#L-640

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03/04/87

Memorandum 87-20

Subject: Study L-640 - AB 362 (Trusts)

The California Bankers Association (CBA) has written the Commission expressing concern with several provisions in the Trust Law, which will become operative on July 1, 1987. (See letter from L. Bruce Norman attached as Exhibit 1.) The Commission has a clean-up bill relating to trusts currently pending in the Legislature, so we have a vehicle to accomplish any revisions the Commission approves in response to the CBA suggestions. Assembly Bill 362 (Harris) makes several minor and technical changes in the Trust Law and has an urgency clause so that it will become operative at the same time as the Trust Law itself. On February 25, AB 362 was approved by the Assembly Judiciary Committee.

CBA makes the following suggestions:

§ 16222. Participation in business; change in form of business

Section 16222 gives a trustee power to "continue or participate in the operation of any business or other enterprise that is part of the trust property." However, a business may be operated "only as authorized by the trust instrument or by the court." The statute does give the trustee the power to operate the business without a court order for a "reasonable time pending a court hearing on the matter or pending a sale of the business." The power to operate a business is continued from former Probate Code Section 1120.2(17).

CBA believes that the specific limitation on operation of a business provided in Section 16222(b) may force trustees to petition for authority to operate a "business or other enterprise" even though the activity may not really be a business. (See Exhibit 1, at 1-2.) The basic problem is that there is no definition of "business or other enterprise." However, the anticipated difficulty of agreeing on a useful definition has stalled previous Commission discussions of this problem. It appears that a common problem faced by trustees involves continued rental of real property. The staff believes that it would be

useful to make clear in Section 16222 that leasing residential property with four or fewer units is presumed not to be operating a business or other enterprise. Another approach would be to amend the section to provide that "business" is to be construed narrowly or add this gloss to the comment, if the section is to be amended.

In light of the lack of a useful definition of business, CBA requests that Section 16222 be amended to apply its restrictive limitation only prospectively. This would avoid the problem CBA sees in applying the requirement of obtaining a court order under Section 16222(b) to pre-operative date trusts. Accordingly, the staff proposes that the Commission consider revising Section 16222 as follows:

> **§ 16222. Participation in business; change in form of business**
>
> 16222. (a) Subject to subdivision (b), the trustee has the power to continue or participate in the operation of any business or other enterprise that is part of the trust property and may effect incorporation, dissolution, or other change in the form of the organization of the business or enterprise.
>
> (b) Except as provided in subdivision (c), the trustee may continue the operation of a business or other enterprise only as authorized by the trust instrument or by the court.
>
> (c) The trustee may continue the operation of a business or other enterprise for a reasonable time pending a court hearing on the matter or pending a sale of the business or other enterprise.
>
> (d) The limitation provided in subdivision (b) does not affect any power to operate a business or other enterprise that the trustee has under a trust created by an instrument executed before July 1, 1987.
>
> **Comment.** Subdivision (d) is added to Section 16222 to limit the rule in subdivision (b) requiring court authorization for the trustee to operate a business or other enterprise that is a part of trust property. This is a special application of the rule stated in Section 16203.

§ 15408. Trust with uneconomically low principal

The Trust Law permits a trustee to terminate a trust without petitioning the court where the trust principal does not exceed $20,000 in value. Section 15408(b). Section 15410 provides general rules governing the disposition of property upon termination. Although Section 15408(b) envisions termination without court involvement because of the amount involved, the trustee will be forced to petition

the court for an order determining the manner of distribution where the trust instrument does not provide distribution rules, thereby defeating the purpose of Section 15408(b) in such cases.

The desire to avoid the expense of court involvement that is reflected in Section 15408(b) impels CBA to request amendment of Section 15410 to permit the trustee to distribute, without court order, in accordance with certain guidelines. (See Exhibit 1, at 2.) CBA suggests the following language:

> The trustee shall distribute the property of the trust to the then income beneficiaries in the proportions in which they are, at the time of termination, entitled to receive such income; provided, however, that if the rights to income are not then fixed by the terms of the trust, distribution shall be made, by right of representation, to such beneficiaries as are then entitled or authorized in the trustee's discretion to receive trust payments.

The staff thinks that this is a useful refinement that is consistent with the Commission's intention in providing the special rules governing trusts with uneconomically low principal. These concepts might be implemented in Section 15410 as follows:

> § 15410. Disposition of property upon termination
>
> 15410. At the termination of a trust, the trust property shall be ~~disposed of~~ distributed as follows:
>
> (a) In the case of a trust that is revoked by the settlor, as directed by the settlor.
>
> (b) In the case of a trust that is terminated by the consent of the settlor and all beneficiaries, as agreed by the settlor and all beneficiaries.
>
> (c) In any other case, as provided in the trust instrument or in a manner directed by the court that conforms as nearly as possible to the intention of the settlor as expressed in the trust instrument.
>
> (d) If a trust is terminated by the trustee pursuant to subdivision (b) of Section 15408, the trust property ~~shall~~ may be distributed as determined by the trustee pursuant to ~~this subdivision.~~ the standard provided in subdivision (c) without the need for a court order. Where the trust instrument does not provide a manner of distribution at termination and the settlor's intent is not adequately expressed in the trust instrument, the trustee may distribute the trust property as follows:
>
> (1) To the beneficiaries who, at the time of termination, are entitled to income under the trust instrument, in the relative proportions to which they are

entitled to receive income.

(2) If there are no income beneficiaries, as described in paragraph (1), to the beneficiaries who would be entitled to distributions at the conclusion of the trust, whether under the trust instrument or pursuant to exercise of the trustee's discretion, by right of representation as provided in Section 240.

§ 16441(a). Measure of liability for interest

Section 16441 provides that if the trustee is liable for interest in assessing the damages for breach of trust, the amount of interest is the legal rate or the amount of interest actually received, whichever is greater. The legal rate of interest on judgments is 10% pursuant to Code of Civil Procedure Section 685.010. This rate was increased from 7%, effective January 1, 1983. It should be noted that we are not here concerned with interest on *judgments*. We are concerned in this discussion with prejudgment interest on liabilities determined to be in existence before July 1, 1987.

CBA suggests that it would be inequitable to apply the 10% rate to a liability for breach existing before the operative date of the increase in the rate. (See Exhibit 1, at 3.) CBA cites case-law authority for the proposition that the rate in effect from time to time should be applied. Consider also the rule stated in Section 685.010(b): "A change in the rate of interest may be made applicable only to the interest that accrues after the operative date of the statute that changes the rate." In the context of the Trust Law, the statute that changes the rate is operative on July 1, 1987, not January 1, 1983.

Law prior to the Trust Law is not clear. Civil Code Section 2262 (repealed operative July 1, 1987) provides: "If a trustee omits to invest the trust moneys according to [Section 2261], he must pay simple interest thereon, if such omission is negligent merely, and compound interest if it is willful." See also Civil Code § 2237. The maximum rate of interest applied under this law appears to be 7%, although this amount could be compounded. There are instances where a lower rate was applied for some reason. See, e.g., *In re* Guardianship of Di Carlo, 3 Cal. 2d 225, 233, 44 P.2d 562 (1935) (6% rate). The meaning of "legal rate" can be confusing since 1983 when the maximum rate on judgments

(as opposed to contracts) was raised to 10%. There are now two "legal rates" and we do not know whether a 10% rate has been applied in determining the liability for breach of trust. It should also be noted that the Trust Law does not continue the authority of the court to impose compound interest. In this respect, the imposition of the 10% rate may be viewed as a trade-off. Whether the trade-off should be applied to liability existing before the operative date is another question.

The Trust Law does not provide a special transitional rule to liability for breach. Thus, under Section 15001(b), the new law applies regardless of the date of creation of the trust "unless in the opinion of the court application of a particular provision . . . would substantially interfere with the . . . the rights of the parties and other interested persons . . . ." The Commission's recommendation contains the following explanation:

> The rules governing accountability and the measure of liability of trustees represent a different formulation of the same general rules, although there may be some question about the details of the application of either existing law or the proposed law. On balance, however, the proposed law results in distinct limitations on the liability of trustees, so there should not be any serious objection to application of the entire package to all trusts from a policy standpoint. [*Recommendation Proposing the Trust Law,* 18 Cal. L. Revision Comm'n Reports 501, 609 (1986). Footnote omitted.]

The staff believes that it is appropriate to distinguish the issue of the rate of interest from the general rules governing the measure of liability for breach of trust. Accordingly, the staff proposes to amend Section 16441 to provide that a rate of interest applies only from its operative date. This leaves open the question of what is the appropriate rate between January 1, 1983, and June 30, 1987. A court faced with a willful breach occurring in 1980 may decide to impose compound interest at the 7% rate up to July 1, 1987. From then on the 10% simple interest rate would apply.

To clarify the application of the interest rate in the Trust Law, Section 16441 could be amended as follows:

> § 16441. Measure of liability for interest
>
> 16441. (a) If the trustee is liable for interest pursuant to Section 16440, the trustee is liable for the greater of the following amounts:
>
> ~~(a)~~ (1) The amount of interest that accrues at the legal rate on judgments.
>
> ~~(b)~~ (2) The amount of interest actually received.
>
> (b) As to a claim arising before July 1, 1987, the rate of interest provided by this section applies to the liability on the claim only on and after July 1, 1987.
>
> **Comment.** Section 16441 is amended to make clear that the rate of interest provided in subdivision (a)(1) applies in the determination of liability on a claim arising before the operative date of the Trust Law only to the portion of the liability that accrues on or after the operative date. This rule is consistent with the rule applicable to interest on judgments. See Code Civ. Proc. § 685.010(b); American Nat'l Bank v. Peacock, 165 Cal. App. 3d 1206, 1210-12, 212 Cal. Rptr. 97 (1985).

§ 17203(c). Notice to Attorney General

In the case of a trust with a charitable disposition, the Attorney General is entitled to notice of proceedings concerning the trust. Prob. Code § 17203(c). Beneficiaries of revocable trusts are not entitled to notice of proceedings during the time the trust remains revocable and the settlor is competent, unless the settlor otherwise directs. Prob. Code § 15802. The Attorney General is considered a beneficiary of a charitable trust, since the Attorney General is a person entitled to enforce the trust. See Prob. Code § 24 ("beneficiary" defined). Thus, the Attorney General is treated as a beneficiary of a revocable trust with a charitable disposition, with the effect that the Attorney General is not entitled to notice while the trust is revocable. As stated in the summary to the Commission's recommendation:

> The proposed law codifies the principle that the Attorney General should get notice of proceedings involving charitable trusts, except where the charitable interest is subject to revocation or where the Attorney General has waived notice. [*Recommendation Proposing the Trust Law*, 18 Cal. L. Revision Comm'n Reports 501, 508 (1986).]

this case the guardian ad litem may rely on general family benefit accruing to living members of the beneficiary's family as a basis for approving a modification or termination of the trust.

Comment. Section 15405 is amended to make clear that it applies to a minor and to replace the phrase "legally incapacitated" with "lacks legal capacity" for conformity with guardianship and conservatorship law. See, e.g, Section 2582. This is a nonsubstantive revision.

Respectfully submitted,

Stan G. Ulrich
Staff Counsel

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February 20, 1987

Mr. Stan G. Ulrich
Staff Counsel
California Law Revision Commission
4000 Middlefield Road, Suite D-2
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Re: Chapter 820 of the Statutes of 1986; the Trust Law

Dear Stan:

This will confirm our telephone conversation of a week ago, February 13, 1987.

The California Bankers Association ("CBA"), in implementing a training seminar on the new Trust Law, has encountered some questions and concerns which should be addressed by the Commission before the law becomes effective July 1, 1987.

The CBA recognizes the narrow time constraints for further consideration by the Commission of Trust Law matters, and appreciates the Commission's indulgence in this regard.

A. Sec. 16222 [Participation in business; change in form of business].

The CBA continues to believe that a definition of "business or other enterprise" is needed to provide fair notice of what activities the trustee must seek court authority to continue if the trust agreement is silent regarding the matter.

You reminded me the probable reason the Commission did not previously define these terms as then requested by the CBA was because no one, including the CBA, offered a satisfactory definition.

While I doubt whether the CBA or anyone else will be able to offer a definition that would be non-controversial; the history of the problem is the very point. How is a trustee going to know when he/she/it should seek court authority? Is managing improved real property participating in the operation

of a business or other enterprise? How about renting out a bedroom and bathroom of a private residence? The point at which managing investments becomes operating an enterprise can well become the subject of debate among reasonable people.

It would therefore seem the very least the Commission should do is apply a transition date to Sec. 16222 to permit settlors and their legal counsel to solve the lack of definition problem through drafting.

B. Sec. 15408(b) [Trust with uneconomically low principal]

The CBA is hopeful that, with the new power to terminate small trusts, the best interest of the beneficiaries of such trusts will be served. However, the spirit of Sec. 15408(b) can be lost in applying Sec. 15410 [Disposition of property upon termination] to the facts.

Where there is no settlor and the trust instrument does not provide for disposition upon an "early" termination, it would appear the trustee must resort to a court proceeding.

The CBA believes the beneficiaries' interest and probable intent of the settlor upon these facts would be better served (particularly in terms of expense to the trust estate saved) were Sec. 15410 to be amended to specify distribution in an equitable manner. Following is a suggested method of distribution:

> The Trustee shall distribute the property of the Trust to the then income beneficiaries in the proportions in which they are, at the time of termination, entitled to receive such income; provided, however, that if the rights to income are not then fixed by the terms of the Trust, distribution shall be made, by right of representation, to such beneficiaries as are then entitled or authorized in the Trustee's discretion to receive Trust payments.

This would cover the most common situations. Exceptions would be resolved in a court proceeding as now provided in Sec. 15410.

C. Sec. 16441(a) [Measure of liability for interest]

When interest is payable by reason of a continuing (several years duration) breach of trust pursuant to Sec. 16440 (a)(1) or (a)(2), the method of calculation if measured by the legal rate on judgments is unclear.

In comparing the postjudgment cases cited in Code of Civil Procedure Sec. 685.010 [and in particular C. Norman Peterson Co. v. Container Corp. of America (1985) 172 C. A. 3d 628], the rate in effect from time to time should be applied. That is, interest on a continuing breach of trust which occurs at the beginning of 1980 should be calculated three years at 7% (1980 to 1983) and four years two months at 10% (1983 to date).

Unless amended, Sec. 16441(a) could also be construed to apply the current legal rate on judgments to the liability for all years. In my example, interest would be calculated at 10% for each year since 1980. That result would be inequitable and could possibly provide the beneficiaries with an unwarranted windfall.

D. Sec. 17203(c) [Notice]

For purposes of giving notice incident to a Sec. 17200 petition, it is clear beneficiaries of a revocable trust would not be entitled to notice while the trust is revocable.

However, it would seem notice to the Attorney General would nevertheless be required (unless waived by the AG) if the trust could fairly be characterized as a "charitable trust." I am unable to locate a definition of charitable trust, but there is no doubt such trusts are intended to be covered by the new Trust Law [Sec. 82(a)(1) of AB 362].

If a revocable trust can be a charitable trust, there would be no benefit in giving the AG notice since the Comment to Sec. 17210 states that the AG stands in the place of the charitable beneficiaries.

The CBA believes clarification of this technical issue would be appropriate.

E. Sec. 17457 [Administration of transferred trusts]

While we realize the chapter on "transfer of trust from another jurisdiction" is little changed from prior law, further explanation of which law should be applicable to validity and construction of dispositive clauses as contrasted to day-to-day trust administration of a trust so transferred seems needed.

Although you disagreed with my interpretation, Sec. 17457 is broad enough to mean a trust transferred will be construed under California law for all purposes. Obviously such an interpretation would be unacceptable when considering whether a trust is revocable or irrevocable (governing instrument silent), for example. Moreover, a trust specifying that the laws of another state are applicable to a particular trust would effectively prevent that trust and all like it from being accepted for transfer pursuant to Sec. 17455 since the transfer would violate the trust instrument [Sec. 17455(a)(2)].

The CBA believes the addition of language to Sec. 17457 which captures the concept suggested below would be appropriate.

> The validity of a trust transferred to this state pursuant to this chapter, and the construction of its beneficial provisions, shall continue to be governed by the laws of the state so specified in the trust or in the absence of a specification the laws of the jurisdiction from which the trust is being transferred to this state.

The comment to Sec. 17457 would also have to be modified to indicate that this section <u>does</u> provide choice of law rules.

F. Sec. 15405 [Guardian ad litem]

I believe Amy Bernstein was going to call you to discuss whether an interpretation issue was present with respect to the appointment of a guardian ad litem for a minor person for purposes of Secs. 15403 and 15404.

Since Sec. 17208 lists a minor and an incapacitated person separately with respect to appointment of a guardian ad litem generally, was it intended that the family benefit doctrine not apply to a minor beneficiary?

The CBA believes this issue should be clarified.

Very truly yours,

L. Bruce Norman
First Vice President and
Trust Counsel

LBN:hks

cc: Paulette E. R. Leahy
Amy J. Bernstein
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