

#L-640

Memorandum 85-96

Subject: Study L-640 - Probate Code (Comprehensive Trust Law--claims procedure for trusts)

BACKGROUND

At the October 1985 meeting the Commission reviewed the draft of a provision to subject a revocable trust to claims of the settlor's creditors on the death of the settlor if the settlor's probate estate is inadequate to satisfy the claims:

18201. Upon the death of a settlor who had retained the power to revoke the trust in whole or in part, the property that was subject to the power of revocation during the settlor's lifetime is subject to the claims of creditors of the decedent settlor's estate and to the expenses of administration of the estate to the extent that the decedent settlor's estate is inadequate to satisfy such claims and expenses.

The Commission generally approved the basic policy of this provision but expressed concern about its procedural implementation. The purpose of this memorandum is to highlight issues and problems involved in implementing the statute.

Chuck Collier has alerted us to the fact that there are currently two ABA committees working in this area. We are trying to get copies of any material they may have produced, and will supplement this memorandum if and when we receive the material. Meanwhile, we can make a start at resolving some of the policy issues in this memorandum.

EXISTING LAW

Whether assets in a revocable trust are subject to claims of creditors upon the death of the settlor is not clear under California law. If there is a direction in the trust instrument to pay debts, the issue is resolved. But if there is no direction to pay debts, the answer is murky.

Liability During Settlor's Life

Initially, inquiry must be made whether assets of a revocable trust are subject to the settlor's creditors during the settlor's life. If creditors cannot reach the assets during the settlor's life

when the trust was fully revocable by the settlor, it is difficult to argue that the creditors gain any greater rights by the settlor's death and the trust becoming irrevocable.

It is established that a settlor cannot create a spendthrift trust on his or her own behalf. See, e.g., *Nelson v. California Trust Company*, 33 Cal.2d 501, 202 P.2d 1021 (1949). However, this is an easier case than the ordinary revocable trust, since the settlor is the beneficiary of the trust. In the case of a revocable trust where the settlor merely retains an unexercised power of revocation, the analogy to spendthrift trust law becomes somewhat strained.

Another basis for access of the settlor's creditors to assets of a revocable trust is the possibility of a fraudulent conveyance in the creation of the trust. In the case of a self-settled or Dacey trust where the settlor is also trustee, Civil Code Section 3440 would, by its terms, subject some of the trust assets to creditors of the settlor: "Every transfer of personal property . . . made by a person having at the time the possession or control of the property, and not accompanied by an immediate delivery followed by an actual and continued change of possession of the things transferred, is conclusively presumed fraudulent and void as against the transferor's creditors while the transferor remains in possession" We have not found an appellate case expressly applying this section to trusts, however.

Where the settlor is not the trustee and there is an actual transfer of possession, the fraudulent conveyance statutes would still preserve creditor rights in the assets if the transfer was made while the settlor was insolvent or with the intent to defeat creditors. Civil Code §§ 3439.04-.07. Again, we have not found an appellate case expressly applying these provisions to trusts.

But suppose a revocable trust is legitimately created with an independent trustee and no income to the settlor--all the settlor retains is a power of revocation. Is there any basis on which the creditors of the settlor may reach the trust estate? One possible approach is for the creditor to seize the power of revocation and exercise it. Although this approach appears theoretically possible, again we have found no appellate case where this was actually done.

Another approach is through the law governing powers of appointment. The power of revocation by the settlor of a revocable trust is analogous to a general power of appointment held by the donor. The assets subject to the power are not owned by the holder of the power but the general power can be exercised in the holder's favor, just as a power of revocation of a revocable trust can be exercised in the settlor's favor. The law is clear that creditors of the holder of a general power may reach property that is subject to the unexercised power. Civil Code § 1390.4. This section has not been construed by a California appellate court to apply to revocable trusts, but similar provisions in other jurisdictions have been so construed.

There thus appears to be adequate basis in the California law for creditors of the settlor of a revocable trust to reach the trust assets during the settlor's lifetime. However, we have been able to find no appellate cases either permitting or precluding this, and it must be concluded that the present state of the law is unclear.

Liability After Settlor's Death

With the law governing creditors' rights against assets of a revocable trust during the settlor's lifetime unclear, one would assume that the law governing their rights after the settlor's death is equally unclear. This would be a safe assumption.

At least one California case has addressed this point. The court in Estate of Heigho, 186 Cal. App. 2d 360, 9 Cal. Rptr. 196 (1960), holds that the assets of a revocable inter vivos trust cannot be recaptured by the executor of the deceased settlor's estate unless the trust is shown to be a fraudulent conveyance. However, it has been pointed out that the unusual facts of this case presented numerous issues of estoppel and waiver that weaken the authority of any general rule. Chillag, Creditors' Rights to Reach Nonprobate Assets, 5 CEB Est. Plan. R. 1 (1983).

In terms of general fraudulent conveyance law, a good argument can be made for the ability of the personal representative of the settlor to reach the trust assets on behalf of creditors. In the case of the self-settled or Dacey trust, Civil Code Section 3440 provides

that the transfer of personal property is conclusively presumed fraudulent and void "as against any person on whom the transferor's estate devolves in trust for the benefit of others than the transferor." This cryptic language has not been construed, but arguably it would permit the settlor's personal representative to recover the trust assets.

A more specific statute covers all cases of fraudulent conveyances. Probate Code Section 579 provides:

If the decedent, in his lifetime, conveyed any real or personal property, or any right or interest therein, with intent to defraud his creditors, or to avoid any obligation due another, or made a conveyance that by law is void as against creditors, or made a gift of property in view of death, and there is a deficiency of assets in the hands of the executor or administrator, the latter, on application of any creditor, must commence and prosecute to final judgment an action for the recovery of the same for the benefit of the creditors.

In applying this statute, the Heigho case held the particular trust involved was not a fraudulent conveyance. We have found no other appellate case applying this statute to a trust.

An argument could be made that the transfer of property pursuant to a revocable trust is not really absolute until the settlor dies and the trust becomes irrevocable. Thus the transfer in effect occurs at the death of the settlor. If the settlor leaves insufficient assets in the probate estate to satisfy creditors, the revocable trust must be viewed as a fraudulent conveyance subject to recovery by the personal representative, since it leaves the settlor insolvent. This argument is made in Effland, Rights of Creditors in Nonprobate Assets, 48 Mo. L. Rev. 431 (1983). So far as we know, no court has yet adopted this argument.

If the revocable trust is analogized to a general power of appointment, upon the settlor's death the trust assets would remain subject to creditors' claims. The power of appointment statute (Civil Code Section 1390.3) makes clear that:

Upon the death of the donee, to the extent that his estate is inadequate to satisfy the claims of creditors of the estate and the expenses of administration of the estate, property subject to a general testamentary power of appointment or to a general power of appointment that was presently exercisable at the time of his death is subject to such claims and expenses to the same extent that it would be subject to the claims and expenses if the property had been owned by the donee.

And where the donor reserves the general power of appointment for himself or herself, creditors need not even show that the donor's estate is inadequate (Civil Code Section 1390.4):

Property subject to an unexercised general power of appointment created by the donor in favor of himself, whether or not presently exercisable, is subject to the claims of creditors of the donor or of his estate and to the expenses of the administration of the estate.

Again, these statutes have not been applied to revocable trusts in California, although comparable provisions in other jurisdictions have been applied to revocable trusts.

Finally, it should be noted that a gift made in "view of death" (made in contemplation, fear, or peril of death and with the intent that it take effect only in case of death) is subject to claims of creditors. Civil Code § 1153. Presumably this rule would apply to trusts created by the settlor in view of death .

In summary, the law governing rights of creditors upon the death of the settlor of a revocable trust is no more clear than the law governing their rights during the settlor's life. There appears to be adequate basis in the law to allow creditors to reach the assets, but there is no clear statement of the right or of the procedure in the law.

POLICY CONSIDERATIONS

Should Trust Assets Be Liable?

The first policy consideration we must face is whether trust assets should be liable to the decedent's creditors at all. The Commission agreed with the staff that the assets should be liable, but it is worth reviewing the policy arguments on this point.

At common law, creditors of the settlor could not reach trust assets in a revocable trust either during the settlor's lifetime or at death. Restatement (Second) of Trusts § 330 comment o (1957). The reasoning behind this position is that the power to revoke is only a "power" and not "property". Of course this point is merely linguistic and does not reflect the reality of the power of revocation. For income tax purposes the trust assets are considered to be still the property of the settlor, and the assets are included in the settlor's estate for estate tax purposes, as they are for bankruptcy purposes.

The root policy question is whether a person should be able to immunize property from his or her creditors by putting it in a trust that remains subject to the settlor's ability to regain until the settlor's death. In essence the revocable trust is a will substitute that enables probate avoidance. The probate system is carefully designed to protect rights of creditors, and it is anomalous to allow a person to defeat the system so readily by the device of labeling what is in effect still his or her property "trust assets."

On the other hand, subjecting the trust assets to creditors claims could, depending upon the implementing procedure, have the effect of nullifying the nonprobate character of the trust. This is a potentially serious problem, since the revocable trust is a heavily used modern estate planning device, one of the primary purposes of which is to avoid probate.

The staff believes public policy favors the protection of creditors. We can see no sound policy to favor beneficiaries who in essence are receiving a windfall at the expense of a creditor who loaned the settlor money or provided the settlor with goods or services or to whom the settlor was otherwise indebted. We should attempt to provide creditor protection with a minimum of impact on the nonprobate aspect of the transfer. But if this is not possible, we believe public policy favors the creditor in this area.

What About Other Nonprobate Assets?

The same argument for subjecting revocable trust assets to creditors' claims can be made for other nonprobate assets as well. These would include joint tenancy property, life insurance proceeds, and retirement benefits. None of these assets is generally subject to claims of the decedent's creditors.

Persons interested in this area have suggested that nonprobate assets generally should be made subject to creditors claims. This was the conclusion of the American Bar Association committee chaired by Chuck Collier that looked into the Missouri trust claims statute, and also the recommendation of Dick Kinyon, both of which have previously been reviewed by the Commission. See Memo. 85-73 (Ex. 4) and First Supp. Memo. 85-73 (Ex. 5).

The staff agrees that a uniform procedure and treatment of all nonprobate assets would be desirable, but does not believe this should be done in the context of the trust statute, for several reasons. First, these other nonprobate assets are often critical for the support of the decedent's survivors, and different policies may affect whether creditors should be given substantive rights in them. Second, because of the varied character of these assets, different procedural provisions may have to be drafted to deal with them adequately. Third, there is an emotional feeling among many people, including legislators, that these assets should be a safe harbor from creditors. As an example, the Commission recommended in connection with the multiple-party account legislation that joint tenancy or pay-on-death bank accounts should be subject to the decedent's debts to the extent the decedent's estate is inadequate; this provision was the first item amended out of the bill by the first committee in the first house it went to. Fourth, the insurance and pension industries trade to some extent on the immunity of their assets from creditor claims, so that we can anticipate substantial political opposition to changes in this respect.

The staff recommends that we bite off one chunk at a time and work to develop an adequate statute dealing with revocable trusts. After we have experience with this we can consider extending the statute or modifying it to deal with other nonprobate assets.

Order of Priority of Trust and Estate Assets

Should trust assets be subject to creditors' claims without precondition, or should they be subject to creditors' claims only if the estate of the settlor is insolvent, i.e., there are insufficient assets to satisfy all valid creditors claims? The basic policy to look through the form of a transfer to its substance would argue for allowing creditor access to trust assets regardless of the condition of the settlor's estate. But the policy to ensure the sanctity of the nonprobate transfer to the extent possible would argue for immunizing the trust assets unless needed to satisfy creditor claims.

There are other factors at work here as well. Protecting trust assets unless the estate is insolvent requires additional procedural

mechanisms for making the determination that the estate is in fact insolvent. But providing immediate creditor access to trust assets would have the effect of accentuating inequitable treatment between trust beneficiaries and estate heirs. (This is a particularly thorny problem, which is developed more extensively below.)

Is there any reason to assume that, if posed the question, the settlor would rather protect beneficiaries of a revocable trust than devisees under a will? Probably the settlor would protect trust beneficiaries before intestate heirs. It is also likely that the settlor would prefer beneficiaries to devisees, depending on whether they are family members, charitable donees, etc., though this is far from clear. Dick Kinyon observes that, "It may even be appropriate to provide that certain non-probate dispositions should abate before or in proportion to specific, demonstrative, or general legacies. For example, a specific gift under a will probably should take precedence over a residuary gift under a revocable living trust." First Supp. 85-73 (Ex. 5).

The staff's fundamental feeling here is that the sentiment to protect nonprobate assets is strong and it will be politically feasible to subject them to creditor claims only if the settlor's estate is insolvent. We will proceed on this assumption.

Should Debts to Which Trust Assets are Applied be Limited?

If trust assets are to receive greater protection than estate assets, the question arises whether they should be subject to general creditor claims or should be seized only if necessary to satisfy priority claims or special claims such as support obligations of the settlor. The staff's basic feeling here is that although limiting the debts for which the trust assets may be used would have some facial attractiveness, it is preferable to implement general policy by making the assets subject to all unsatisfied claims. It would also make the drafting of the statute simpler. We would prefer to see limited availability as a fall-back position in case we run into opposition.

A related question is whether the trust assets should be subject to seizure for purposes other than payment of debts. Specifically, should they be subject to seizure for various family protection

purposes, such as family allowance, probate homestead, share of an omitted spouse or child, etc. We note that Section 6-107 of the Uniform Probate Code provides that assets in a multiple-party account may be recovered for probate to the extent necessary to satisfy debts and expenses of administration, "including statutory allowances to the surviving spouse, minor children and dependent children." This treatment is analogous to the "augmented estate" concept of the Uniform Probate Code. The competing considerations here are the right of the settlor to create an estate plan that is honored by the law versus the policy of the law to protect persons dependent on the settlor from actions by the settlor that would leave them without the necessities of life. The staff approach has been to cover only debts of the settlor, taking one step at a time in this uncharted area. However, it would be possible to broaden our approach if the Commission is so inclined.

With respect to liability of trust assets for the settlor's estate or income taxes, we have not taken any action. We assume the tax laws are adequate to allow the taxing authorities to reach any assets to which they are entitled. And we have statutory mechanisms for proration where one asset is tapped for taxes that are attributable to other assets as well.

Creditor v. Personal Representative Access to Trust Assets

A fundamental issue that must be faced in preparing legislation to deal with access to trust assets for creditors' claims is whether creditors should be allowed direct access to the assets or only via the personal representative of the settlor's estate. Although direct creditor access would seem at first blush simpler, it is in fact fraught with problems:

--How is the trustee to know that the settlor's estate is in fact insolvent, so that payment of the creditor is proper?

--There is no mechanism apart from lawsuit and judgment for resolving disputed claims.

--There is no clear limitation period on the time for presentation of claims by the creditor.

--Allowing direct access would give creditors a means of avoiding compliance with the probate procedures.

--If the trust assets are insufficient to satisfy all creditors, should the trustee pay on a first-come, first-served basis, on a prorata basis, on a priority basis, or on some other basis, and how is this to be determined?

Problems such as these lead to the conclusion that the better approach is to allow the settlor's personal representative to reach the trust assets and bring them into the probate process. This would resolve all the foregoing problems, since the probate process has already built into it such matters as time limits for filing claims, an expeditious dispute resolution process, priority provisions for payment, and collection of all assets and claims so that insolvency is determinable.

What About the Situation Where There Is No Probate Proceeding?

The foregoing discussion assumes that there is in fact a probate of the settlor's estate. If there is not, the creditors would be forced to commence a probate proceeding merely to assert claims against the trust assets. This does not appear to be particularly satisfactory. But what are the alternatives? One alternative would be to draw a procedure parallel to probate procedure for reaching trust assets where there is no probate proceeding; perhaps this could be done by incorporation by reference, with whatever changes may be appropriate.

The staff notes that the problem of creditor rights in a trust asset is no different from the problem facing a creditor when there are general assets, not in a trust, and no probate proceeding has been commenced. In this situation, if the creditor wishes to reach the assets, the creditor may initiate a probate proceeding thereby creating a mechanism for reaching the assets. As far as we know, this approach is satisfactory. Why proliferate parallel procedures? On balance, we would treat assets held in trust the same and require them to be processed through a probate proceeding since the procedures are already in place.

But the other side of the same coin is the situation where there is no probate and no creditors have come forward, and the trustee wishes to dispose of estate assets free of potential creditor claims. The American Bar Association committee study suggests that in this situation, the trustee should be allowed to publish a notice of death and require claims to be filed against the trust within a short period of time. This suggestion is echoed by Dick Kinyon, who states, "If no probate proceeding is commenced within a certain period of time after the decedent's death, consideration should be given to establishing a procedure for a fiduciary holding or a beneficiary receiving non-probate assets to give notice to creditors and determine the validity of claims in order to protect those assets from creditors not filing timely claims." First Supp. Memo. 85-73 (Ex. 5).

Instead of developing a miniature probate procedure, run by the trustee, why not simply permit the trustee to commence a probate proceeding. This would have a number of benefits. It would ensure that the trust assets could be reached only after exhaustion of all estate assets. It would avoid the need to develop and perfect a procedure for notice to creditors, claims filing requirements, procedures for determining the validity of claims, priorities among creditors, etc., since these matters are already dealt with by the probate procedure. In other words, as the saying goes, why reinvent the wheel? The procedure is already in place; all we would need to do is authorize the trustee to use it.

One concern with this resolution is that the relatively simple matter of paying off debts will become entangled with all the probate complexities--collateral issues of will contests, heirship determinations, and the like, not to mention additional fees in probate for the personal representative and attorney. Even the simple process of paying off debts will become complex and rigidified, with formal claim requirements, approval and allowance procedures, etc. In other words, one of the primary reasons for creation of a trust--to avoid probate--would be destroyed.

The staff does not find this argument compelling. To begin with, it would be optional with the trustee whether to elect the probate procedure; there would be no requirement that it be used by the

trustee. In addition, the staff does not believe that in the ordinary case a lot of side or complicating issues will arise; creditors will be given notice, claims will be made and paid, and the estate will close quickly and without incident. The probate fees are allowed for services during the probate of managing the estate assets, including liquidation of assets necessary to pay claims, and it would be entirely appropriate to allow them here. If a simpler procedure should be available for payment of claims against a trust estate, then a simpler procedure should be available for payment of claims against a probate estate. The staff can see no essential difference between the two situations and no reason to have two different procedures.

An alternate approach, though one the staff does not necessarily recommend, is to make recipients of trust assets personally liable for the settlor's debts to the extent of the assets. The staff notes that right now under California law there are a number of situations where property passes to heirs, devisees, or survivors without probate but the persons receiving the property remain liable to the decedent's creditors. For example, a small estate may be set aside to the surviving spouse or minor children of the decedent in a summary proceeding without notice to creditors; the recipients of the estate remain personally liable for claims of creditors (not exceeding the value of the property) for a period of one year thereafter. Prob. Code § 645.3. Likewise, a surviving spouse may take property from the decedent without probate and without notice to creditors; the surviving spouse remains liable to creditors of the decedent (not exceeding the value of the property), with no special limitation on the time for a creditor to act. Prob. Code § 649.4.

In these situations, which probably occur more frequently than does passage of property in an inter vivos trust on the death of the settlor, there is no special claims procedure or cut-off of claims after a short period. We have received no complaints or other information that would indicate that the law is inadequate or functioning improperly in these areas; in fact, our Estates and Trusts Code drafts preserve and clarify this basic approach to creditor claims in these nonprobate situations. The major problem with such an approach in the trust context is that public policy seems to favor

protection of the trust assets until exhaustion of other assets, and liability of the trust beneficiaries to creditors does not implement this policy.

The staff basically favors a minimalist approach here. A creditor of the settlor should be able to commence a probate proceeding to recover trust assets. If the trustee wishes to cut off claims, the trustee should be able to commence a probate proceeding and process the claims. This approach would make use of existing concepts and keep the law simple by not proliferating procedures.

Other Policy Issues

There are numerous subsidiary policy issues that must be resolved in preparing a draft statute, regardless of the general approach taken. We note that taking the basic approach of working through the probate procedure avoids the need to resolve extensive policy issues that are already resolved or will be dealt with in probate procedure. These issues include how notice to creditors is to be given, the procedure for acting on and rejecting claims, and priorities among creditors.

The staff has prepared a draft statute to implement the suggested approach discussed above. See Exhibit 1. In notes following the relevant provisions of the draft statute, we have pointed out the additional policy questions that must be resolved and that we believe are of some significance.

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary

Exhibit 1
Staff Draft

CHAPTER 3. RIGHTS OF CREDITORS OF SETTLOR

Article 1. Rights During Settlor's Lifetime

§ 18200. Creditors' rights against revocable trust during settlor's lifetime

18200. If the settlor retains the power to revoke the trust in whole or in part, the trust property is subject to the claims of creditors of the settlor during the lifetime of the settlor to the extent of the power of revocation.

Comment. Section 18200 is new. This section is analogous to the rule applicable to property subject to an unexercised power of appointment created by a donor in favor of himself or herself. See Civil Code § 1390.4. Section 18200 permits the creditor to ignore the trust to the extent that it is revocable.

Article 2. Rights After Settlor's Death

§ 18250. "Estate" defined

18250. As used in this article, "estate" means estate of the decedent that is subject to administration pursuant to Division 3 (commencing with Section 300).

Comment. Section 18250 makes clear that the term "estate" is intended to refer to the settlor's probate estate and not to the trust estate.

§ 18251. Creditors' rights against revocable trust after settlor's death

18251. (a) Upon the death of a settlor who retained the power to revoke the trust in whole or in part, the trust property that was subject to the power of revocation at the time of the settlor's death is subject to claims of creditors of the settlor and to the expenses

of administration of the settlor's estate to the extent the settlor's estate is inadequate to satisfy the claims and expenses.

(b) Trust property is not subject to claims and expenses pursuant to this section except in the manner and subject to the limitations provided in this article. This article does not limit any provision in a trust instrument that expressly provides for application of the trust property to satisfaction of the debts of the settlor or the expenses of administration of the settlor's estate.

Comment. Section 18251 is new. Subdivision (a) is analogous to the rule applicable upon the death of a donee of a general testamentary power of appointment under Civil Code Section 1390.3(b). Subdivision (b) makes clear that although this article limits the trust property to be applied, the debts and expenses to which the trust property is applied, and the procedure by which the trust property is applied, these limitations do not apply to the extent the trust instrument makes express provision for payment of debts or expenses.

CROSS-REFERENCES

Definitions

Estate § 18250

§ 18252. Freeze on trust assets following death of settlor

18252. (a) Except as provided in subdivision (b), for a period of 40 days after the death of a settlor who retained the power to revoke the trust in whole or in part, the trustee may not distribute to the beneficiaries any of the trust property that was subject to a power of revocation at the time of the settlor's death.

(b) The court may, upon petition of the trustee or a beneficiary of the trust, authorize the trustee to distribute trust property to the beneficiaries if such a distribution appears reasonably necessary for the support of the beneficiaries. [Notwithstanding any other provision of this article, property so distributed is not subject to claims of creditors of the settlor or to the expenses of administration of the settlor's estate.]

Comment. Section 18252 is designed to freeze assets in a revocable trust for a period of 40 days after the settlor's death in order to enable creditors to commence probate proceedings and initiate the procedure for subsequent recovery of the assets for an insolvent estate. Cf. Probe. Code § 649.2 (power of surviving spouse to deal with unprobated real property after 40 days); Health & Safety Code § 18102 (40 day delay for transfer of title to manufactured home,

mobilehome, commercial coach, or truck camper); Veh. Code § 9916 (40-day delay for transfer of title to numbered vessel).

CROSS-REFERENCES

Definitions

Estate § 18250

NOTE. If we are going to give the personal representative the right to reach trust assets, it may be helpful to tie up the assets before they are dissipated, at least for a short term. The 40-day period is selected for consistency with other statutory provisions governing delay that are designed to enable affected persons to act before property is disposed of. The question here is whether 40 days is a sufficiently long time to enable a creditor to determine that the settlor has died, commence probate proceedings, have a personal representative appointed, make a determination that the estate is insolvent, and take action to seize trust assets. We probably don't want to tie up the trust for a longer period.

An alternative solution would be to drop the 40-day freeze and provide that any distributions made after the settlor's death are voidable. This solution has the disadvantage that it impairs security of transactions. We note that the Uniform Probate Code provision making multiple party account assets subject to the decedent's debts requires that a person receiving payments from the account "shall be liable to account" to the personal representative for amounts needed to pay debts. UPC § 6-107. We would also need to protect bona fide purchasers of property from the trust, but such protection would limit the usefulness of the voidable approach.

If we do keep the 40-day freeze or something like it, a cross reference should be made in the general trust provisions. Something like this shouldn't be buried in provisions relating to creditors' rights.

A related point the Commission should consider is whether creditors are to be restricted to the actual assets in the trust at the time of the settlor's death or whether they will be able to trace proceeds of sale or exchange of assets into the trust. The staff's feeling is that the statute will be more workable if we simply allow creditors to reach assets in the trust and not require them to demonstrate that these are assets that were part of the trust at the time of the settlor's death. This would also comport with the basic policy to treat the trust assets as part of the settlor's estate, since the proceeds of assets owned by the settlor at the time of death remain part of the settlor's estate and subject to creditors' claims.

§ 18253. Right of trustee to commence probate proceedings

18253. The trustee of a trust that was revocable during the settlor's lifetime may, upon the death of the settlor, commence proceedings for administration of the estate of the settlor.

Comment. Section 18253 makes clear that the trustee of a revocable trust is an interested person entitled to commence probate proceedings in the estate of the settlor. This is consistent with

Section 323 (interested person may petition for probate). The trustee may wish to commence proceedings in order to terminate creditors' claims and make distributions free of such claims.

CROSS-REFERENCES

Definitions

Estate § 18250

Interested person § 48

Trustee § 84

§ 18254. Personal representative may recover trust assets

18254. (a) To the extent the settlor's estate is inadequate to satisfy claims of creditors and expenses of administration, the personal representative shall, on application of any creditor whose claim is allowed and approved but is not satisfied in full, require the trustee to transfer to the estate for the benefit of creditors trust property that was subject to a power of revocation at the time of the settlor's death. The personal representative may enforce this requirement by a proceeding in the court having jurisdiction of the trust in proceedings under this division.

(b) A trustee that is required to transfer trust property to the settlor's estate pursuant to subdivision (a) may require contribution of property of any other trust that was subject to a power of revocation at the time of the settlor's death, and for this purpose may join the trustee of such a trust in any proceeding brought pursuant to subdivision (a).

(c) If trust property is transferred to the settlor's estate for the benefit of creditors pursuant to this section, the interests of the trust beneficiaries shall abate in such amounts or proportions as the court determines is equitable, giving due regard to the interests of beneficiaries of income and principal and to the interests of beneficiaries of general and specific gifts, and taking into account the intent of the settlor as nearly as it may be ascertained from the trust instrument.

Comment. Subdivision (a) of Section 18254 is drawn from Section 579 (recovery of fraudulent conveyance by personal representative). The proceeding provides a forum for determining whether trust assets were subject to a reserved power of revocation at the time of the settlor's death.

Subdivision (b) enables beneficiaries of a trust to avoid being unfairly or inequitably made to bear creditors' claims alone where the settlor created more than one revocable trust.

Subdivision (c) lays down no rule for abatement of the interests of beneficiaries where trust assets are recovered by the personal representative. The matter is left to the discretion of the court on an equitable basis.

CROSS-REFERENCES

Definitions

Estate § 18250

NOTE. We have enabled the personal representative to commence a proceeding to recover trust assets, drawing on the analogy found in Probate Code Section 579, relating to recovery of fraudulently conveyed property. Uniform Probate Code Section 6-107 requires a "written demand" by the creditor, which seems unnecessary. We have added the right of the trustee to bring in assets of other trusts; this is to avoid selective enforcement by the personal representative and imposing an unfair burden on certain beneficiaries. We have also given the court discretion in abating the interests of beneficiaries; it would be too complex to attempt to derive an abatement formula where trust assets are taken for creditors.

One procedural question that arises is whether the personal representative should be required to bring a proceeding, or whether a demand on the trustee by the personal representative, either with or without a supporting order of the probate court, should be adequate. Or, we could provide that the power of revocation is not terminated by the death of the settlor but is exercisable by the settlor's personal representative to the extent necessary to satisfy debts.

Although the situation here is somewhat different from the situation where a fraudulent conveyance is involved, it may be desirable to require an action, for due process reasons. We do not believe it is necessary to create any special provisions to tie up trust assets pending litigation--the standard temporary restraining orders and undertaking provisions should be sufficient to cover retention or release of assets. Uniform Probate Code Section 6-107 provides that a multiple party account holder is not liable for distributions "unless before payment the institution has been served with process in a proceeding by the personal representative."

Is there a danger that the trust will be crippled by this process? We do not think the procedure will be abused. If the Commission is concerned, we could add a provision for probate court authorization of the lawsuit, so there is another independent determination whether there is in fact a need for the trust assets.

There is another difficult and related due process problem. Since the trust assets are going to be liable if the settlor's estate is insufficient to satisfy creditors, the trustee and beneficiaries are naturally going to be interested in the administration of the estate, particularly in the adequacy of any sales of estate property and in the validity of any allowed and approved claims, as well as in any family allowances granted, etc. Should these persons receive probate notices and have standing to contest activities taken in

probate? They are clearly interested persons and should be involved if the estate is going to be insolvent. Unfortunately, it may not be clear until late in the administration process that the estate is insolvent.

One solution to this problem is simply to give notice to the trustee or beneficiaries or both, and assume that in most cases they will not want to become actively involved in the probate proceedings unless it is clear that the estate will be insolvent. Another approach is to give notice only if it appears to the personal representative that the estate is likely to be insolvent; the staff is not sure this would satisfy due process standards. A quite different approach would be to provide that no order in probate is final until after a final order of distribution in the estate, thereby giving trust beneficiaries an opportunity to be heard if trust assets are pulled into the estate; but this could create many more problems than it solves. What is the Commission's preference?

§ 18255. Administration of trust assets in settlor's estate

18255. Trust property transferred to the settlor's estate for the benefit of creditors pursuant to this article shall be administered as part of the estate and the trustee and trust beneficiaries shall be persons interested in the estate to the extent of the trust property, except as follows:

(a) The trust property is available to satisfy claims of creditors of the settlor and expenses of administration of the estate only to the extent the settlor's estate is otherwise inadequate to satisfy the claims.

(b) The trust property is not subject to a petition to set apart property necessary for the protection of the settlor's family pursuant to Part 3 (commencing with Section 6500) of Division 6 (family protection), except for the benefit of the trust beneficiaries.

Comment. Section 18255 makes clear that trust assets recovered by the personal representative for the benefit of creditors are considered part of the settlor's estate except for certain purposes. Thus the assets may be liquidated if necessary, and are included in the determination of the amount of the bond of the personal representative as well as in the determination of fees.

CROSS-REFERENCES

Definitions

Estate § 18250

NOTE. The draft provides that trust assets may be recovered "for the benefit of creditors." But if the trust assets are to become part of the settlor's estate for this purpose, they should be subject to protection provided by the probate procedure on behalf of the

beneficiaries for purposes such as probate homestead and family allowance. Why should the settlor and the settlor's heirs lose protections and exemptions such as these by putting the property in a trust as an estate planning device? The staff draft makes clear that the rights of creditors in the trust assets are subject to protections in favor of the beneficiaries.

§ 18256. Statute of limitation

18256. No proceeding to require the transfer of trust property may be brought pursuant to this article more than three years after the death of the settlor.

Comment. Section 18256 is designed to enable the trustee to make distributions to beneficiaries free of potential creditors' claims after a sufficient period of time has elapsed without an action to recover trust property for the settlor's estate.

NOTE. A provision such as this may be useful, particularly if the Commission decides that dispositions of trust assets should be voidable. Uniform Probate Code Section 6-107 provides that "no proceeding shall be commenced later than two years following the death of the decedent."

Article 3. Transitional Provisions

§ 18299. Immediate application

18299. This chapter does not apply to any of the following:

(a) Any estate of a settlor in which a final order of distribution was entered before July 1, 1987.

(2) Any trust property distributed before July 1, 1987.

Comment. Section 18299 is intended to apply this chapter to the greatest extent feasible without disrupting completed transactions. See Section 15001 (general rule concerning application of division).

CROSS-REFERENCES

Definitions

Estate § 18250

NOTE. Settlor's of existing revocable trusts perhaps should be given an opportunity to make other arrangements in light of this legislation. Perhaps a deferred operative date would be desirable.