0045b

#L-642 11/22/85

First Supplement to Memorandum 85-96

Subject: Study L-642 - Estates and Trusts Code (Claims Procedure for Trusts--comments on initial staff draft)

Memorandum 85-96 contains an initial staff draft of a procedure to implement the concept that assets of a revocable trust should be available to satisfy creditors' claims upon the death of the settlor in the event the settlor's estate is inadequate to satisfy the claims. Since the memorandum was written we have received the following additional material concerning this matter:

(1) Exhibit 1. Letter from John B. Atkins, chair of an ABA committee studying the same topic. Mr. Atkins informs us that the ABA committee is working on a article dealing with the problem that should be completed in the near future. Mr. Atkins attaches an outline of the article that indicates a wide-ranging consideration of the issues.

(2) Exhibit 2. Letter from Jeff Strathmeyer expressing concern about the staff draft and the opinion that detailed procedures may not be necessary. He suggests an alternate way of proceeding with a few simple but general changes in the existing code.

(3) Exhibit 3. Letter from Executive Committee of the State Bar Section on Estate Planning, Trust and Probate Law expressing concern about provisions in the staff draft. They take the position that the Code should state the general rule that trust assets are liable, and meanwhile they will continue to study the matter and submit a report to the Commission concerning implementing procedures.

The staff sees no need to rush in this area--after all, we have lived with the law as is until now. There is alot going on about the problem, and it cannot hurt to wait and gather more information and thoughts about the issues. The staff draft is intended to raise policy issues that must be resolved, and this will have to be done at some point. Meanwhile, the staff recommends that the Commission defer work on this matter for the time being.

The only concern we have is about the approach suggested by the State Bar of going ahead with a general policy statement in the law without any implementing procedures. We are planning to introduce and enact trust legislation at the 1986 session, and we are concerned that a general statement in the law is bound to cause confusion if we do not prepare implementing legislation in time. Our feeling is that it is better to leave out the general statement until we have adequately reviewed the possible problems it could create and have either decided that existing law is sufficient to handle the problems or have developed new provisions to take care of them.

Respectfully submitted,

Nathaniel Sterling,
Assistant Executive Secretary

American Bar Association

1st. Supp. to Memo 85-96 Study L-642

EXHIBIT 1

November 1, 1985

Nathaniel Sterling
Assistant Executive Secretary
California Law Revision Commission
4000 Middlefield Road
Suite D-2
Palo Alto, CA 94303-4739

Re: Committee D-3 Special Problems of (Corporate) Fiduciaries
Project - Decedent's Creditors Rights against Revocable Trust Assets

Dear Mr. Sterling:

Our Committee is in the process of drafting an article for publication in the American Bar Association Real Property Probate and Trust Section Journal, an article dealing with Decedent's Creditors Rights against Revocable Trust assets. I am enclosing a copy of an outline that was put together regarding the issue. The paper is still in the drafting stage.

I would call your attention to an article published in the Missouri Law Review, Volume 47, page 437 by Richard W. Effland entitled, "Rights of Creditors in Non-Probate Assets". There was also an article published in the Estate Planning and California Probate Reporter, Volume V, No. 1, August, 1983 by Nancy A. Chillag with the same title.

I plan to complete our article by year end or early in 1986. I would though be happy to mail a copy of the article to you upon completion. I would be more than happy to receive any information you may have compiled to date and would additionally be willing to reference your commission as a contributing author.

Lets stay in touch.

Sincerely,

JOHN B. ATKINS

Enclosure

cc: Ray Young

DECEDENTS' CREDITORS RIGHTS AGAINST TRUST ASSETS

I. A recital of the problem - why the issue in the first place?

II. The Basic Estate Plan
   A. Revocable Living Trust with Pour-Over Will

   B. The stand alone Revocable Trust with a separate Will - dispositive provisions not compatible

   C. Trust provision in either draft

      1) precatory language .... "After my death ... to the extent the assets of my probate estate are insufficient, the trustee MAY pay .... legally enforceable claims against me or my estate." (emphasis added)
      2) if the language were directive ... SHALL pay
      3) no provision in the trust for payment of claims arising out of an estate setting

   D. Must a trustee of a living trust make provision for creditors, either known or unknown, prior to distribution to beneficiaries?

      1) In cases of uncertainty, should the trustee seek refunding agreements with beneficiaries as a means of effecting prompt distributions without undo risk.
      2) Out of state beneficiaries? Enforceability?
      3) Should trustee, as an interested party, invoke court supervision in instances where there is a danger of an insolvent estate?
         a) If trustee was personal representative in a pour-over will that would otherwise have been probated.
         b) In the instance of a third party named as Personal Representative

III. How or what procedure would a creditor pursue? What is the appropriate forum for settlement of creditors' disputes?
   A. A Massachusetts domicilliary creates a revocable living trust with a Michigan fiduciary to administer a trust for the benefit of a family living in Michigan.

      1) Finding those assets and commencing action - creditors' dilemma
      2) Jurisdictional issues - federal or state forum

   B. Can an unsecured creditor proceed in the state of the trustee as an interested party against a trustee?

      1) Should trustee object creating an adversarial proceeding?
      2) Should trustee prosecute an appeal if creditor successful?
      3) Trustee honoring claims when it has no legal duty to do so - Remaindermen power to seek surcharge?

IV. Existing state statutes or case law giving creditors access to trust assets

A. Fraudulent conveyances

B. Power to Amend/Revoke the trust retained by grantor-decedent. Is it general power of appointment.

1) Is the power affected by incapacity? Who would exercise the power? the personal representative? Should a probate proceeding be initiated or may the trustee honor claims directly? What procedure should be followed? Is it relevant? How is power exercised?
2) Is the power (to revoke) of appointment affected by prior incapacity of the grantor?
3) What if decedent exercised the power immediately prior to death which basically revokes the transfer?
4) Is a "power" synonymous with "property"

C. Decedent's power of appointment in a trust created by a third party. Can the trustee be required to exercise the power?

D. Reserved life estate - undistributed income

E. Irrevocable transfer during life - spendthrift provision

1) Where in the terms of the trust a trustee is to pay the grantor or apply for his/her benefit as much of the income or principal as the trustee in its intrammelled discretion determines.

a) Is discretion to pay income or principal to other beneficiaries a factor?

2) General Principle of Restatement (Second) of Trust §156(2) standing for the proposition that one can not effectively create a spendthrift trust in favor of oneself.

3) Is the gift transaction completed? Is it necessary to perfect creditors' rights?

4) Clifford Trust and other reversionary interests.

5) Grantors interest in trust is mere expectancy as opposed to an external standard upon which a trustee exercises discretion.

V. Types of Creditors claims

A. Federal estate taxing authorities, state and county taxing authorities

B. Unsecured creditors

1) Commercial loan to grantor creating a trust with the bank's trust department.

2) Contingent claims
   a. Wrongful death suits against estate of decedent
   b. co-signer or guarantor
3) Unsecured medical claims incurred prior to death
4) Funeral expenses

C. Rights of the spouse and children of the grantor-decedent for widows/widowers allowances, homestead allowances and family allowances against a living trust made irrevocable upon death.

VI. <u>Related issues</u>

A. Bankruptcy Act - any remedy upon death of grantor?

B. Community Standards - trustee of revocable trust, made irrevocable on death, not honoring local creditors' claims against insolvent probate estate

C. Confidentiality of the living trust and whether that outweighs the public policy to protect creditors

D. Other

may pay / shall pay - duty of discretion / directive
trustee purchase of claim & [illegible] liability

EXHIBIT 2

CEB
CALIFORNIA CONTINUING EDUCATION OF THE BAR
2300 Shattuck Avenue, Berkeley, CA 94704
(415) 642-3973; Direct Phone: (415) 642-8317

November 5, 1985

Nathaniel Sterling, Esq.
California Law Revision Commission
4000 Middlefield Road
Palo Alto, California 94306

Re: Study L-640 (Claims Procedure for Trusts)

Dear Nat:

As a public policy matter, I strongly support the position that revocable trust assets should be subject to the claims of creditors. My feelings on this subject were strengthened by the recent case of Estate of Davis (August 26, 1985) 85 Daily Journal DAR 3077, in which the decedent's adult child was allowed to retain a $179,000 IRA to the detriment of a judgment-debtor of the estate who had been tragically injured in an automobile accident caused by the decedent.

Nevertheless, I have substantial objecions to the approach taken in the memorandum of October 29th. First, I am adamantly opposed to the trend of having forty day waiting periods for the transfer of non-probate assets. Where is this trend going to take us in the long run? Are we going to be consistent and take the position nothing (including life insurance) can be transferred for forty days? Alternatively, will we have a two tier system where some assets have delay periods and others do not? I don't think anyone will accept the first alternative. The second alternative is equally intolerable. Will estate plannners soon be required to instruct living trust clients to keep some assets out of the trust in order to avoid the forty day freeze? We have already started to create this type of anomalous situation with various vehicles under AB 196 (40 day delay for a Prob C §630 type transfer, but not for a joint tenancy transfer). Arguably, this is necessary to protect beneficiaries in the Probate 630 area, but I hate to see us get into the same mess for the sake of an occasional creditor. Second, the great lack of litigation in this area suggests to me we don't need to get very specific about procedures in this area.

I would suggest:

A) Adoption of the previously proposed section 18201.

B) Revision of Probate Code Section 579 to add to the list of property which may be pursued by the executor both 18201 property and also general power of appointment property made liable for debts under Civil C §§1390.1-1390.5.

C) Addition of a Prob C §579a, which would specify that whenever a holder of nonprobate property has been required to deliver it to the estate under Prob C §579, he may apply to the probate court for an order compelling holders of other nonprobate assets to reimburse the transferor in proportions determined by the court. A few guidelines could be added here (e.g., transferees of fraudulently conveyed property bear the burden first), but I don't think it will work to get too specific.

D) Add a provision confirming that Prob C §579 is the exclusive method for reaching these assets.

As a related matter, we already have some questions about what a power of appointment is under the statute, and I think we will develop similar questions in the future regarding what is or is not a power to revoke (e.g., at what point is a power of amendment so extensive that it is a power of appointment or a power of revocation)? I would like to see an amendment or comment which makes clear that the substance and not the form of the power is determinative.

In closing, let me reemphasize my belief that the lack of litigation in this area suggests the problem of creditor's rights is not all that common. Accordingly, although a remedy is needed, the tail should not wag the dog, and we should not do anything which will result in greater burdens for everyone else in the system.

Very truly yours,

Jeffrey A. Dennis-Strathmeyer

JAD-S:kg

EXHIBIT 3

ESTATE PLANNING, TRUST AND PROBATE LAW SECTION
THE STATE BAR OF CALIFORNIA

555 FRANKLIN STREET
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(415) 561-8200

November 18, 1985

(619) 456-3010

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

RE: TRUST LAW

Dear John:

Several meetings ago, Stan Ulrich asked that we find someone to review Sections 16100 through 16105 of the proposed trust law. David Watts, an attorney with O'Melveny & Myers, reviewed the sections and indicated that he could suggest no changes. In particular, we asked that he review the references to the Internal Revenue Code to be sure that all cross-references were accurate.

At the November 16, 1985 meeting of the Executive Committee of the State Bar Section on Estate Planning, Trust and Probate Law, we reviewed Memorandum 85-96 concerning the claims procedure for trusts. While all members of the Executive Committee are concerned that something be done to improve this area of the law, there were a number of specific concerns expressed about the proposal contained in Memorandum 85-96. After discussing the matter, the Executive Committee voted overwhelmingly to leave Sections

18200 and 18201 just as they are in the current draft of the Trust Law and not to include the proposal in contained in Memorandum 85-96. Several members of the Executive Committee have been assigned to continue the study of the area, and just as soon as we have a report, we will submit it to the Law Revision Commission.

For your information, there was significant concern with respect to the freeze on trust assets imposed by proposed Section 18252, as well as the proposal in Section 18254. (How much trust property is to be transferred? Is there a need for corresponding sections in the estate administration portion of the code? Should the code specify a way of charging the interest of trust beneficiaries?) As to Section 18255, is any accounting required by the executor once the funds have been transferred to the probate and should the excess not needed in the probate be returned to the trust? If this procedure is, in fact, enacted, why should the statute of limitations under Section 18256 be so long? Should there be an alternative cut-off date once an executor has obtained assets from the trust and the order transferring the funds has become final?

Because of the number of questions raised by Memorandum 85-96, it is our feeling that the two provisions in the present draft of the statute be left as they are until more thought can be given to an alternative procedure to be inserted.

Best regards,

Theodore J. Cranston

TJC:jfk
ccs: James A. Willett, Esquire
James V. Quillinan, Esquire