

First Supplement to Memorandum 92-5

Subject: Study L-708 - Special Needs Trusts (Comments from Department of Health Services and State Bar Team)

Attached to this supplement are additional letters commenting on the staff draft recommendation on *Special Needs Trust for Disabled Minor or Incompetent Person*. Exhibit 1 is from Judith A. Imel, Staff Attorney with the Department of Health Services. Exhibit 2 is from Sterling L. Ross, Jr., on behalf of Team 1 of the Executive Committee of the State Bar Estate Planning, Trust and Probate Law Section. These comments are analyzed below.

Public Policy Issue

The letters from Judith A. Imel of the Department of Health Services (attached to this supplement) and from Joseph O. Egan of the Department of Developmental Services (attached to Memorandum 92-5) both question the overall policy of treating special needs trusts in this limited area of the law. However, it must be remembered that the Commission is not considering a proposal to create a new type of trust. These trusts exist now, both in the wider context of special needs trusts established by relatives of disabled people and the narrow subject of damage awards or settlements payable to minors or incompetent adults. The draft recommendation attempts a compromise between the interests of the public agencies and those who might benefit from special needs trusts in this limited area. The staff does not see that the policy issue can be so neatly resolved as suggested in the public agency letters. There is a large and growing literature on these issues that we can explore if the Commission desires.

Some of the policy considerations were summarized in Memorandum 91-16 as follows:

Some feel that the natural desire of parents and other family members to help a disabled relative should be encouraged by the law, rather than discouraged. Others focus on the entire

population of disabled persons and conclude that those who can pay for all or part of their own care should be required to do so, leaving more resources for those who cannot pay. On the other hand, taxpayers may justifiably feel that their disabled relative has a right to government assistance and that a right of reimbursement amounts to double taxation. Public officials need to balance their budgets and, particularly in a time of deficit, look around for other sources.

Complexity and Specificity

Ms. Imel suggests that the draft should make distinctions between different public benefit programs and remarks that the law and regulations governing programs such as Medi-Cal are "very complex and highly technical." (See Exhibit 1, p. 2.) It is this complexity and technicality that argue for the general approach taken by the draft recommendation. If the statute were drafted to be consistent with today's federal regulations, next month or next year the statute would be out of step. It is only through stating general principles and incorporating reimbursement rights by reference that we can hope to draft a usable statute.

Ms. Imel suggests that the recommendation may mislead people into thinking that a special needs trust will not disqualify a beneficiary from any public benefit program. Specifically, she cites the last sentence of the first paragraph of page one of the recommendation and suggests that the footnote is not sufficient to support the statement. This sentence reads: "If the trust instrument is properly drawn, the existence of trust assets will not disqualify the beneficiary from receiving public benefits." We can soften this sentence by substituting "generally should not" for "will not" and the point will not suffer. The footnote could be revised to an "E.g." cite. We can also cite additional materials, such as Frolik, *Discretionary Trusts for a Disabled Beneficiary: A Solution or a Trap for the Unwary?*, 46 U. Pitt. L. Rev. 335, 341-44 (1985) ([U]nder federal law, a properly drawn discretionary trust will not be considered 'property' or an 'asset' of the beneficiary."); McMullen, *Family Support of the Disabled: A Legislative Proposal To Create Incentives To Support Disabled Family Members*, 23 U. Mich. J.L. Ref. 439 (1990); Mooney, *Discretionary Trusts: An Estate Plan To Supplement Public Assistance for Disabled*

Persons, 25 Ariz. L. Rev. 939 (1983); Comment, *Probate Code Section 15306: Discretionary Trusts as a Financial Solution for the Disabled*, 37 UCLA L. Rev 595 (1990). The reader must not overlook the introductory qualification of the questioned sentence, that the trust instrument must be properly drawn. This assumes that the trust is drafted so that it cannot be reached by the beneficiary or the public agency or treated as a resource in eligibility determinations.

Prob. Code § 3602 (amended). Disposition of balance of award or settlement

Ms. Imel suggests inserting a specific requirement that statutory liens be first satisfied before any money is paid into a trust. (See Exhibit 2, p. 2; the language mentioned is in Section 3602(d) of the current draft.) The staff has added a provision along these lines in a different location -- Section 3604(d). This provision requires the court to order that statutory liens be first satisfied before payment is made to the trust. This should be sufficient to solve the problem raised. Putting the rule in Section 3604 means that the rule need be stated only once, whereas the suggested revision would require additions to both Sections 3602 and 3611.

Prob. Code § 3604 (added). Special needs trust

The first point made by Team 1 of the State Bar Executive Committee concerning the determination of the beneficiary's condition (see Exhibit 2, p. 1) has already been dealt with in the draft. See Section 3604(b)(2).

The Team's second comment concerns jurisdiction and supervision of the court in what is now the second sentence of Section 3604(a). (See Exhibit 2, p. 2.) The Team raises several questions concerning the degree of supervision anticipated by the statute and proposes to replace the supervision reference with a provision permitting inclusion in the trust of additional terms required by the court in its discretion. The supervision rule was added in response to a Commission decision at the last meeting. The intermediate draft reviewed by Team 1 did not contain the qualifying language "to the extent determined by the court." The staff believes that this standard preserves needed flexibility and answers the concern expressed by Team 1.

Further review of the draft statute suggests to the staff that it would be useful to describe the trust under Section 3604 as a "special needs trust." This is the heading of the section. It is the language we use in discussing the matter. It would simplify other references to the trust under Section 3604 and would allow reference to the "beneficiary" of the special needs trust. Accordingly, the staff would revise Section 3604 as follows and would add "special needs" in other sections as appropriate.

3604. (a) When if a court makes an order under Section 3602 or 3611 that money of a minor or incompetent person be paid to a special needs trust established under this section, the terms of the trust shall be reviewed and approved by the court and shall satisfy the requirements of this section. The trust is subject to continuing jurisdiction of the court, and is subject to court supervision to the extent determined by the court.

(b) A special needs trust may be established and continued under this section only if the court determines all of the following:

(1) The That the minor or incompetent person has a disability that substantially impairs the individual's ability to provide for the individual's own care or custody and constitutes a substantial handicap.

(2) The That the minor or incompetent person will have special needs that are not likely to be met without the trust.

(3) That money to be paid to the trust does not exceed the amount needed to meet the special needs of the minor or incompetent person.

(c) If at any time it appears that (1) that any of the requirements of subdivision (b) are not satisfied or the trustee is not making payments from the trust for the special needs of the ~~minor or incompetent person~~ beneficiary, and (2) that the Department of Health Services, Department of Mental Health, or Department of Developmental Services has a claim against trust property, the director of that department may petition the court for an order terminating the trust.

(d) The court's order under Section 3602 or 3611 for payment of money to a special needs trust established under this section shall include a provision that all statutory liens in favor of the Department of Health Services, Department of Mental Health, and Department of Developmental Services shall first be satisfied.

Prob. Code § 3605 (added). Claim of Department of Health Services, Department of Mental Health, or Department of Developmental Services

Team 1 asks what happens to the funds where a trust is terminated under Section 3605(b). The answer would depend upon whether the trust

terminates because of the death of the beneficiary or because the standards of Section 3604(b) are no longer being met. The staff sees no reason why the general rules governing disposition of trust property on termination would not apply, subject, of course, to the special reimbursement provisions in Section 3605. Applying Section 15410(c) in the Trust Law, the trust property would be disposed of "as provided in the trust instrument or in a manner directed by the court that conforms as nearly as possible to the intention of the settlor as expressed in the trust instrument." The staff would add a cross-reference to Section 15410 in the comment.

Team 1 notes a technical deficiency in that the notice and statute of limitation provisions in Section 3605(c)-(d) apply only to trust termination by death, and not where the trust terminates by court order. The staff agrees that these rules should be made applicable to both types of termination.

Team 1 also makes some suggestions for revising language in the comment to this section. The staff has no objection to these editorial suggestions.

Ms. Imel suggests that the second sentence of the comment use the language of Probate Code Section 15306(b), by changing "social services" to "public social services under Division 9 (commencing with Section 10000) of the Welfare and Institutions Code." (See Exhibit 1, p. 2.) We can make this change.

Ms. Imel also suggests that the references to specific statutes in the comment to this section cause confusion and should be deleted. (See Exhibit 1, p. 3.) This is because the statutes cited allow for recovery from the beneficiary's estate whereas the property in question is in trust, and the trust may not pay the remainder to the beneficiary's estate. The staff thinks that more is required here than deleting statutory references in the comment. Section 3605(b) provides that on termination of the trust, trust property is subject to claims for reimbursement "to the extent authorized by law." The public agency's right must derive from some statute or regulation. For example, Welfare and Institutions Code Section 14009.5(a) refers to claims "against the estate of the decedent, or against any recipient of the property of that decedent by distribution or survival." This

language is directed toward estates, but also applies to something broader, as indicated by use of the word "survival." A reference to this section in the comment to Section 3605 seems appropriate since Section 14009.5 may apply if the trust remainder goes to the estate or if the other reference to recipients taking by distribution or survival is applicable. However, more is needed. As suggested in the draft set out below, the staff would add a provision that the trust property is to be treated as property owned by the beneficiary or as part of the beneficiary's estate for purposes of determining rights of reimbursement. The principle to be implemented is that the original award or settlement would have been the beneficiary's property but for the special needs trust, and after the special needs trust has served its purpose, the deferred reimbursement claims are next in line. The technical question of whether the property passes outside the beneficiary's estate should not affect this principle.

Taking all of these suggestions into account, the staff proposes to revise Section 3605 as follows:

3605. (a) This section applies only to a special needs trust established on or after January 1, 1993, that satisfies one of the following requirements:

(1) The trust is established under Section 3604.

(2) The trust is established under Article 10 (commencing with Section 2580) of Chapter 6 of Part 4 to receive money paid pursuant to a compromise or judgment for the conservatee.

(b) Notwithstanding any provision in the trust instrument ~~to the contrary,~~ at the death of the special needs trust beneficiary or on termination of the trust, the trust property is subject to claims of the Department of Health Services, Department of Mental Health, and Department of Developmental Services to the extent authorized by law as if the trust property is owned by the beneficiary or is part of the beneficiary's estate.

~~(1) Death of the minor, incompetent person, or conservatee who is the beneficiary of the trust.~~

~~(2) A court order under Section 3604 terminating the trust because any of the requirements of subdivision (b) of Section 3604 are not satisfied, or because the trustee is not making payments from the trust for the special needs of the minor or incompetent person.~~

(c) If At the death of the special needs trust beneficiary or on termination of the trust, if the trustee knows or has reason to believe the decedent beneficiary received services or benefits from the Department of Health

Services, Department of Mental Health, or Department of Developmental Services, the trustee shall give notice of the decedent's beneficiary's death or the trust termination as provided in Section 1215, addressed to the director of that department at the Sacramento office of the director. Failure to give the notice prevents the running of the statute of limitations against that department's claim.

(d) The director has four months after notice is given in which to make the claim. The claim shall be paid as a preferred claim prior to any other distribution. If trust property is distributed before expiration of four months after notice is given, the director has a claim against the distributees to the full extent of the claim, or each distributee's share of trust property, whichever is less. The claim against distributees includes interest at a rate equal to that earned in the Pooled Money Investment Account, Article 4.5 (commencing with Section 16480) of Chapter 3 of Part 2 of Division 4 of Title 2 of the Government Code, from the date of distribution or the date of filing the claim, whichever is later, plus other accruing costs as in the case of enforcement of a money judgment.

(e) If a claim made pursuant to subdivision (d) is rejected, the director of the department making the claim may bring an action against the trust. The action shall be commenced within three months after the notice of rejection is given.

Comment. Section 3605 is new. Section 3605 permits reimbursement from special needs trusts established under Section 3604 or under the substituted judgment provisions of conservatorship law (Sections 2580-2586). Section 3605 does not affect any reimbursement rights that may exist with respect to other trusts, including special needs trusts established before the operative date of the section. ~~If the trust beneficiary has a substantial disability and the existence of the trust does not disqualify the beneficiary from receiving Medi-Cal benefits, while the trust is in existence it is not subject to claims of public entities for reimbursement for social services provided.~~ See also Prob. Code § 15306(b) (right of reimbursement for public social services under Division 9 (commencing with Section 10000) of the Welfare and Institutions Code).

On the death of the special needs trust beneficiary or termination of the trust, trust property ~~becomes~~ may become subject to such reimbursement claims under federal or state law. See, e.g., 42 U.S.C. § 1396p(b)(1)(B) (Medicaid); Welf. & Inst. Code §§ 7276, 7513-7513.2 (state hospital costs), 14009.5 (Medi-Cal). For this purpose, the trust property is treated as property of the beneficiary's estate.

Subdivisions (c) and (d) are drawn from Sections 215, 9202, and 9203. Subdivision (e) is drawn from Sections 9252(c) and 9353(a)(1).

On termination of a special needs trust, the normal rules governing distribution of property are applicable.

subject to the claims reimbursement provisions of this section. See Section 15410 (disposition of property on trust termination).

Prob. Code § 3611 (amended). Order of court

Ms. Imel makes the same point as to satisfaction of liens under this section as under Section 3602 discussed *supra*.

Respectfully submitted,

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January 6, 1992

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COMMENTS ON SPECIAL NEEDS TRUSTS FOR DISABLED MINOR OR INCOMPETENT PERSON

Dear Members of the Commission:

The Department of Health Services appreciates the opportunity to comment upon the November 14, 1991, redraft of the Recommendation Relating to Special Needs Trust for Disabled Minor or Incompetent Person.

Many of the comments in our October 8, 1991, letter have been incorporated into this redraft, but we share the Department of Developmental Services' concern that the effect of this recommendation will transfer more costs of medical care for disabled minors or incompetent people to the public, even where a settlement with a liable third party provided for medical care. Allowing individuals who have received assets for medical care to retain those assets in a special needs trust while public benefits are provided may result in denying care to other individuals who have no assets, because the public funds have been exhausted. Although proposed Probate Code section 3605 allows state agency claims to be satisfied from the trust property after the death of the beneficiary, public funds will still be expended for that beneficiary's care on a continuing basis, possibly for many years before the trust property is available to satisfy those claims. Public benefits are for those people without other resources. We consider this to be a significant public policy issue, and urge careful consideration of the consequences of the recommendation.

Consequently, we do not agree with the first complete sentence on page 2, which states:

"A disabled minor or incompetent person entitled to damages has just as urgent a need for public medical and other benefits as does a disabled child whose parents have the means to establish a special needs trust that preserves the child's eligibility for benefits."

Public benefits such as Medi-Cal are based on financial need, and beneficiaries must meet eligibility income and property standards. An individual who has property in excess of the eligibility standard, even if it was received as damages, is not the intended recipient of public benefits and does not have as urgent a need for public benefits as an individual who meets the eligibility standard for property. Also, third parties pay damages as the result of a legal duty owed to the disabled minor or incompetent person; parents generally establish a special needs trust for an adult disabled or incompetent child, for whom they have no legal duty to provide support.

We are also concerned that the recommendation and the comments on particular sections make no distinction between the different public benefit programs and their requirements. As we commented before, there is a danger of misleading people who may conclude that a special needs trust will not disqualify a beneficiary from any public benefit program. For example, the last sentence in the first paragraph on page 1 of the recommendation does not state that the cited article applies only to the Supplement Security Income program.

We agree with the comments of the Department of Developmental Services and with the amendments they proposed to the Probate Code sections. We add the following comments:

The law and regulations which govern public benefit programs such as Medi-Cal are very complex and highly technical. It is essential that terms be used consistently, to avoid confusion or unintended consequences. References should be to a "disabled minor or incompetent person" in each section of the Probate Code being added or amended, instead of sometimes using "minor or incompetent person." For accuracy in the fifth line of the Comment on section 3605, the reference should use the language of Probate Code section 15306(b): "public social services under Division 9 (commencing with Section 10000) of the Welfare and Institutions Code."

We suggest that the following be added to sections 3602(c)(2) and 3611(c):

"Before payment to the trustee, statutory liens must first be satisfied."

Although your staff recommended in Memorandum 91-64 that similar language be included in the Comments to these sections, we believe that it would be more effective notice in the statutes. Although state agencies may pursue legal remedies to collect the liens which

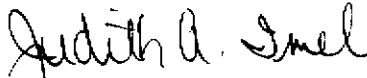
are not satisfied prior to funding the trust, it requires time and resources to do so, at a time when both are limited. It would also provide notice about the liens to people who use a compact version of the Probate Code, which does not include the Comments. References to specific sections of the Welfare and Institutions Code which authorize liens could remain in the Comments.

After the death of the beneficiary or termination of the trust, section 3605 authorizes claims against trust property to the extent authorized by law. The Comment to this section states that on the death of the beneficiary, the trust property becomes subject to claims under federal or state law. However, the sections of existing law cited as examples provide for recovery from the estates of beneficiaries. Trust property generally passes outside the estate. In fact, that is often a primary reason for creating a trust. None of the cited laws authorize claims on trust property unless the trust terms specify that trust property will be placed in the beneficiary's estate. We suggest that the references to specific statutes be deleted from the Comment, to avoid confusion.

Thank you for the opportunity to comment on this recommendation. If you have questions regarding our comments, please contact me at (916) 657-3089. I plan to attend the Law Review Commission meeting in Sacramento on January 23, 1992, when you consider this item.

Very truly yours,

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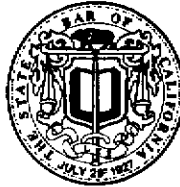
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Re: Tentative Recommendation
Special Needs Trust for Disabled Minor or
Incompetent Person

Dear Commissioners:

The following are the comments of Team One relating to Staff Draft of the Recommendation Relating to Special Needs Trusts for Disabled Minor or Incompetent Person:

1. Section 3604(b)(2).

This section requires that for the trust to be approved by the court the minor or incompetent person must "likely have special needs not provided by public programs that can be provided by the trust."

As drafted, the above language might be construed to require a showing that the beneficiary will have a need for trust distributions at the outset of trust administration. The beneficiary may not require distributions immediately because the severity of the person's condition limits the person's capacity to benefit from supplemental services. As the person's condition improves, however, special needs distributions may be critical in facilitating continued improvement.

Team One suggests, therefore, that subparagraph (2) be revised as follows:

(2) It is likely during the term of the trust that the minor or incompetent person will have special needs not provided by public program that can be provided by the trust.

2. Section 3604(c).

This section requires that "a trust established under this section is subject to the continuing jurisdiction of and supervision by the court."

It is unclear what "supervision by the court" requires.

The Comment gives examples of certain requirements, including periodic accountings, etc. If these requirements are discretionary with the court, what is the minimum requirement for "supervision by the court"? Can the court approve a trust that requires the trustee to mail a list of receipts and disbursements to the beneficiary, and nothing more? Does court supervision mean court-approved accountings?

As noted in Team One's earlier report on this proposal, we believe it would be unwise to require any specific provision or protection in the statute itself since this would deprive the trial court of the flexibility to fashion a trust to suit the particular circumstances of the case.

We recommend that Section 3604(c) be revised to read as follows: "a trust established under this section shall include such additional terms as the court in its discretion may require."

We further recommend that the Comments remain unchanged since they provide examples of protections which the court may require if it determines them necessary.

3. Section 3605.

The Comment to this section states that "on the death of the beneficiary, trust property becomes subject to such claims under federal or state law." This sentence is misleading since, as we noted in our earlier report, it might be construed to authorize a claim immediately on death notwithstanding the protections of federal and state law. We urge that the sentence be amended to read: "on the death of the beneficiary, trust property may become subject to such claims under federal or state law."

Section 3605(2) apparently allows the court to terminate an otherwise irrevocable trust if the requirements of subdivision (b) of this section are not satisfied. What happens to the assets of the trust on termination? Do they revert to a court-blocked account? To a guardianship or conservatorship? To the beneficiary, individually? To remaindermen?

Section 3605(c) requires the trustee to give notice of the beneficiary's death to the Department of Health Services or the Department of Developmental Services if the trustee knows or has reason to believe that the beneficiary were receiving services or benefits from either department. Section 3605(d) establishes a statute of limitations which commences on the giving of such notice and expires four months thereafter.

Since the notice only applies to trusts terminated on the beneficiary's death, there is no statute of limitations protection to trusts terminated by order of the court under Section 3605(b)(2). We recommend that the giving of notice and the statute of limitations also apply to court-ordered trust terminations.

The last paragraph of the Comment should be clarified to indicate that Section 3605 creates no new substantive rights of reimbursement for public entities, but rather such rights are the same as provided by existing law. We recommend that the last paragraph be revised to read as follows:

Section 3605 permits reimbursement from trusts established under Section 3604 or under the substituted judgment provisions of conservatorship law (Sections 2580-2586) if reimbursement is otherwise authorized by existing law. In addition, Section 3605 does not affect reimbursement rights with respect to other trusts.

Respectfully submitted,



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cc: Members of Team One
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