#L-629 9/5/85

Memorandum 84-61

Subject: Study L-629 - Item v. Aggregate Theory of Community Property (Consequences of Carlston v. Coss)

Under California community property law, each spouse owns a present, existing, and equal interest in community property. Civil Code § 5105. From time to time the question arises whether this half interest extends to each item of community property or whether the interest of each spouse is one-half the aggregate of the community assets.

While the question is metaphysical, the answer has a practical impact on the rights of the spouses. The law is clear, for example, that at dissolution of marriage the aggregate theory prevails, and each spouse is entitled to a total of half the value of all community assets. Any other solution would be conterproductive, since if each spouse were awarded a one-half interest in each item of property, all that would be accomplished would be the conversion of community property to tenancy in common property, and a further partition action would still be necessary.

At termination of the marriage by death, as opposed to dissolution, the item theory prevails. The decedent is entitled to dispose of his or her half of each item of community property by will or by will-substitute. Dargie v. Patterson, 176 Cal. 714, 169 P. 360 (1917). This result is necessary because otherwise the decedent would have absolute power to determine what assets the survivor would be left with, thereby depriving the survivor of an important property right. The dead hand of the first to die would dictate the result.

A recent Court of Appeal decision, however, departs from these principles and adopts an aggregate theory for disposition of community property at death. In Carlston v. Coss, 153 Cal. App.3d 1069, 200 Cal. Rptr. 416 (1984), the wife sought to dispose of community assets by creating three Totten trust accounts and one joint account, totaling $86,000, with her sister. The total amount disposed of was less than one-half the community estate. The husband sought to recover one-half the amount of each account, on the item theory. The court held that since the total amount disposed of was less than one-half the community, the husband was not entitled to recover any of the funds.

While this case seems not unreasonable on its face, the holding creates potential problems and has been sharply criticized. To begin with, it destroys the standard principle of the widow's election--the survivor may abide by the decedent's estate plan or may take half the community by right. As the commentary in V Estate Planning & California Probate Reporter 143 (CEB 1984) observes, "The result went beyond forcing an election; the survivor was certainly forced, but he had no election." The commentary also points out:

> The lack of a true election was probably inconsequential in this case, but the decision introduces considerable uncertainty with respect to the state of the law. Are surviving spouses still entitled to half of community property life insurance policies and pension plans regardless of other assets received by them? If not, can a surviving spouse be forced to accept other property in lieu of a pension? This uncertainty will presumably produce complex litigation involving the character and value of property and presenting the usual complex valuation problems associated with pensions, IRAs, etc.

The reference to valuation in this commentary highlights a second major problem with application of the aggregate theory. In order to determine whether the disposition made by the decedent aggregates one-half of the community estate, it may be necessary to value the entire estate in a case where no valuation would otherwise be required. If the estate is entirely liquid, this will not be a substantial problem; but if the estate includes illiquid assets, the valuation difficulties could be substantial.

The illiquid estate presents other problems as well. Suppose the decedent disposes of all the liquid assets, leaving the survivor with illiquid assets only? Is it fair to give this sort of control to the decedent, or to force the survivor to accept certain assets? This is the concern of Professor Reppy, who has written to us on several occasions pointing out problems with the aggregate theory. See Exhibit 1. Professor Reppy also points out the mischief that can arise if the decedent is permitted, for example, to dispose of the entire community property business managed by the survivor or to make other vindictive dispositions.

The question the Commission needs to decide is whether legislation in this area is necessary or desirable. In favor of legislation is that it could short-cut alot of confusion and litigation that Carlston

v. Coss may engender. As the CEB Reporter commentary states, "there is no precedent cited for the court's position, and it opens a can of worms which perhaps should have remained closed." Opposed to legislation is that the offending case is an aberrant decision that conflicts with established state law and that may be either ignored or corrected in subsequent cases. It is a complex area, and perhaps best left to case law to straighten out; legislation could conceivably create more problems than it cures.

If the Commission is inclined to legislate in this area, there are several possible approaches that should be investigated. One is simply to codify the item theory. But, as Professor Reppy points out, this makes little sense where there are two fungible assets of equal value and the decedent leaves one to the surviving spouse and disposes of the other; in this situation it is better not to allow the survivor to force one-half of each. Professor Reppy's proposed solution is to limit the aggregate approach to fungible assets. A different alternative is to endorse the aggregate approach but to permit the survivor, rather than the decedent, to select which half he or she will take. This eliminates the dead hand control that makes the aggregate approach offensive; but it could destroy the decedent's estate plan. A related concept is to give the court some control over what assets can be removed from the survivor. For example, the ability of the decedent to control real property, a business, or sentimental property, can be limited. The Commission has done some work on this concept in the past.

The staff will work on drafting after the Commission has decided the policy in this area.

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary

EXHIBIT 1

Duke University
DURHAM
NORTH CAROLINA

SCHOOL OF LAW POSTAL CODE 27706

April 30, 1984

Nathaniel Sterling
Assistant Executive Secretary
California Law Revision Commission
4000 Middlefield Road, Room D-2
Palo Alto, CA 94306

Dear Nat:

Remember the problem I told you about involving community property interacting with wills law, where one spouse leaves, say $10,000 by will to X and the community property consists of $1 million in stocks but only $6000 in cash? I indicated that technically under present law X cannot get more than $3000 (half the cash on hand) because a will cannot force a sale of property, and because under the "item" theory of community ownership the decedent spouse can deal with only half the account.

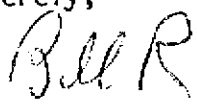
The problem is wholly avoided by Carlston v Coss, 200 Cal. Rptr. 416 (App. 1984) which adopts the aggregate theory of community ownership at death. The deceased spouse left the entire contents of three bank accounts to Sister, and it was held this was valid because the total property exceeded the amount of the bank accounts.

This adoption of the aggregate theory results in some horrifying possibilities. Angry at Husband, wife bequeaths his entire law business (community property) to her Brother, a lawyer, and gives Husband in lieu other items of community property of equal value (e.g., their house). Under the aggregate theory, husband cannot make an election to keep half of his law books, half his accounts receivable, half his office lease, etc. They are community property in which he owned a half interest, yet aggregate theory says his rights in the half interest can be wholly taken from him as long as he ends up in the aggregate with as much by value as he had before Wife died.

I think the result in Carlston where the Wife dealt with an item of community property -- an entire bank account -- is unacceptable both logically and legally. On the other hand, if by will Wife had left Sister $86,000, I think fairness and logic demands that she be able to do this under the item theory of ownership by altering the rules concerning management and control to force a sale, if necessary, to raise the cash to fund the bequest if Husband elects against complete emptying of all the bank accounts to pay Sister $86,000 ( a right he has under the item theory).

In any event, if the Law Revision Commission is continuing a study of community property, it certainly will want to consider the startling adoption of the aggregate theory in Carlston and at least confine use of that theory to testamentary-type dealings with cash so that a horror story like the angry bequest of the surviving spouse's entire business cannot come true.

Sincerely,



William A. Reppy, Jr.
Professor of Law

Duke University
DURHAM
NORTH CAROLINA

SCHOOL OF LAW

POSTAL CODE 27706

July 25, 1984

Mr. Nathaniel Sterling
Assistant Executive Secretary
California Law Revision Commission
4000 Middlefield Road, Room D-2
Palo Alto, California 94306

Dear Nat:

Thank you for expressing anew an interest in my views about the item vs. the aggregate theory of community property law. I consider Carlston v. Coss completely unacceptable. Under it, the wife can pass all the liquid assets of the community to a friend or relative (e.g., a child of a prior marriage) while leaving the husband with a very illiquid half of the community despite the fact they are co-owners of each asset. For example, the community may own a minority interest in a family corporation (the husband inherited it and transmuted it to community) equal in value to half the community. There are also publicly traded stocks, cash, etc. of equal value. Wife leaves Husband the minority share of the family corporation. He is going to have a devil of a time finding a buyer and meanwhile has no liquid assets to use for day to day enjoyment of life.

The wife's legatee -- the child of a prior marriage in our hypothetical -- should be, if Husband wishes by making an election, forced to share with Husband the burdens of ownership of the illiquid stock.

Only one exception to the item theory of ownership at death is tolerable, and it is not clear from reading Carlston v. Coss if that was such a case. The aggregate theory can apply to fungible items. Thus, if there are two community bank accounts each containing $10,000 it would be senseless to allow an election by the Husband when the wife bequeathed the entire contents of one account to him and the other account to the child. (I think, however, that under strict item theory approach Husband could do so and if he is the intestate heir as well as residuary legatee his election is "free." That is, if Wife's nearest relative is Sister, not a child, Husband can elect against the bequest of the account in Bank X to the

sister, take half of that account and not care a bit that all of the benefits under the will he had to forfeit to make an election come to him instead via intestacy.)

One simple solution to the Carlston v. Coss problem is for the wife to make a contract with the husband inter vivos that he will not contest her succession scheme. That is, she agrees not to sever the joint tenancy ownership of their house and he promises that she can set up a Totten trust for (or make a bequest to) a relative. Since the Husband is getting more than fifty percent in such a situation, he surely ought to agree. If the spouses will cooperate in the estate planning process the problem, then, is very small.

If they cannot cooperate it is just the type of situation we fear: the first-to-die spouse will invoke Carlston's item theory to make a vindictive succession plan, giving away the husband's golf clubs, his fishing yacht (all community property, I am assuming) in return for the house (after she severs the likely joint tenancy).

If you agree with me the problem is how to define fungibility in a statutory revision of the law. I think publicly traded stocks are fungible and thus if Son gets all the community cash (say $20,000 worth) and Husband of decedent wife ends up with $20,000 worth of publicly traded stocks, maybe he should not be able to elect. (Because of the stepped up basis for the stock under section 1014(b)(6) of the Internal Revenue Code the husband is probably quite happy with this.)

Short of depriving a spouse of testamentary power over half the community property I see no way to structure a succession scheme that will avoid creation of cotenancies between the surviving spouse and the legatee of the deceased spouse. As indicated above, the parties themselves can avoid this by an agreement between the two spouses that each will abide by the will of the other, wills that consistently make aggregate theory dispositions of entire assets that are community-owned.

Sincerely,

Bill

William A. Reppy, Jr.
Professor of Law

WAR:jma