

6/20/85

First Supplement to Memorandum 85-61

Subject: Study L-640 - Probate Code (Spendthrift Trusts)

We have just received a letter relating to spendthrift trusts from Mr. Charles A. Collier, Jr., writing on behalf of the Estate Planning, Trust and Probate Law Section of the State Bar. (A copy of this letter is attached hereto as Exhibit 1.) Mr. Collier suggests in the conclusion of his letter that the Commission defer further work on "creditor aspects of spendthrift trusts".

The Commission needs to decide whether the study of spendthrift trusts should be deferred until after the bulk of the work on the Probate Code revision project is completed. If so, the existing law on spendthrift trusts could be continued as it is, without dealing with the various problems that have been identified in Professor Niles' background study and in Memorandum 85-61. Postponing further consideration of spendthrift trusts would clearly save the Commission quite a bit of time in meetings. The problems that have been discussed in studies and memorandums are probably not ones that demand immediate solution; many of the uncertainties in existing law have persisted for decades, seemingly without serious consequences. A reading of Professor Niles' background study supports the idea that the substance of existing law is in fairly good shape.

It would be simple to defer the study of spendthrift trusts by leaving Civil Code Sections 859 and 867 and Code of Civil Procedure Section 709.010 where they are and without amendment. There does not appear to be any consensus about what if anything to do with the old Field Code provisions on spendthrift trusts, so it is probably best to leave them alone until they can be carefully studied. It would not be good to make a halfhearted attempt to clean up Sections 859 and 867.

Mr. Collier's letter in Exhibit 1 raises many questions, but the staff will limit comment to several points. In paragraph 4, Mr. Collier quotes some comments of Professor Niles from almost 2 years ago; a reading of the background study attached to Memorandum 85-61

show that Professor Niles now has a different view of the trust "garnishment" statute, Code of Civil Procedure Section 709.010. Professor Niles will not be able to attend the June meeting, but he told the staff by telephone today that he supports the approach of draft Section 709.010.

In paragraph 6, Mr. Collier suggests that it is inappropriate to consider changes in the recently enacted Section 709.010. It should be noted that Section 709.010 was never intended to be the final word on spendthrift trusts.

In paragraph 9, Mr. Collier expresses surprise that a creditor could still seek the surplus amount under Civil Code Section 859. It bears repeating that the wage garnishment exemption standard in Code of Civil Procedure Section 709.010(c) applies only to periodic payments made from a spendthrift or support trust; in other cases involving spendthrift trusts, the surplus amount would be available by application of Civil Code Section 859 and Code of Civil Procedure Section 709.010(b).

Paragraphs 5, 13, 15, and 16 of Mr. Collier's letter suggest that Section 709.010 has nothing to do with discretionary trusts. The staff does not agree with this view. Section 709.010(e) explicitly provides that it does not affect or limit the trustee's discretion, nor require its exercise in a particular manner. This provision does not displace other principles of existing trust law which determine whether or not a trustee can be compelled to exercise discretion or directed to exercise discretion in a particular manner. See, e.g., Civil Code § 2269 (exercise of discretionary powers). It would be incorrect to suggest that a payment made in the trustee's discretion (whether or not pursuant to a standard provided in the trust) is free from creditors' claims under Section 709.010. Simply put, Section 709.010 permits creditors to reach payments that are being made to beneficiaries, notwithstanding a restraint on involuntary alienation in the trust. If the trustee truly has discretion to stop making payments, then the creditor will get nothing when the trustee actually stops making payments, but will get what the court decides as long as payments actually continue. If the beneficiary can compel the trustee to make payments in fulfilling the purposes of the trust, the creditor

can reach a part of such payments once the trustee starts making payments.

Paragraph 19 of Mr. Collier's letter suggests that the reference to Probate Code Section 1220 in the comment to draft Section 709.010 (see page 5, Exhibit 1, Memorandum 85-61) is in error. This citation refers to a section in the comprehensive draft statute dealing with the rights of a creditor against a revocable trust during the trustor's lifetime. (See pp. 98-99 of the draft statute attached to Memorandum 85-32, considered in part at the April Commission meeting.)

Respectfully submitted,

Stan G. Ulrich
Staff Counsel

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June 18, 1985

VIA EXPRESS MAIL

John H. DeMouilly
Executive Secretary
California Law Revision Commission
4000 Middlefield Road, Room D-2
Palo Alto, California 94303

Re: Memoranda 85-33, 85-54 and 85-61 -
Spendthrift Trusts

Dear John:

The purpose of this letter is to comment on behalf of the Executive Committee of the Estate Planning, Trust and Probate Law Section, State Bar of California, on the various proposals involving spendthrift trusts. These comments are as follows:

1. The Staff Memorandum 83-17 dealt with spendthrift trusts and what was then proposed §§4210-4213. It proposed retaining existing law except to allow a judgment creditor on a judgment for child or spousal support to reach funds subject to a spendthrift trust in such amounts as the court might determine. At that time the spendthrift trust provisions were part of the comprehensive review of trust law.
2. In Memorandum 85-37, the Staff recommended that there be a separate bill dealing with spendthrift trusts and proposed an approach which "in essence treats spendthrift trust income as earnings". The wage garnishment approach was articulated.
3. The Committee in Study L-641, a tentative recommendation relating to garnishment of amounts payable to trust beneficiaries dated August 1, 1983, proposed the wage garnishment approach and indicated that it "would replace the existing rule that permits a creditor of the beneficiary of a spendthrift trust to reach the surplus over the amount necessary for education and support of a beneficiary". It was intended to provide an automatic

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standard which would not require a court determination of surplus income.

4. In the Second Supplement to Memorandum 83-60, Professor Niles, the Commission's consultant on trusts, stated in his letter of September 9, 1983, attached to that Supplement as Exhibit 1:

"The suggestion that a beneficiary of a spendthrift trust should have no more of a right to shield trust income than he or she would have to shield earned income has an appeal, but in the end, I think the Commission will reject it. The analogy is imperfect because the rights and privileges of donors are entitled to some consideration. I suspect that the bar will not be willing to limit protective trusts on an amount based on the minimum wage. I believe that it is imperative to study all aspects of spendthrift and discretionary trusts . . . I hope that the garnishment proposal will be held up until the various studies are completed."

5. Assembly Bill 22-82 was introduced on January 5, 1984, by Assemblyman McAlister. It was opposed by the Estate Planning, Trust and Probate Law Section, State Bar of California. Attached are copies of letters of February 2, 1984 and May 9, 1984, setting forth various grounds of opposition, many of which are still relevant. The State Bar eventually withdrew its formal opposition after changes were made (a) to require a court determination on the matter and (b) to make it clear that discretionary trusts were not affected. Your letter of June 5, 1984, addressed to this writer, set forth various proposed changes in the bill to clarify the inapplicability of the bill to discretionary trusts.

6. The new law, which became effective January 1, 1985, being CCP §709.010, has had only a few months of operation. Yet the staff memos, Memoranda 85-33, 85-54, and 85-61, suggest comprehensive changes in that wage garnishment approach to spendthrift trusts. These Memoranda, and particularly the latter two, make many proposals which would, it is believed, extensively erode the protection of a spendthrift trust.

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7. It is not clear from Memoranda 85-54 and 85-61 whether the rights to garnish a spendthrift trust under CCP §709.010 are in addition to or in lieu of the rights under CCP §859 to reach surplus of rents and profits.

8. At the May meeting of the Commission, you will recall, the discussion of a \$5,000 periodic payment to a trust beneficiary, and how much of that could be reached under the wage garnishment approach and/or under the surplus income approach. There was disagreement between the draftsmen.

9. It had been the expectation that the wage garnishment approach would simplify the administration of creditor rights on spendthrift trusts by giving an objective standard for garnishment rather than the somewhat indefinite standard of surplus income in excess of that needed over education and support. It was not anticipated that both remedies (wage garnishment and surplus income standards) would be available. Memorandum 85-54 suggests that both remedies should be available to a creditor. They do not seem to be stated in the alternative.

10. Even if they are in the alternative as to a single creditor, there is nothing to preclude creditor A from seeking to reach assets pursuant to the wage garnishment standard and creditor B then seeking to reach assets on the surplus income theory.

11. Memorandum 85-54 acknowledges that California law has been unclear as to whether or not the trustor may validly restrain alienation of principal. Sections 859 and 867 of the Civil Code refer to income from rents and profits. CCP §709.010 appears to settle the issue as to a periodic payment whether from income or from principal. The Staff perceives a gap as to nonperiodic payments and the ability of a creditor to reach principal in those cases.

12. Proposed new subsection (g) of §709.010 which attempts to define periodic payments would, if enacted, effectively destroy any protections for discretionary payments from a trust, whether or not spendthrifted. Periodic payments is so broadly defined that it would seem to include any payments made whether or not required to be made, that is, whether or not discretionary (proposed (g)(3)).

13. Proposed subsection (g)(4) refers to rights to payments in the trustee's discretion pursuant to an objective standard. According to Professor Halbach at the Commission's May meeting, a trust which provides in the trustee's discretion for payments for "support" or "maintenance" or "education" would be deemed a trust with objective standards and hence would apparently give the creditor the right to seek amounts which, in the trustee's discretion, would otherwise be paid for such beneficiary's support, maintenance or education. Since most trusts are drafted with this type of language where discretion is involved (based upon the ascertainable standard concepts under the Internal Revenue Code), the proposed language suggests a discretionary trust really is not discretionary, that a beneficiary could compel support, and therefore the creditor, including a trustee in bankruptcy, could reach the amount for support, etc.

14. The proposed language in subsections (g)(3) and (4) seems on its face inconsistent with subsections (i)1 and 2.

15. At the time AB-2282 was being considered in the legislative process, the example given of periodic payments was a fixed payment of perhaps \$500 per month being paid to a beneficiary. To so define periodic payments to include discretionary payments for support, for maintenance, for education, for health, etc., it is believed, destroys the concept of a discretionary trust and a spendthrift trust as to creditors.

16. There are undoubtedly tens of thousands of trusts in California which contain discretionary trust provisions. Unless the concept of "periodic payments" is narrowly limited so as to not include payments made in a trustee's discretion, it will necessitate the review and change of innumerable trust documents at great cost to the clients.

17. Memoranda 85-54 and 85-61 deal with spendthrift, support and discretionary trusts without differentiation. It is believed that these are distinct types of trusts and have distinct purposes. To broaden provisions applicable to periodic payments from a spendthrift trust to other types of trusts is unwarranted.

18. Proposed subsection (c) of §709.010 is intended to establish the principal that the judgment debtor's interest as beneficiary includes whatever the judgment debtor can reach for his or her own benefit. In connection with a discretionary trust, this raises the question again as to whether the beneficiary can compel support from the trust using a station-in-life test and, if so, can the creditor also reach a like amount.

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19. Memorandum 85-54 at page 5 of Exhibit 1 refers to Probate Code §1220. It is believed that this reference is in error.

20. Exhibit 2 sets forth proposed §621. The discussion at the May Commission meeting left it unclear as to whether that section served a function and, if so, what function was served thereby.

21. Proposed §622 in Exhibit 2 gives the beneficiary the right to assign his or her interest in the spendthrift or the protective trust to the same extent as subject to enforcement of the money judgment. This again raises a question of a beneficiary's right to compel payment of support, maintenance or educational expenses from a discretionary trust. If he or she can compel such payment, is it not subject to assignment? If it can be assigned, is not the spendthrift essentially meaningless in a trust for a beneficiary's support, maintenance, education or health? The proposed definition of a support trust (see Exhibit 6 to Memorandum 85-61), that is, one for "education or support", is so narrowly defined as to be of little practical use.

22. In Professor Niles' memorandum attached to Memorandum 85-33 at page 12, he made the following comments with reference to the amendments to §709.010 enacted in 1984:

"In many situations, however, the garnishment statute will not be of value. In discretionary trusts the remedy will not be available until and unless the trustee's discretion has been exercised in favor of the beneficiary."

It is believed that the concepts in Memoranda 85-54 and 85-61 depart from the concept of Professor Niles that discretionary trusts would not be reached.

23. The writer of this letter has not found any citation to cases where a beneficiary of a trust, which gave the trustee discretion to provide funds for support, maintenance or education, was able to compel a distribution for support. If such a case were cited in any of the Memoranda, it has not come to this writer's attention.

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24. Exhibit 5 to Memorandum 85-61 points out the practical problem of providing a certain sum for support and having a portion of that garnished, having to provide more funds to replace same, having that subject to garnishment, etc.

25. One of the initial arguments for the wage garnishment approach was to save court time. The initial proposal of course, did not require court involvement at all. The very broad definitions of periodic payments in proposed Memoranda 85-54 and 85-61, it is submitted, will create much more litigation than ever existed in the past on spendthrift trusts.

26. Prior to the Staff's commencing its work on spendthrift trusts, the State Bar Section was not aware of any agitation from creditors to change the spendthrift rules in California.

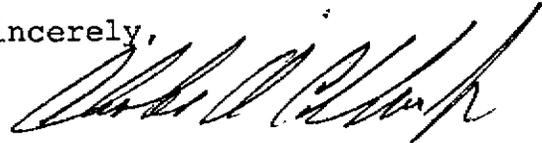
27. As noted earlier in this letter in a quote from Professor Niles, there is a fundamental difference between wages earned by the person who has incurred the debt and the ability of his creditors to reach that property and property of a donor put in trust for the benefit of a third party. It is not that beneficiary's money unless and until distributed. It is often put in a spendthrift trust or discretionary trust to protect the beneficiary against his creditors, against his own improvidence, against his being a spendthrift. It is intended to protect the weak, the uninitiated, the alcoholic, the naive, the drug user, etc. The protections of a spendthrift trust or a discretionary trust are intended by the testator of the will or the grantor of the trust to protect the beneficiaries against themselves. To broaden the creditor's rights in connection with such trusts changes the nature of those trusts dramatically, removes many of the protections intended for the beneficiaries and represents a basic change in California law.

28. The provisions on spendthrift trusts are found in the Civil Code or Code of Civil Procedure as to creditor's rights. They are not specifically involved in the Commission's work on probate administration nor in their present form do they necessarily impact on the proposed new comprehensive trust statute. Since the law as to spendthrift trusts was just changed, further change does not seem necessary at this time. There are innumerable problems with the proposals, a great deal

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of Commission time can be spent discussing the pros and cons of changes as to discretionary trusts and spendthrift trusts, etc. Given the numerous problems raised in this letter, in letters from others, in the letters submitted in 1984 with reference to AB-2282, etc., it is respectfully submitted that the Commission elect to defer further work on the creditor aspects of spendthrift trusts until its current priorities have been completed.

Sincerely,



Charles A. Collier, Jr.
for the Executive Committee

CAC:vjd
Enclosures

cc: Kenneth M. Klug, Esq. (w/encls.)
Theodore J. Cranston, Esq. (w/encls.)
James V. Quillinan, Esq. (w/encls.)
K. Bruce Friedman, Esq. (w/encls.)

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February 2, 1984

Assembly Judiciary Committee
Elihu Harris, Chairman
California State Capitol,
Room 6031
Sacramento, CA 95814

Attention: Lettie Young, Committee Consultant

Re: AB 2282

Dear Mr. Harris:

The California Law Revision Commission has proposed an amendment to certain provisions of the Code of Civil Procedures which would, in general, provide that amounts payable to a trust beneficiary pursuant to a trust agreement would be subject to garnishment under a writ of execution to the same extent as earnings. Justification given for such proposal is such availability would avoid the necessity of a court determination that garnishment is the appropriate means to reach a beneficiary's income. It's suggested that spendthrift provisions of trust instruments provide more protection from creditor's of beneficiaries of trusts than for wage earners and that such "discrimination" should not be tolerated.

The Executive Committee of the Estate Planning, Trust and Probate Law Section of the California State Bar strongly opposes such proposal. The opposition is based upon the following factors.

1. No compelling need for such legislation has been shown other than the theoretical observation that undefined "discrimination" would be avoided.
2. There are adequate remedies presently provided to reach surplus funds in any spendthrift trust.

3. Such proposal is stated to be effective and applicable to all trusts, whether created before or after the proposed legislation. As a result, at least many hundreds of thousands of trust documents would be affected by this proposed legislation.

4. The Law Revision Commission proposal overlooks the basic fact that there is a basic distinction between a trust instrument wherein a third person establishes the fund upon which the beneficiary draws, subject to the terms and conditions originally imposed by the third person trustor and a wage earner who generates his own earnings.

This proposal would unilaterally affect the intent of creators of untold numbers of documents. No compelling demand of creditors is shown or cited for support.

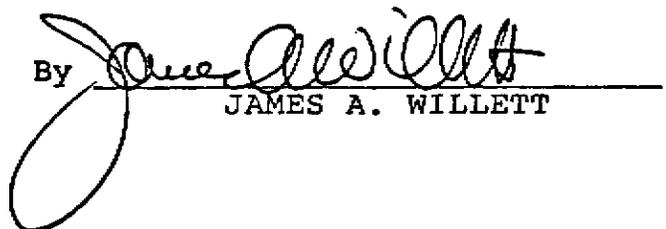
It is believed that any such proposal is premature at the least. The Law Revision Commission is in the process of reviewing and proposing suggestions and consolidation of the Probate Code and Civil Code provisions dealing with trusts. It is believed that consideration of this topic would best be viewed in the context of such major revision rather than in piecemeal fashion as this proposal suggests.

The Executive Committee represents approximately 4,000 California lawyers who have a special interest in the field of estate planning, trust, and probate law. The Executive Committee which represents such group of lawyers urges rejection of this ill-considered proposal.

Very truly yours,

EXECUTIVE COMMITTEE

By



JAMES A. WILLETT

JAW:kt

bcc: Charles A. Collier, Jr.
H. Neal Wells, III
Matthew S. Rae, Jr.

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JAMES A. WILLIAMS, *Sacramento*

May 9, 1984

The Honorable Alister McAlister
State Capitol
Sacramento, California 95814

Re: AB 2282

Dear Mr. McAlister:

The Estate Planning, Trust and Probate Law Section of the State Bar of California consists of more than 4,000 practitioners throughout the state.

Section Position: Opposition.

Reasons for Opposition: The Section opposes AB 2282 on the following grounds:

1. Existing California law which recognizes a spendthrift trust, Civil Code Section 867, is in accord with the majority rule and with the rule of the Restatement of Trusts, Second, Section 151.
2. The proponents of the Bill contend that the right of a creditor to garnish assets of a spendthrift trust would lessen court time. However, few if any such petitions are filed with the court to determine what constitutes surplus income in a spendthrift trust. Therefore, the savings, if any, of court time would be minimal and do not constitute a reason for enactment of this change.

3. The Bill, as amended, states that if a trustee has discretion to distribute income, the creditor cannot compel exercise of that discretion. Presumably, lawyers throughout the state will feel it necessary to contact their clients and modify, where appropriate, existing estate plans at a considerable cost to clients to make distributions of income from trusts discretionary where there is no adverse tax consequence. Thus, the Bill would increase consumer costs significantly.

4. The Bill purports to apply to existing trusts including irrevocable inter vivos and testamentary trusts. Such retroactive provisions have been held invalid and unconstitutional in other jurisdictions. See, e.g., Borsch Estate 362 Pa. 581, 67 A.2d 119 (1949). The Supreme Court of Pennsylvania in that decision held as unconstitutional a law which gave the income beneficiary different rights than had existed when a spendthrift trust was created. It was noted that a donor of a trust has an individual right of property in the execution of the trust and, as such, is able to put such limitations on the use of the property as the donor deems proper. To have the law changed in California as to existing trusts, it is believed, would be an unconstitutional taking of property rights.

5. So far as known, there has been no pressure from creditors in California to change the existing law.

6. A spendthrift trust provision is a limitation on a transfer of property in trust by a donor for the benefit of one or more beneficiaries. It is very different than earnings of a beneficiary from his or her own efforts which are subject to garnishment. It is not the beneficiary's property except to the extent provided in the trust document itself, including any limitations imposed by a spendthrift provision. There is concern that, under the 1978 Federal Bankruptcy Act, a trustee in bankruptcy acting on state law has the right to reduce a trust beneficiary's interest if not spendthrifted to a present interest and, therefore, force sale of trust assets in an amount equal to the present value of an interest. This could jeopardize thousands of existing trusts and upset the intended disposition of property by the donor or testator.

7. Under Internal Revenue Code Section 1014(b)(7), a qualified terminable interest trust for a surviving spouse which defers tax requires that all income be distributed to

that surviving spouse in order to qualify for deferral. If the creditor has a right to reach into the trust and have the trustee transfer property directly to the creditor, it is unclear whether the trust would still qualify for tax deferral, especially if the creditor sought trust assets only where the surviving spouse, for example, had guaranteed the debts of a third party and the debt was not actually the debt of the spouse.

8. The California Law Revision Commission is undertaking a comprehensive review of California trust law and expects to introduce a comprehensive bill on trust reform in 1985. This isolated bill seems to be premature and presented without consideration for its bankruptcy consequences, constitutionality, or income and estate tax consequences.

9. The Section recently conducted a poll of its members, seeking members' views on the changes in California law proposed by AB 2282. The members opposed any change in the law by a margin of approximately 3 to 1 in a non-spendthrift trust context and a margin of 5 to 1 in connection with changes in a spendthrift trust.

10. In AB 2282, Proposed Section 709.010(c) states that any court determinations in connection with the levy under that subdivision shall be made by the court where the judgment sought to be enforced was entered. This would seem to indicate that, if a judgment was entered by a federal district court, for example, the parties would have to have the matter determined in that court rather than in a state court.

11. There is a fundamental difference between a person setting aside his or her own property in trust for the benefit of third parties and imposing a spendthrift provision on those transfers from a wage earner protecting his or her own property from his or her creditors.

12. Under existing law, once property is distributed from a trust it is no longer subject to the spendthrift provision, and the creditor can levy against the distributee. Thus, property in a spendthrift trust, once distributed, becomes available under existing law to creditors. Creditors need only determine when distributions are made.

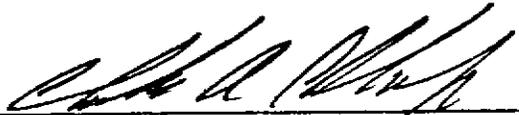
13. The Federal Bankruptcy Act, 11 U.S.C. Section 522(b), gives the bankrupt a choice of a federal or state law exemption. Section 541(c)(2) of the Bankruptcy Act states: "A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy law is enforceable in a case under this title." To greatly expand the rights of creditors, as does AB 2282, under state law would similarly increase the ability of the trustee in bankruptcy to reach trust assets. See Matter of Goff 706 F.2d 574, 580-582 (5th Cir. 1983). The bankruptcy implications of AB 2282 are serious. To allow the creditor to levy directly on assets in a non-spendthrift trust or spendthrift trust would appear to give the trustee in bankruptcy a right to take over trust assets and defeat the purposes of the trust.

14. If a creditor could levy directly on trust assets, the beneficiary would appear to be taxable on the funds subject to the levy, even though never received by the trust beneficiary. Therefore, AB 2282 can injure taxpayers.

For the various reasons stated, the Section strongly opposes AB 2282.

Estate Planning, Trust and
Probate Law Section, State
Bar

By


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