above-quoted statute? Time will tell, although one might hope that Ohio Department of Job & Family Services

soon publishes guidance clear enough to avoid wasteful, case-by-case litigation.²²

Conclusion

The Supreme Court's opinion in *Pack* is profoundly helpful in recognizing that common law pure discretionary trusts and wholly discretionary trusts should not be counted as resources for Medicaid purposes. The Court's acknowledgment and blessing of the common law pure discretionary trust, and the Ohio Trust Code's Wholly Discretionary Trust, provides an opportunity for greater administrative consistency in acting on Medicaid applications. The decision also confirms the interpretive role of courts where trust distributional standards are open to debate, or where administrative decisions prove unreliable. Finally, *Pack* offers clear guidance for practitioners that, in drafting third party-settled trusts for beneficiaries who are disabled, Ohio's new statutory wholly discretionary trust is the preferred vehicle when Medicaid eligibility is a consideration.

¹ *Pack v. Osborn* (2008), 117 Ohio St. 3d 14.

² *Restatement (Third) of Trusts* section 50 cmt. b., Reporter's Notes to cmt. a. and b.; *Restatement (Second) of Trusts* section 187; 2 Austin W. Scott & William F. Fratcher, *The Law of Trusts*, Section 130 (4th ed. 1987), sections 128.3 - 128.7; George G. Bogert and George T. Bogert, *The Law of Trusts and Trustees*, section 182 (at pp. 424-428), sections 228-230, and section 811(rev. 2d.ed. 1979).

³ *Pack v. Osborn*, 2006 WL 1214835 (Ohio App. 5 Dist.), 2006 Ohio 2253 (Slip Copy). See Richard E. Davis, *Recent Cases Involving Supplemental Needs Trusts*, 17 PLJO 70 (Nov./Dec. 2006), for a detailed discussion and critique of the trial court and appellate decision in *Pack*.

⁴ The authors, along with Janet Lowder, were counsel for amicus curiae Ohio State Bar Association, National Academy of Elder Law Attorneys, and Down Syndrome Association of Central Ohio, before the Ohio Supreme Court.

⁵ *Supra*, n 1.

⁶ *Id.* at 18.

⁷ See Richard E. Davis, *Ohio's New Medicaid Trust Rule*, 14 PLJO 74 (Mar./Apr. 2003), at 76-77 for a summary of a few of these decisions. Note that William J. Browning, counsel for appellee in *Pack v. Osborn* also represented appellant in one of these cases, *Metz v. Ohio Dept. of Human Serv.* 145 Ohio App.3d 304 (2001). Appellant was unsuccessful in that case, primarily because the subject trust, which granted to the trustee "sole" discretion, had a distribution standard that referred to the Medicaid applicant's "health, care, maintenance and support."

⁸ *Supra* (Davis), at 72.

⁹ 76 Ohio St.3d 547, 688 N.E.2d 908 (1996). In dissent, Justice Stratton stated, "Where a child has reached the age of majority and the obligation to support has ceased, I strongly believe it would be against public policy to allow a parent to create a trust where the trust income or corpus can go to the child at the discretion of the trustee, except when such distributions would render the child ineligible for medical assistance from the government." It was primarily because of this statement that the Ohio Trust Code did not include in R. C. § 5804.10 the ability of a court to terminate a trust if the court determines that its purpose has become contrary to public policy, an ability that is included in § 410 of the Uniform Trust Code. See Richard E. Davis and Stanley C. Kent, "The Impact of the Uniform Trust Code on Special Needs Trusts", 1 *NAELA Journal* 235 (2005), at 263.

¹⁰ *Supra*, n. 3.

¹¹ See William J. Browning, "New Ohio Statute for Special Needs Trusts", 15 PLJO 79 (Mar./Apr. 2004). Browning, counsel for appellee in *Pack v. Osborn*, was instrumental in securing the codification of O.A.C. § 5101:1-39-27.1 as R. C. § 5111.151, which became effective on March 9, 2004. The statute was subsequently amended

twice, first to incorporate changes in gifting rules made by the federal Deficit Reduction Act of 2005, and second to reflect provisions contained in the Ohio Trust Code.

¹² See Richard E. Davis and Alan Newman, “Codify—Not Modify: Creditor Remedies Under the Ohio Uniform Trust Code,” 15 PLJO 24 (Nov./Dec. 2004) and Richard E. Davis, “Treatment of Supplemental Needs Trusts Under the OUTC,” 16 PLJO 17 (Sep./Oct. 2005).

¹³ Virtually identical language is contained in O.A.C. § 5101:1-39-27.1(C)(4)(b).

¹⁴ In this regard, it should be noted that the distribution purposes proscribed in R. C. § 5111.151(G)(2) were copied, virtually verbatim, from the express distribution standard that was contained in the testamentary trust under review in *Bureau of Support v. Kreitzer*, 16 Ohio St.2d 147, 243 N.E.2d 83 (1968). In *Kreitzer*, it was the support standard implicit in words “medical care,” “health,” and “maintenance” that caused the result in that case.

¹⁵ Clifton B. Kruse, Jr., in *Third Party and Self Created Trusts—Planning for the Elderly and Disabled Client* (3d ed. 2002), analyzed 75 Medicaid eligibility cases from around the country, to determine those factors that typically result in the trust being treated as a countable resource of its beneficiary. Most of those trusts were hybrid trusts, in which the trust contained a support standard but in which the trustee was also granted extended discretion by the use of “sole,” “absolute,” or “uncontrolled.” In only 40% of the hybrid trusts were the trusts treated as being countable resources. Of the 75 cases, only 5 were pure discretionary trusts with no support standard, and in none was the trust treated as a resource.

¹⁶ *Supra*, n. 1, at 19-20.

¹⁷ The administrative appeal process is detailed in R. C. § 5101.35.

¹⁸ *Supra*, n. 1, at 21.

¹⁹ *Id.* at 20-21.

²⁰ *Fenn College v. Nance* (1965), 4 Ohio Misc. 183, R. C. § 2101.24(B)(1)(b).

²¹ O. A. C. § 5101:6-7-01(C)(2) directs that “The hearing officer's conclusions of policy and recommendations shall be based solely on published ODJFS regulations, or local agency policy adopted pursuant to options authorized in state law, except when these regulations and policies are silent and reference to the Revised Code or other statutory source is necessary to resolve the issue.” The second step of the appeal process, a review of the State Hearing decision by an administrative appeal officer assigned by ODJFS’ Office of Legal Counsel, involves a broader standard, *i.e.*, whether “the decision relies on an incorrect application of law or rule.” O. A. C. § 5101:6-8-01(C)(1)(c).

²² Such litigation might be avoided by invoking the provision of R. C. § 5111.151(G)(4)(i) which provides that “if an applicant or recipient provides written documentation showing that the cost of a civil action brought to compel payments from the trust would be cost prohibitive, the trust shall not be counted as an available resource.”

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