Memorandum 83-37

Subject: Study L-640 - Trusts (Duty to Account; Spendthrift Trusts)

The Commission began consideration of the staff draft of a statute governing trusts at the May meeting. (See Memorandum 83-17 and the draft statute attached thereto as Exhibit 1.) We plan to finish considering this draft at the June meeting. We will start at Section 4500 (compensation and expenses of trustees) on page 40 of the draft statute. Two additional matters need review:

1. Trustee's Duty to Account to Beneficiaries

At the May meeting the Commission decided that there should not be different rules governing the duty of trustees to account under testamentary trusts in existence before July 1, 1977, than there are for other trusts. The Commission decided that all trustees should be required to account annually, subject to waiver by trust beneficiaries. Redrafted accounting provisions are attached to this memorandum as Exhibit 1. This material would replace Sections 4182, 4183, and 4340 as they appear in the draft statute attached as Exhibit 1 to Memorandum 83-17. You should review the new draft to see whether any items included in the accounting should be omitted or whether other items should be included.

The Commission may also want to reconsider requiring an annual accounting. The staff anticipates strong opposition to this proposal. Coincidentally, a letter on this matter recently reached the staff. (See the letter of J.H. Perkins, attached as Exhibit 2 to this memorandum.) The Executive Committee of the State Bar Estate Planning, Trust and Probate Law Section is also on record as opposing a mandatory annual accounting.

2. Application of Spendthrift Trust Income to Creditors' Claims

As discussed in Memorandum 83-43, on the agenda for the June meeting, the staff proposes to slow down the trust study to provide time for detailed background studies by consultants on various aspects of trust law. The staff suggests, however, that one aspect of a complex problem be dealt with in the next legislative session--the extent to which income of a spendthrift trust may be reached by creditors. At the last meeting, the Commission decided that spendthrift trust income should be subject to creditors' claims to the same extent as earnings. A staff draft of a tentative recommendation implementing this decision is attached to this memorandum as Exhibit 3. The staff proposes to distribute this recommendation for comment after the June meeting if it is approved by the Commission and after making any necessary revisions.

The approach approved by the Commission in essence treats spendthrift trust income as earnings. Under Code of Civil Procedure Section 706.050 which incorporates the federal restrictions on wage garnishment, one-fourth of periodically paid income of a spendthrift trust would be subject to creditors' claims. If the payments are less than $435.50 per month however, the payments are completely exempt. Amounts between $435.50 and $580.66 are subject to creditor's claims. Accordingly, it can be seen that small spendthrift trusts would be safe from the claims of general creditors. Three-fourths of the income from spendthrift trusts paying large amounts would be protected. One-half to 65% of the income could be reached by a support creditor by operation of Code of Civil Procedure Section 706.052. On the other hand, the trust beneficiary may be able to protect greater amounts by claiming a hardship exemption under Code of Civil Procedure Section 706.051 (as to general creditors) or obtaining an equitable division under Code of Civil Procedure Section 706.052(b) (as to support creditors). A greater amount may also be withheld where the state is seeking to enforce a tax liability under the standard provided in Code of Civil Procedure Section 706.076.

The staff draft deals only with the narrow issue of exemption from enforcement of money judgments. We have intentionally not dealt with the issues of the voluntary assignability of the beneficiary's interest and whether the remainder interest is subject to spendthrift protection. These issues will be considered in the course of the study of trust law.

The Commission should be aware of alternative schemes for limiting the protection of spendthrift trusts:

1. <u>Exceptions based on type of claim.</u> As discussed in Memorandum 83-17, exceptions may be provided for claims for child or spousal support, for taxes, and for necessaries furnished the beneficiary. Exceptions may also be provided as to tort claims or debts due the trustor. See G.G. Bogert & G.T. Bogert, Handbook of the Law of Trusts § 40, at 155 (5th ed. 1973). Incorporating the wage garnishment scheme has the effect of giving special protection to support creditors, but only up to the level permitted by federal law. This limitation is logical only to

the extent that the trust income is akin to earnings for a particular beneficiary. The wage garnishment scheme also permits greater withholding to satisfy tax claims by the state.

2. Limitation on trust principal. Virginia limits support trusts to $500,000 of principal. Va. Code § 55-19 (1981). (The limit was set at $200,000 from 1919 until 1980.)

3. Dollar limitation on exempt income. Louisiana and Oklahoma have adopted a model statute proposed by Dean Griswold that subjects income over $5,000 per year to creditors' claims (raised to $10,000 in Louisiana). See La. Rev. Stat. Ann. § 9:2004 (West 1964); Okla. Stat. Ann. tit. 60, § 175.25 (West 1971); E. Griswold, Spendthrift Trusts § 565, at 648 (2d ed. 1947). Griswold's model statute also permits creditors to reach 10% of amounts exceeding $12 per week (remember that this is in terms of early 1940's dollars), and permits favored creditors (support, necessities, and tort) to reach any amount that is just under the circumstances.

4. Percentage of trust income subject to enforcement. In general, New York and New Jersey permit execution on 10% of the gross income from a trust. See N.J. Stat. Ann. § 2A:17-50 (1952), § 2A:17-57 (Supp. 1982) (10% of amounts over $48 per week, greater percentage if payments over $7,500 per year); N.Y. Civ. Prac. Law § 5231 (McKinney 1978) (amounts over $85 per week).

Respectfully submitted,

Stan G. Ulrich
Staff Counsel

EXHIBIT 1

Article 3. Trustees' Duty to Account to Beneficiaries

§ 4340. Trustee's general duty to inform and account to beneficiaries

4340. (a) The trustee shall keep the beneficiaries of the trust reasonably informed of the trust and its administration.

(b) Upon reasonable request, the trustee shall provide the beneficiary with a copy of the terms of the trust which describe or affect the beneficiary's interest and with relevant information about the assets of the trust and the particulars relating to the administration of the trust.

Comment. Subdivision (a) of Section 4340 is the same as the first sentence of Uniform Probate Code Section 7-303 and is consistent with the duty stated in California case law to give beneficiaries complete and accurate information relative to the administration of a trust when requested at reasonable times. See Strauss v. Superior Court, 36 Cal.2d 396, 401, 224 P.2d 726 (1950). Subdivision (b) is the same in substance as Uniform Probate Code Section 7-303(b). If the trustee does not comply with the reasonable request of the beneficiary, an accounting may be compelled as provided in Section 4620(b)(4). See also Section 24 ("beneficiary" defined).

§ 4341. Duty to account annually to income beneficiary

4341. (a) At least annually, at the termination of the trust, and upon a change of trustees, the trustee shall furnish an accounting to each income beneficiary, as defined in subdivision (a) of Section 4802, and, upon written request, to any other beneficiary.

(b) The annual accounting shall contain the following:

(1) A statement of the principal and income receipts and disbursements that have occurred since the preceding accounting.

(2) The value of each trust asset as of the end of the fiscal year of the trust.

(3) The total value of all assets as of the end of the current and preceding fiscal year of the trust.

(4) The net income for the current and preceding fiscal year of the trust.

(5) The trustee's compensation for the current and preceding fiscal year of the trust.

(6) A statement that the recipient of the accounting may petition the court pursuant to Section 4620 to obtain a court review of the accounting.

(7) The name and location of the appropriate court in which to file a petition.

(c) A valuation satisfies the requirements of this section if it is a reasonable estimate of the trustee.

(d) The trustee is not required to furnish an annual accounting to any beneficiary who has waived the right to an annual accounting in writing.

Comment. Section 4341 supersedes subdivisions (b) and (c) of former Section 1120.1a, and parts of former Sections 1121 and 1138.1(a)(5). The requirement of an annual accounting is drawn from the former statute applicable to testamentary trusts created before July 1, 1977. See former Section 1120.1a. Subdivision (c) makes clear that an accounting by a professional accountant is not required. Subdivision (d) permits waiver of the annual accounting, but not the accounting required on termination or change of trustees. A beneficiary who waives an annual accounting may still make reasonable requests for accountings. An accounting may be required under Section 4340 in certain circumstances more frequently than annually.

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May 16, 1983

John DeMoully
Executive Director
California Law Revision
Commission
4000 Middlefield Road
Suite D-2
Palo Alto, CA

Re: Trust Administration - Probate Code
Sec. 1120.1a

Dear Mr. DeMoully:

I will appreciate it if you will bring to the attention of the Commission a recently enacted, particularly onerous provision of the Probate Code.

It appears that the Legislature is attempting to remove all testamentary trusts from the continuing jurisdiction of the Superior Court, and that is probably desirable. (See, Probate Code, Secs. 1120 and 1138). However, the Legislature added Section 1120.1a to the Code which apparently treats all trusts created in Wills executed before July 1, 1977 in a special category.

The enactment requires trustees of all such trusts to provide a statement to all beneficiaries of the trust which provides, among other things, that the necessity for mandatory court supervision has been eliminated and that Section 1138.1 of the Code gives the beneficiary and remaindermen the right to petition to determine important matters relating to the trust. We are preparing the necessary notice for all of the trusts in our office which were created by Will executed before July 1, 1977, and that is not a serious problem. However, Section 1120.1a also states that with respect to all such trusts an annual summary must be provided to each income beneficiary of the trust, a burdensome duty which is not required of any other trustees, whether the trust is under continuing court jurisdiction or not. Further, the statute appears to require that in addition to providing the notice and the annual summaries, the trustee must file a petition with the court seeking removal of the trust from continuing jurisdiction of the court, whether or not the trustee wishes to have it removed from such jurisdiction. In this respect, the statute is not thoughtfully drawn.

We have considered advising clients with trust Wills executed before July 1, 1977 to execute codicils to avoid the impact of Section 1120.1a, but this procedure seems unduly burdensome and costly to clients in order to avoid the impact of poorly considered legislation.

I personally feel certain that Section 1120.1a will be extensively disregarded, which could create problems for trustees. I believe the Commission should take prompt steps to bring about the repeal of Probate Code Sec. 1120.1a.

Very truly yours,

J. H. Perkins

JHP:lg

cc Estate Planning,
Income Tax and Probate Section
of the Fresno County Bar Assoc.
Attention: James H. Peloian

EXHIBIT 3

STAFF DRAFT

TENTATIVE RECOMMENDATION

relating to

ENFORCEMENT OF JUDGMENTS AGAINST SPENDTHRIFT TRUSTS

Introduction

California law recognizes the validity of spendthrift trusts that protect the amount necessary for the education and support of the beneficiary from claims of creditors.[1] The surplus income over the amount necessary for education and support is specifically made subject to creditors' claims.[2] A creditor who seeks to satisfy a judgment against a beneficiary of a spendthrift trust will find it necessary to apply to a court to determine the surplus income.[3] This may be a futile exercise, however, since a station-in-life test is used to determine the amount necessary for the beneficiary's education and support.[4] Moreover, if

1. See, *e.g.*, Canfield v. Security-First Nat'l Bank, 13 Cal.2d 1, 11-12, 87 P.2d 830 (1939); see generally 7 B. Witkin, Summary of California Law *Trusts* § 94, at 5452-54 (8th ed. 1974).

2. Civil Code § 859.

3. Civil Code § 859; Code Civ. Proc. §§ 699.720(a)(8) (interest of trust beneficiary not subject to levy of execution), 709.010 (judicial procedure for reaching interest of trust beneficiary).

4. See Canfield v. Security-First Nat'l Bank, 13 Cal.2d 1, 21-24, 87 P.2d 830 (1939); Magner v. Crooks, 139 Cal. 640, 642, 73 P. 585 (1903). The station-in-life rule has seldom given a creditor payment on a claim. Powell, *The Rule Against Perpetuities and Spendthrift Trusts in New York: Comments and Suggestions*, 71 Colum. L. Rev. 688, 699 (1971). The California Supreme Court has rejected the more extreme New York cases, but has continued to embrace the station-in-life test which considers factors such as the social background of the beneficiary and the need for servants. See, *e.g.*, Canfield v. Security-First Nat'l Bank, 13 Cal.2d 1, 24-28, 87 P.2d 830 (1939). The Commission has criticized the station-in-life test as it related to the exemption of household furnishings and personal effects. See the Comment to Code Civ. Proc. § 704.020; *Tentative Recommendation Proposing the Enforcement of Judgments Law*, 15 Cal. L. Revision Comm'n Reports 2001, 2078 (1980).

the trustee has discretion to determine the disposition of the surplus, the attempt to reach the surplus may be self-defeating.[5]

The Law Revision Commission concludes that existing law is unfair to creditors, particularly to favored creditors such as those entitled to child or spousal support,[6] those who furnished necessaries to the beneficiary, tort creditors, and tax creditors.[7] By application of the station-in-life rule, excessive amounts have been shielded from creditors. The most convincing modern justification for continuing the recognition of spendthrift trusts is that the "protection of impecunious beneficiaries is in accord with public policy, at least to the extent of keeping such beneficiaries from becoming public charges."[8] A similar policy supports the various exemptions from enforcement of money judgments.[9]

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5. See Estate of Canfield, 80 Cal. App.2d 443, 181 P.2d 732 (1947); E. Griswold, Spendthrift Trusts § 428 (2d ed. 1947).

6. The policy favoring support creditors over other creditors is reflected in the Wage Garnishment Law (see Code Civ. Proc. §§ 706.050-706.052), in the federal Consumer Creditor Protection Act (see 15 U.S.C. § 1673(b) (Supp. V 1981), and in the Enforcement of Judgments Law (see Code Civ. Proc. § 703.070). See also Restatement (Second) of Trusts § 157 (1959). Although the California courts have refused to make an exception for support creditors, in one case the court concluded that the interests of the child should be taken into account in determining under Civil Code Section 859 the amount necessary for the support of the beneficiary. Estate of Johnston, 252 Cal. App.2d 923, 929-30, 60 Cal. Rptr. 852 (1967).

7. See Restatement (Second) of Trusts § 159 (1959). Favored status of creditors furnishing necessaries is recognized to some extent in Code of Civil Procedure Section 706.051 which precludes a hardship exemption in wage garnishment where the debt was incurred for the common necessaries of life furnished to the judgment debtor or the family of the judgment debtor. Code of Civil Procedure Section 706.076 permits a court to approve the withholding of any amount of earnings over that necessary for support in satisfaction of a state tax liability.

8. Canfield v. Security-First Nat'l Bank, 13 Cal.2d 1, 11, 87 P.2d 830 (1939).

9. See Holmes v. Marshall, 145 Cal. 777, 778-79, 79 P. 534 (1905); Tentative Recommendation Proposing the Enforcement of Judgments Law, 15 Cal. L. Revision Comm'n Reports 2001, 2075-76 (1980).

Recommendation

In furtherance of this policy, the Commission recommends that amounts payable to a beneficiary of a spendthrift trust on a periodic basis be made subject to enforcement of a money judgment to the same extent as earnings. This recommendation has two key advantages over existing law:

(1) The wage garnishment exemption, as applied to spendthrift trust income, provides a mechanical formula for determining amounts that are available to satisfy a money judgment. Under existing law,[10] $435.50 per month is protected from creditors. General creditors can reach the amount over $435.50 up to $580.66, and one-fourth of the amount payable to the beneficiary where monthly payments exceed $580.66. A creditor entitled to child or spousal support may generally reach half of the amount of the payment.[11] Where the trust beneficiary can show that a greater amount is necessary for his or her support and the support of his or her dependents, a hardship claim may be made.[12] In the case of a garnishment by a support creditor, the beneficiary may apply for an equitable division by the court where the beneficiary is also required to support other persons.[13]

(2) The recommended scheme permits levy under a writ of execution as an efficient alternative to making an application to a court such as is required where the creditor is seeking a determination of surplus.[14] This avoids the expense to the parties and to the court system of possibly futile proceedings. At the same time, the beneficiary of the spendthrift trust is left with the same amount of income as he or she would be entitled to if the money were earned rather than a gift.

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10. Code Civ. Proc. § 706.050. This provision incorporates the federal standard provided in 15 U.S.C. § 1673(a) (1976) which protects an amount of disposable earnings per week equal to 30 times the federal minimum wage (currently $3.35). Disposable earnings are earnings remaining after the deduction of taxes and other amounts required to be deducted. 15 U.S.C. § 1672(b) (1976).

11. Code Civ. Proc. § 706.052. Under certain circumstances, as much as 65% may be withheld. See Code Civ. Proc. § 706.052(c) and the Comment thereto.

12. Code Civ. Proc. § 706.051.

13. Code Civ. Proc. § 706.052(b).

14. Civil Code § 859; Code Civ. Proc. § 709.010.

The proposed legislation also permits the creditor to resort to the court proceeding generally available for enforcement against the interests of trust beneficiaries.[15] If this course is chosen, the court determines any exemption issues before ordering the beneficiary's interest applied to the satisfaction of the judgment by an order directed to the trustee to pay the non-exempt amount under the applicable wage garnishment standard.

The Commission also recommends that this new legislation be applied to all spendthrift trusts, whether executed or in force before or after the operative date of the new statute. It has long been settled that debtors have no vested right in exemption laws[16] and New York decisions have upheld the application of the 10% garnishment statute to existing trusts.[17]

Proposed Legislation

The Commission's recommendation would be effectuated by enactment of the following measure:

An act to amend Sections 859 and 867 of the Civil Code, and to amend Sections 699.720 and 709.010 of the Code of Civil Procedure, relating to trusts.

The people of the State of California do enact as follows:

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15. Code Civ. Proc. § 709.010(b).

16. See E. Griswold, Spendthrift Trusts § 391, at 483 (2d ed. 1947); Vukowich, Debtors' Exemption Rights, 62 Geo. L.J. 779, 865 (1974); 35 C.J.S. Exemptions § 6 (1960).

17. Brearly School v. Ward, 201 N.Y. 358, 94 N.E. 1001 (1911).

§ 859
405/918

Civil Code § 859 (amended). Claims of creditors against spendthrift trust

SECTION 1. Section 859 of the Civil Code is amended to read:

859. (a) Where a trust is created to receive the rents and profits of real or personal property, and no valid direction for accumulation is given, the surplus of such rents and profits, beyond the sum that may be necessary for the education and support of the person for whose benefit the trust is created, may be applied to the satisfaction of a money judgment against the person as provided in Section 709.010 of the Code of Civil Procedure.

(b) If the beneficiary's interest in a spendthrift trust is payable periodically, the beneficiary's interest may be applied to the satisfaction of a money judgment against the beneficiary as provided in Section 709.010 of the Code of Civil Procedure.

Comment. Section 859 is amended to make periodic payments to a beneficiary of a spendthrift trust subject to enforcement of a money judgment. See Code Civ. Proc. § 709.010(c) (interest of beneficiary under spendthrift trust subject to enforcement to same extent as earnings).

405/928

Civil Code § 867 (technical amendment). Restraint on disposition of beneficiary's interest

SEC. 2. Section 867 of the Civil Code is amended to read:

867. ~~The~~ Subject to Section 709.010 of the Code of Civil Procedure, the beneficiary of a trust for the receipt of the rents and profits of real property, or for the payment of an annuity out of such rents and profits, may be restrained from disposing of his interest in such trust, during his life or for a term of years, by the instrument creating the trust.

Comment. Section 867 is amended to recognize that the interest of a trust beneficiary may be ordered to be applied to the satisfaction of a money judgment under Code of Civil Procedure Section 709.010.

405/930

Code of Civil Procedure § 699.720 (technical amendment). Property not subject to execution

SEC. 3. Section 699.720 of the Code of Civil Procedure is amended to read:

699.720. (a) The following types of property are not subject to execution:

(1) An alcoholic beverage license that is transferable under Article 5 (commencing with Section 24070) of Chapter 6 of Division 9 of the Business and Professions Code.

(2) The interest of a partner in a partnership where the partnership is not a judgment debtor.

(3) A cause of action that is the subject of a pending action or special proceeding.

(4) A judgment in favor of the judgment debtor prior to the expiration of the time for appeal from such judgment or, if an appeal is filed, prior to the final determination of the appeal.

(5) A debt (other than earnings) owing and unpaid by a public entity.

(6) The loan value of an unmatured life insurance, endowment, or annuity policy.

(7) A franchise granted by a public entity and all the rights and privileges thereof.

(8) The interest of a trust beneficiary, other than periodic payments to a beneficiary under a spendthrift trust.

(9) A contingent remainder, executory interest, or other interest in property that is not vested.

(10) Property in a guardianship or conservatorship estate.

(b) Nothing in subdivision (a) affects or limits the right of the judgment creditor to apply property to the satisfaction of a money judgment pursuant to any applicable procedure other than execution.

Comment. Subdivision (a)(8) of Section 699.720 is amended for consistency with Section 709.010 which, in subdivision (c)(1), permits execution on the nonexempt part of periodic payments made to a judgment debtor as beneficiary under a spendthrift trust.

405/939

Code of Civil Procedure § 709.010 (amended). Enforcement against trusts

SEC. 4. Section 709.010 of the Code of Civil Procedure is amended to read:

709.010. (a) As used in this section, "trust" has the meaning provided in Section 1138 of the Probate Code but includes a trust subject to court supervision under Article 1 (commencing with Section 1120) of Chapter 19 of Division 3 of the Probate Code.

(b) ~~The~~ Except as provided in subdivision (c), the judgment debtor's interest as a beneficiary of a trust is subject to enforcement of a money judgment only upon petition under this section by the judgment creditor to the court prescribed in Chapter 19 (commencing with Section 1120) of Division 3 of the Probate Code (administration of trusts). The judgment debtor's interest in the trust may be applied to the satisfaction of the money judgment by such means as the court, in its discretion, determines are proper, including but not limited to imposition of a lien on or sale of the judgment debtor's interest, collection of trust income, and liquidation and transfer of trust assets by the trustee.

(c) ~~Nothing in this section affects the law relating to enforcement of a money judgment against the judgment debtor's interest in a spendthrift trust, but surplus~~ With respect to a spendthrift trust:

(1) If the judgment debtor's interest as beneficiary of a spendthrift trust is payable periodically, the amount of such periodic payments that may be applied to the satisfaction of a money judgment before payment is the amount that may be withheld from a like amount of earnings under Chapter 5 (commencing with Section 706.010) (Wage Garnishment Law). Periodic payments under a spendthrift trust may be applied to the satisfaction of a money judgment by levy under a writ of execution or as provided in subdivision (b).

(2) Surplus amounts from a spendthrift trust liable pursuant to Section 859 of the Civil Code are subject to enforcement of a money judgment under ~~this section~~ subdivision (b).

Comment. Section 709.010 is amended to make periodic payments to the beneficiary of a spendthrift trust subject to enforcement of a money judgment before payment to the same extent as earnings are subject to garnishment. See Sections 706.050-706.052, 706.074, 706.076 (exemptions from wage garnishment). Subdivision (c)(1) makes clear that periodic payments under a spendthrift trust may be reached by levy under a writ of execution or by the judicial procedure provided by subdivision (b). Subdivision (c) provides an exception to the general rule that nonassignable property is not subject to enforcement of a money judgment. See Section 695.030(b)(1) (interest in spendthrift trust subject to enforcement to extent provided by law).

405/961

SEC. 5. This act applies to all spendthrift trusts, regardless of whether the trust was executed before or after the operative date of this act.