

## Memorandum 78-17

Subject: Study D-39.200 - Enforcement of Judgments (Comprehensive Statute--Exemptions)

This memorandum presents several questions of policy that remain in the exemptions chapter of the Enforcement of Judgments Law.

Tracing

At the February meeting, the Commission requested the staff to research tracing principles further. The staff suggests that the Commission consider the following revised tracing provision:

707.160. (a) An exempt amount remains exempt after it is paid to the judgment debtor and an exempt amount may be traced through deposit accounts and in the form of cash and the equivalent of cash.

(b) The tracing of exempt amounts in deposit accounts shall be accomplished by application of the principle of first-in first-out, last-in first-out, or any other reasonable basis for tracing selected by the judgment debtor.

(c) The judgment debtor has the burden of tracing exempt amounts pursuant to this section.

Subdivision (a) has been revised in response to Commission suggestions. The Comment will state that cash equivalents include cashiers' checks, certified checks, and money orders.

Subdivision (b) has been revised to permit the judgment debtor to select the manner of tracing. Previously, the Commission had decided to make first-in first-out mandatory. As revised, subdivision (b) adopts the principle of the Uniform Exemptions Act. We propose this principle as a result of further analysis of the application of tracing in the exemption context and the desire to reject the rule in California U.S. Bond & Mort. Corp. v. Grodzins, 139 Cal. App. 240, 34 P.2d 193 (1934), where it was held that the portion of life insurance benefits which exceeded the exempt amount when received was earmarked for creditors even though benefits remaining at the time of levy were below the exempt amount. In Grodzins, the surviving wife received \$10,000 in life insurance benefits, deposited \$5,000 in a savings and loan account, and spent the remainder for the support of herself and her minor children. Under the exemption in effect at the time, approximately \$8,900 of the \$10,000

would have been exempt. The creditor was permitted to reach \$1,100 of the remaining \$5,000.

We consider this rule to be undesirable because, if the lump-sum received at a remote time before levy had been \$15,000, for example, and the wife had spent \$7,000 of it before levy, the creditor would have been able to apply the remaining \$8,000 to the judgment. The staff considers this to be an unjust result which destroys the purpose of the exemption. A preferable rule was applied in *Medical Fin. Ass'n v. Rambo*, 33 Cal. App.2d Supp. 756, 758-60, 86 P.2d 159 (1939), where the court stated that the "question of exemption does not arise until there is a levy, and the intent of the statute is that it be determined on facts then existing." This case involved garnishment of wages at a time when one-half of the earnings received during a 30-day period were exempt. The debtor had already received some earnings and the creditor claimed that those earnings should be counted toward the exemption, leaving the remainder subject to levy in the amount of one-half of the total. The court viewed the purpose of the exemption to be to shield one-half of each installment of earnings for the debtor to support himself and his family.

Assuming the rejection of Grodzins and the codification of Rambo, when an exemption claim is made, it will be necessary for the debtor to identify the nature of the funds in a deposit account by tracing their origin. We believe that the debtor should have the option of selecting the manner of tracing in order to avoid different results depending upon the fortuity of the nature and number of accounts the debtor has maintained. Tracing was easy in Grodzins because apparently the \$5,000 in life insurance benefits was segregated in one account. If the debtor had commingled the benefits with earnings and spent money from the account, application of first-in first-out might determine that the exempt benefits had been consumed before the creditor had levied or even before judgment was entered. On the other hand, if the benefits were deposited in an account with a large amount in it already, the debtor could have the benefit of the exemption under the first-in first-out rule. Mandatory use of first-in first-out would also have the effect of nullifying other exemptions, such as the exemption for proceeds from the sale or destruction of a motor vehicle.

We have attempted to discover the manner of tracing employed by California courts in exemption cases but have not as yet been successful. In cases involving constructive trusts and equitable liens, the courts apply a variety of tracing methods depending on the factual situation. See generally D. Dobbs, Handbook on the Law of Remedies § 5.16, at 425-30 (1973); 7 B. Witkin, Summary of California Law Trusts §§ 86-88, at 5446-49 (8th ed. 1974). The method of tracing used may depend, for example, on whether several trust funds have been comingled, whether the trustee acted wrongfully, whether funds were used to purchase valuable property, or whether funds were dissipated and then replaced. The principles governing which method of tracing will be applied in these cases offer no guidance in the area of exemptions because the factual situations are distinct. No trust principles are involved in exemption cases, nor are we concerned with detecting wrongdoers. The ability to trace in the case of constructive trusts and equitable liens results in the beneficiary obtaining priority over general creditors, whereas in the exemption context, the question of priority is not involved. We do believe, however, that the principle in this area which permits utilization of different tracing methods may be appropriately adopted in the tracing of exemptions.

#### Life Insurance Exemption

The life insurance exemption has been revised as follows:

707.500. (a) Except as otherwise provided in subdivision (b), unmatured life insurance, endowment, and annuity policies are not subject to the enforcement of a money judgment.

(b) The aggregate loan value of unmatured life insurance, endowment, and annuity policies is exempt in an amount not exceeding five thousand dollars (\$5,000).

(c) Benefits from matured life insurance, endowment, and annuity policies, and death benefits, payable to the insured or a spouse or dependent of the insured, are exempt to the extent reasonably necessary for the support of the insured or a spouse or dependent of the insured.

(d) If a dwelling exemption has not been obtained, the amount of the exemption provided by subdivision (b) is increased by ten thousand dollars (\$10,000). If the exemption provided by this subdivision is obtained and the claimant later claims a dwelling exemption, the dwelling exemption shall be reduced by the amount of the exemption claimed under this subdivision.

Comment. Section 707.500 supersedes the exemptions provided in former Sections 690.9 (life insurance represented by \$500 annual premium) and 690.10 (group life insurance) and portions of former Section 690.18 (death benefits from public entity). Under subdivision (a), the judgment creditor is precluded from reaching an unmatured policy except to the extent provided by subdivision (b). Subdivision (a) prevents the judgment creditor from forcing the judgment debtor to surrender a life insurance policy for its cash value.

Subdivision (c) limits the exemption of benefits from a life insurance policy to the insured or a spouse or dependent of the insured who need the benefits for support. Under former law, the exemption was available to any person, including creditors of the judgment debtor and artificial persons. See Jackson v. Fisher, 56 Cal.2d 196, \_\_\_, 363 P.2d 479, \_\_\_, 14 Cal. Rptr. 439, \_\_\_ (1961). The exemption may be asserted against creditors of the insured or of the spouse or dependents of the insured. See Holmes v. Marshall, 145 Cal. 777, \_\_\_, 79 P. 534, \_\_\_ (1905).

Subdivision (d) is new. It affords a larger exemption for the loan value of life insurance to the extent that the full dwelling exemption is not claimed. See Section 707.410 (dwelling exemption). See also Section 707.170 (adjustment of dollar amounts of exemptions).

The Commission may want to consider restricting the loan value exemption to amounts that are left with the insurance company. We can identify three reasons for exempting a portion of loan value. It may be to attempt to ensure that the protected amount will be available upon maturity of the policy; protecting the loan value in the hands of the insurer provides a fund out of which the debtor can pay the policy premiums; and the loan value may be drawn on as a bank account to meet current expenses. The staff tends to believe the first two are the more important policies and that, since we propose a \$2,000 deposit account exemption for dealing with current expenses, it is worthwhile to consider preventing tracing of the exemption of loan value into deposit accounts or cash.

#### Retirement, Disability, Unemployment, and Health Benefits and Personal Injury Awards

The staff believes there is a possibility for abuse in completely exempting retirement, disability, and health benefits. We suggest that the complete exemption for retirement, disability, unemployment, and health benefits in the draft statute be changed to an exemption to the extent reasonably necessary for the support of the judgment debtor and

the spouse and dependents of the judgment debtor. This should at least be done in the case of private insurance and plans since there is a possibility for abuse.

Generally, there will be a hearing on the exemption claim since these benefits will be in deposit accounts and the debtor will have to trace their origin in exempt benefits. Consequently, the additional issue of whether the benefits are necessary for support should not result in significantly more hearings.

The Commission should also consider making personal injury awards and settlements exempt to the extent reasonably necessary since there does not appear to be any reason to distinguish between insurance benefits and personal injury awards.

The Commission may want to distinguish between benefits available for disability or illness and benefits paid for medical care. Section 5(4) of the Uniform Exemptions Act provides a complete exemption for "benefits paid or payable for medical, surgical, or hospital care to the extent they are or will be used to pay for the care." Section 6 of the Uniform Exemptions Act exempts to the extent necessary for support "benefits paid or payable by reason of disability, illness, or unemployment."

Respectfully submitted,

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