

The Dark Side of Pooled Trusts

BY RENÉE LOVELACE, CELA

The Omnibus Budget Reconciliation Act of 1993 ("OBRA '93") created a sweeping transfer penalty system.¹ However, among the exemptions from the transfer penalty system are transfers of an individual's own funds into a trust which allows the income and assets of a number of persons with disabilities to be managed by a non-profit organization (an "NPO").² These trusts are described in 42 U.S.C. § 1396p (d)(4)(C)³ and are commonly referred to as "d4C" trusts. The term "pooled trust" is used for both d4C (first-party, self-settled) trusts and third-party trusts⁴, which are often administered by the same trust managers.

Pooled trusts hold the promise of serving as an amazing technique to promote respectful quality of care and independent living options for persons with disabilities of all ages. But there is a dark side to these trusts which develops not only from their seductive appearance of simplicity and the tantalizing remainder interest that the NPO can keep in the trust at the death of a beneficiary, but also from the tendency of NPOs to underestimate startup and operating costs. To these potential problems are added the following typical factors:

- The trustee has full discretion over distributions from each sub-account—including the power to withhold distributions.
- The trust is irrevocable.

Getting a Pooled Trust off the Ground

Some trusts that started with great plans for serving a beneficial role in their communities now appear to be

hobbled by high costs and low revenues. Most successful pooled trusts appear to have started with massive⁵ investments of capital, pro bono legal time, and/or committed NPO staff time. Further, intense and sustained efforts and investments were generally required to get the trusts to where some are now self-sufficient (with current income meeting current expenses).

Consider the typical startup steps: (1) an existing NPO becomes committed to establishing a pooled trust, or an NPO is incorporated for that express purpose; (2) attorneys, typically pro bono, draft the trust agreement and related documents;⁶ (3) the NPO hires or trains staff to market and operate the pooled trust;⁷ (4) marketing begins; (5) new clients execute Joinder Agreements and pay initial sign-up fees;⁸ and then (6) the NPO manages the trust, often delegating out financial and legal aspects of administering the trust.

In taking many of the steps in the process, the dark side of pooled trusts tends to be concomitant with the bright side—i.e., good characteristics and the challenges appear to be inextricably woven together. For example, NPOs generally serve as the foundation for pooled trusts. NPOs are often staffed by committed and compassionate employees, but like all other humans and organizations, NPOs and their staff have limits. NPO characteristics often include:

An Established Track Record. NPOs have a long history of serving persons in need. But few employees, other than those in financial institutions and attorneys' offices, have had significant experience with trust administration and distributions. Also, some NPO staff have grown to accept that burn-out is a health and job risk if they do not delineate work time and personal time, leading attorneys to fear that there will be a cultural mentality of "all you have to do is try hard until 5:00 p.m."

Compassionate Staff. NPOs often have compassionate staff, but too many disparate requirements can wear down even the most compassionate person. In order to run a successful pooled trust, the administrator must be

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1. Prior to the Omnibus Budget Reconciliation Act of 1993 (OBRA '93), there were many techniques that individuals used to transfer their property into trust and then qualify for Medicaid. After OBRA '93, many of these transfer techniques generated transfer penalties, i.e., resulted in a period of time during which such individuals would not be eligible for Medicaid. For an overview of OBRA '93 and related topics, see Clifton B. Kruse, Jr., *Third Party and Self Created Trusts: Planning for the Elderly and the Disabled Client* (2d ed., ABA 1998).
2. For statutory analysis, case law, strategies, and forms, see Kruse, *supra* n. 1, and pooled trust resources including the following: (a) *Pooled Trusts Manual* (National Guardianship Association, see www.guardianship.org/store/index.htm); (b) M. Kent Olsen, *Pooled Income Trusts Following OBRA '93 Form (Including Joinder Agreement & Analysis)* (Fall 1994 NAELA Institute); (c) Renée C. Lovelace, *"Pooled Trusts: The Arc of Texas Approach and Alternatives"* (Fall 1996 NAELA Institute); (d) H. Clyde Farrell, *Important Addition to the Estate Planning Toolbox: New Special Needs Trust Options from the Arc of Texas Pooled Trust* (Jan. 10, 2001) (available at <http://texas.nami.org/Legal.html>); (e) Mary Catherine Rabbitt, *Special Needs Trust Overview: An Overview of Pooled Trusts* (Fall 2000 NAELA Institute); (f) Renée C. Lovelace, *Pooled Trusts: Opportunities and Risks*, (June 1997) *The ElderLaw Report*, p. 2.; and (g) past issues of the NAELA Quarterly for articles on d4C and the companion d4A trusts, also referred to as "pay-over" (to charitable purposes) and "pay-back" (to the State) trusts, respectively.
3. 42 U.S.C. § 1396p(d)(4)(C) reads as follows:
"(C) A trust containing the assets of an individual who is disabled (as defined in section 1614(a)(3)) that meets the following conditions:
(i) The trust is established and managed by a non-profit association.
(ii) A separate account is maintained for each beneficiary of the trust, but, for purposes of investment and management of funds, the trust pools these accounts.
(iii) Accounts in the trust are established solely for the benefit of individuals who are disabled (as defined in section 1614(a)(3)) by the parent, grandparent, or legal guardian of such individuals, by such individuals, or by a court.
(iv) To the extent that amounts remaining in the beneficiary's account upon the death of the beneficiary are not retained by the trust, the trust pays to the State from such remaining amounts in the account an amount equal to the total amount of medical assistance paid on behalf of the beneficiary under the State plan under this title."
4. Only self-settled trusts are addressed by the federal statute. Third-party pooled trusts (funded with property contributed by someone other than the trust beneficiary, such as a parent) rely on common law in the same manner as individual third-party trusts.
5. The term "massive" is used to clearly distinguish the investments from "large" or "significant."
6. For resources, see *supra* n. 2.
7. The NPO may play only a limited management role, delegating investments and record keeping to a corporate fiduciary and distributions to an attorney or other professional.
8. Most pooled trusts have a Master Pooled Trust Agreement, signed by the NPO and trustee, that includes a form Joinder Agreement as an exhibit. Individuals establishing sub-accounts in a Master Pooled Trust complete a Joinder Agreement for their sub-account. Some pooled trust administrators address only whether the proposed beneficiary meets the disability requirement (for d4C trusts, but not always applicable to third-party trusts) and has authority to establish the trust.

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interested in trusts and administration, enjoy the challenge of determining distributions that are permissible and advisable, and be proactive in reading regulations and rules.

Committed Board. NPOs often have passionately committed boards. Some NPO boards include the very most sophisticated and successful businesspersons; however, NPO board commitment is not always coupled with sophisticated financial skills.

Volunteer Attorneys. NPOs often attract high quality volunteer attorneys. Mission-oriented attorneys thrive on challenges, but whether an attorney's Don Quixote approach can survive long enough for the NPO to get the trust to self-sufficiency may depend on the attorney's case load and personal circumstances. Further, while it is important for attorneys to participate in pro bono legal work, it may be that where a complicated activity is primarily performed pro bono — with not-for-compensation counterparts, sophistication in the legal area will grow slowly. Not only are great opportunities wasted when good ideas are underutilized, but each startup is made more difficult. That appears to be the case with pooled trusts. Consider the pro bono cycle that often exists with pooled trusts. Start with the fact that there are many attorneys who contribute uncountable hours to NPO missions. Recognize that prudent businesses do not incur expenses that they can avoid and that NPOs are generally able to find attorneys to work pro bono. As a result, few NPO mission projects have a legal services budget. Unfortunately, in a complex area such as pooled trusts, by the time an attorney develops a base of expertise while working pro bono, he or she will likely have stretched family and firm budgets to a point where efforts can no longer be pro bono. Rather than pay the attorney at that point, an NPO may turn to another free attorney, who will need to start at the bottom of the learning curve⁹.

Fundraising Skills. NPOs often have the capability to raise funds for special projects. However, if the trust does not become self-sufficient and funding declines, the pooled trust's quality may decline as well.

Built-in Market. NPOs generally have a market among their own membership. Many NPOs have established pooled trusts primarily for funding by parents of children with disabilities, expecting third-party pooled trusts to be their main focus. This market, however, has remained elusive. Attorneys and pooled trust administrators have noted a pattern of inaction among families with children with disabilities, some of whom forestall making a decision by mulling over their options for years. This situation appears to be changing, but slowly. Meanwhile, much of the growth in pooled trusts has come from personal injury settlements, where the need is more immediate.

Successfully Controlling Expectations

"Under-promise and over-deliver" is the motto of one trust administrator.¹⁰ Well-run pooled trusts can greatly

improve quality of life for trust beneficiaries, but they cannot solve all problems. The dark side here is having unrealistic expectations. A major success factor appears to be controlling the expectations of all parties involved.

NPO Expectations

Perhaps the most serious NPO expectations to consider are whether the NPO expects pooled trusts to (1) be easy to administer and (2) make money. Pooled trust administration is difficult and costs are high. Steps include investing assets, managing the mechanics of prorating gains and losses to sub-accounts that are constantly changing in value, filing annual tax returns for the sub-accounts, designing forms, completing the joinder processes, making appropriate distributions for the benefit of sub-account beneficiaries, handling the mechanics of making distributions, maintaining record keeping, and much more. NPO members often expect pooled trusts to charge lower fees than corporate fiduciaries. However, with added personal care and attention, low fees are not realistic unless the trust is continually subsidized. But when charges are increased to cover actual costs, the trust is more difficult to market.

Some pooled trusts have resolved this problem, to the disappointment of advocates, by working primarily with large sub-accounts.

The Self-sufficiency Formula. The economic formula for self-sufficiency is easy to understand but difficult to attain:

Funds available to pay expenses must equal or exceed expenses.

Funding comes from income, i.e., grantor initiation fees and annual sub-account fees, as well as from charitable contributions and the NPO's allocations of resources. Expenses include staff time, overhead, investment fees, legal expenses, promotional costs, and many others. *There is no free lunch.* Either the pooled trust covers the expenses with the fees paid by sub-accounts, or someone else covers expenses (with time or money).

Realistic View of Who Pays What. Direct pooled trust charges can be misleading as some expenses are either charged directly to each sub-account or paid in other ways. While stated costs may be little more than one percent in some cases, total costs may be three percent or higher. Expenses tend to be paid by (1) trust sub-accounts, (2) NPO general revenues and resources, (3) specific contributions to the trust, (4) pro bono legal assistance, (5) other volunteer time, and/or (6) other parties. Time-consuming functions that some pooled trusts do not perform include: marketing, assisting grantors with the Joinder Agreement, annual care plans detailing distributions, and analyzing the appropriateness of individual distributions. Pooled trusts that do perform these functions have higher cost structures.

Joinder Agreement. The Joinder Agreement often serves as the framework for a beneficiary's long term care

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9. No major NPO, academic institution, or other organization appears to have taken on the mission of providing leverage and assistance to pooled trusts. Meanwhile, states have become more aggressive in pursuing the remainder interests of these trusts, despite the wording of the statute (see *supra*; n. 3). Attorneys and local NPOs tend to be fighting these battles alone, with attorneys often working on a pro bono basis.

10. Alan Kemp, Director of the Arc of Indiana Master Pooled Trust; see some of Mr. Kemp's other suggestions in the *Pooled Trusts Manual*, *supra*, n. 2.

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plan. It takes time to study alternatives and make good choices. Without good advice, a grantor may miss planning opportunities including retirement benefits, disability benefits, caregiver issues, incapacity planning, steps to avoid guardianship, and housing and employment options.

Several trusts require grantors to be represented by an attorney for the entire process because, as one administrator noted, "otherwise it is an ethical quagmire." Another administrator recommends legal representation but does not require it, noting "[i]f a trust requires clients to use an attorney, that trust has added one more hurdle for families who are already reluctant to move off the sidelines and establish a sub-account."

Distributions. The distribution process is a major cost component. Alternatives for handling the logistics of distributions include: (1) depending on personal representatives to plan distributions and make requests, (2) making all distributions according to an annual care plan, (3) working with court-appointed guardians, where the distribution process can often be more predictable, and (4) making the distribution process as flexible as possible by taking calls directly from beneficiaries. Where trusts take individual requests from beneficiaries, the distribution cost structure is likely to be higher. Trusts may, for example, take requests only over recorded lines, work with helpful bank officers who share the mission and provide extra services, or request that personal representatives pay expenses themselves and then submit fully documented reimbursement requests.

Attorney Expectations.

A common attorney expectation is that he or she will be able to merge his or her missions with money. But when working with NPOs and human services missions, that seems to happen fairly rarely.

A pooled trust can be an expensive pro bono project. Further, attorneys may have unrealistic expectations of NPOs. An NPO that has a primary focus on substantive member assistance, including technical assistance, may be more likely to provide adequate support for the pooled trust than an NPO that has a greater focus on less technical activities involving publicity [e.g., benefit galas, celebrity endorsements, some legislative initiatives and discussion groups]. But past activities do not always predict which NPO will be most committed; as with many projects, it depends on the key supporting individuals and staff.

Trust Administrator Expectations.

It is easy to set out what attorneys, NPOs, and clients expect of the trust administrator: Mother Teresa with an M.S.W., M.B.A. and J.D. Administering a pooled trust requires consistent attention to detail, rigorous examination of the applicable public benefits consequences, and

the patience of a saint. It appears that a pooled trust administrator should expect a job in which he or she must have high levels of both (a) passionate commitment, and (b) tolerance for tedium.

Administrators have noted, however, that if they are also expected to raise funds, it may be too difficult to perform their other obligations.

Sub-account Beneficiaries' Expectations.

Pooled trust managers often work hard to create expectations they can satisfy. Most emphasize the clear disclosure of all possible charges. Some require large print waivers and/or fee descriptions for clients to sign. Pooled trusts also emphasize precision and clarity in the distribution process. Some pooled trusts operate from annual distribution plans prepared in accordance with an actuarial calculation, bringing in outside advocates to review plans and distributions—much like an appropriate planning (as opposed to purely financial) audit.

The plan plus audit system could also prevent a rogue trust administrator from playing Robin Hood—declining to make distributions to a more wealthy beneficiary hoping that the funds will eventually become available for less prosperous beneficiaries.

Finally, it is important that both trustee and beneficiary are aware of options for terminating their relationship.

Coming Into the Light?

It has been eight years since OBRA '93 brought d4C trusts to the scene; some third-party trusts have been in operation for many more years. While some pooled trusts continue to grow and even thrive, there are significant unanswered questions and major open issues.¹¹ Pooled trusts, with their nearly miraculous capabilities, are arguably terribly underutilized and underdeveloped.

NPOs, persons with disabilities, families, funding sources, and State agencies are continually becoming more sophisticated, and there are fewer risks (and opportunities) that escape their scrutiny. The following are this author's suggestions for steps that front-line attorneys can take to make pooled trusts more credible, marketable, and perhaps even more attractive as a for-profit endeavor.

Step #1. Remove the Remainder Benefit Conflicts of Interest. Where the trustee has discretion over distributions and the trust keeps the remainder, a potentially serious conflict of interest exists. Some of the ways that this conflict of interest can be removed is by using one or more of the following: (a) making the remainder benefit optional; (b) using distribution plans based on beneficiaries' actuarial life expectancies, i.e., planning to distribute all funds during beneficiaries' lifetimes; (c) having distribution plans and patterns reviewed by outside advocates; (d) ensuring that the remainder cannot be used for

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11. Major unresolved issues in some States include (a) the State's right to reimbursement for Medicaid paid prior to the trust retaining remainder interests, (b) whether transfers by persons age 65 and over will be penalized (attorneys have argued that transfers to a pooled trust are not uncompensated when there is an actuarially-based pay-out plan or where sub-account beneficiaries who outlive their sub-account may benefit from the remainder interest left in the trust by others), (c) whether pooled trust interests are securities (many trusts rely on state securities exemptions), and (d) permitted uses of the remainder interest retained by pooled trusts. In addition, there are many administrative and distribution issues that are not yet efficiently addressed.

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administrative expenses, but may only be used to add individual beneficiaries to the trust or to purchase goods or services for other individual beneficiaries; (e) letting designated individuals direct the remainder to other charitable beneficiaries; (f) pricing services so that current income covers current expenses; and (g) prohibiting members and staff from referring to pooled trusts as fundraising devices.

Step #2: Remove the Threat of Irrevocability. Pooled trusts created in the future could be drafted to make changes easier. Some pooled trusts have facilitated transfers of sub-accounts to other trusts or closed out accounts by analogizing the transfers to IRA-to-IRA transfers and by using state statutes permitting trust amendments with all beneficiaries' permission. Most have gone to court to do so.

Step #3: Disclose All Real and Perceived Conflicts of Interest. Every market that touches people with money will attract vendors selling goods and services. The best way to ensure that pooled trust participants receive good legal services is to make it easier for good attorneys to give good advice by providing training and handouts. Also, the NPO

could adopt as policy a requirement that all estate planning and disability attorneys, financial product salespersons, medical and therapeutic providers, and other prospective vendors interacting with the trust, the NPO, trust beneficiaries, and grantors disclose their profit possibilities. The best defense against conflicts of interest playing an exploitive role appears to be clearly, consistently, and continually updating complete disclosures.

Step #4: Maximize Market Opportunities. Front-line attorneys can help pooled trusts grow in credibility by:

(a) Defending trusts against state actions where States demand repayment prior to the trust retaining the remainder. If conflicts have been removed, (see Step #1), then arguably States have no credible basis for demanding repayment if the trust has been designated to receive the remainder and, by doing so, they are threatening to destroy a charitable and advocacy tool that Congress created;

(b) recommending to all clients that they include power of attorney provisions to permit agents to establish pooled trust sub-accounts for principals who experience catastrophic medical events;

(c) designing approaches for smaller NPOs to collaborate with existing pooled trusts; and

(d) protecting a quality-of-care avenue by continuing to defend transfers into pooled trusts by persons age 65 and over by arguing that such transfers are not uncompensated. Penalizing such transfers removes a major source of advocacy and systemic protection for persons in nursing homes.

"I Have a Dream"

It is this author's view that continued thousands of volunteer hours are unlikely to generate the quantum leap

forward that major funding or a major for-profit business could generate by addressing and resolving some of the key impediments to growth. Apparently, too many entrenched inefficiencies exist.

What would happen, for example, if a major NPO or for-profit business (1) centralized information and approaches on many of the impediments to growth; (2) leveraged the substantial efforts of many attorneys, NPOs, and pooled trust administrators around the country (easily tens of thousands of hours of experience); and (3) centralized forms and functions for annual reporting and distributions?

Many elder law attorneys likely share the dream that it would then be possible for more local NPOs to operate pooled trusts closer to home. Smaller NPOs, faith-based initiatives, community foundations, community organizations, and small groups could all operate pooled trusts with

local management and auditing—without the massive investment that now precludes many pooled trusts from starting or from being able to assist beneficiaries with small sub-accounts.

In turn, the possibility exists that more courts would be comfortable directing funds to the trusts, thus increasing market competition. Pooled trusts could be used as a way to collect information on a wide range

of planning options, including charitable remainder trusts, charitable lead trusts, insurance trusts, funding sub-accounts with IRAs and other retirement benefits, and other steps. More funds could be administered or monitored by advocates who could, in turn, make a person-by-person difference in how nursing homes and care facilities treat their clients, while also promoting more independent living arrangements. Public benefits providing basic housing, shelter, and medical supports could be leveraged by pooled trusts providing respectful personal attention, dignified quality of care, more options and choices, coordination of services, and—ultimately—giving persons with disabilities more control over their lives.

Conclusion

Pooled trusts hold the promise of improved quality of care for millions of Americans, if we can minimize the dark side by taking pooled trusts into the light.

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