

## Memorandum 91-10

Subject: Study L-3041 - Procedure for Creditor to Reach Nonprobate  
Property (Policy Issues)

## BACKGROUND

The probate process ensures that a decedent's debts will be paid before the property passes to beneficiaries. But with the increasing use of probate-avoiding devices such as living trusts and beneficiary designations in bank accounts and retirement funds, creditor-protection features of the law may be circumvented.

In response to this development, California law has made clear that many property transfers on death that occur outside the probate process are nonetheless subject to claims of the decedent's creditors. For example, small estates taken by affidavit are subject to creditor claims (Probate Code Section 13109), as are community funds taken by a surviving spouse without probate (Probate Code Section 13550). Living trust property is liable to the extent the decedent's probate estate is insufficient (Probate Code Section 18201), as is property fraudulently transferred during lifetime and gifts made in view of impending death (Probate Code Section 9653). General powers of appointment are likewise subject to creditors if the estate is inadequate (Civil Code § 1390(b)). Most recently, the Commission has decided to recommend to the Legislature that a person be authorized to make a transfer-on-death designation for a vehicle, but the vehicle is subject to the decedent's debts if the probate estate is inadequate.

The California law in this area is developing on a sporadic, hit and miss, basis, and the Commission has decided to look into the possibility of a standardized procedural scheme that will cover the various types of nonprobate property in a thorough and consistent manner, and that will resolve the numerous unresolved problems in the existing California statutes.

This memorandum presents basic policy issues the Commission should consider in developing a statute to govern the area.

## WHAT IS NONPROBATE PROPERTY?

Although we know generally what we mean by nonprobate property--living trusts, beneficiary designations, etc.--trying to define it is not so simple. There are a number of possible approaches to describing what we mean to cover by the statute:

(1) Property owned at death by the decedent, or in which the decedent retained an interest at death, that is not subject to administration in the decedent's estate.

(2) Specifically identified property, e.g., revocable living trusts, gifts made in view of impending death, joint tenancy property, multiple-party bank accounts, vehicles and vessels with transfer on death designations, life insurance, retirement benefits, savings bonds, general powers of appointment, and other property transferred on death pursuant to a contractual provision in an instrument recognized in Section 5000 of the Probate Code.

(3) Property that is part of the decedent's gross estate for federal estate tax purposes. The federal tax law is pretty thorough in cataloguing property that might be considered taxable to the decedent whether or not it passes through probate, including property in which the decedent had an interest at the time of death, transfers taking effect at death, revocable transfers, joint interests, etc.

The concept of paralleling or incorporating the federal estate tax law has some attractions. It is too bad that the federal tax code is miserable to work with, and we would be imposing it on people whose estate is small enough they would not otherwise have to become involved with it. Also, the federal tax code might be overinclusive for our purposes, picking up such items as gifts made within three years before death; nor do we want to be tied to all the little variations and changes that continually occur in the federal tax law.

On balance, the staff suggests that nonprobate property be defined by a combination of general definitions and specific illustrations.

This would combine (1) and (2), above, to yield something like: "Nonprobate property is all property owned at death or transferred from the decedent to a beneficiary at death that is not otherwise subject to administration in the decedent's estate, including but not limited to, property in a living trust, property subject to a general power of appointment, property held as a joint tenant, life insurance proceeds,

retirement benefits, and other property described in Section 5000 that is the subject of a beneficiary designation or contractual obligation for transfer on death."

#### PREFERENCE FOR NONPROBATE PROPERTY

The basic approach taken by the existing statutes is that nonprobate property will be subjected to claims of a decedent's creditors only if the probate estate is inadequate. This approach in effect gives the nonprobate property a preference over probate assets. Is this preference appropriate?

The staff believes that nonprobate property should continue to receive a statutory preference over assets in the decedent's estate. Nonprobate transfers in the ordinary case will reflect the decedent's intent that they not be subjected to probate delays and expenses. In fact, many forms of the most important nonprobate assets already receive either a common law or a statutory exemption from creditors. This is the case for example, with joint tenancy property and life insurance proceeds. In addition, a preference for nonprobate property would minimize the need to invoke procedures for collecting from them, with all the complications that will involve, since it will be a fairly unusual case where the decedent's estate is insolvent.

#### EXEMPTIONS FOR NONPROBATE PROPERTY

What about the existing exemptions for nonprobate property--should they be preserved?

To begin with, it appears that many of the statutory exemptions do not apply after the death of the debtor--they are personal to the debtor and not to the debtor's beneficiaries. The statutes do make clear that the court may, on petition and in its discretion, set apart exempt property that is part of the probate estate to the surviving spouse and minor children. Prob. Code § 6510. The effect of this provision appears to be that the property set apart is not required to participate in the payment of claims in administration.

The staff would permit the court in its discretion to apply the exemptions to nonprobate property to the same extent as to probate assets. The exemptions are designed to protect the debtor and persons

dependent on the debtor. It is arguably even more important that the exemptions apply after the debtor's death, during a difficult time for the debtor's dependents.

There is one nonprobate asset that is a special case--joint tenancy property. Joint tenancy property enjoys an extensive common law protection from creditors of a deceased joint tenant. This protection affects secured creditors as well as unsecured creditors, and applies to the decedent's interest as well as the survivor's. The complete exemption for joint tenancy property is at odds with the rest of the law. It can be argued that a creditor who has obtained a security interest during the decedent's lifetime on the decedent's interest in property held in joint tenancy at least should be protected, although the question arises why the creditor didn't require all joint tenants to give security. With respect to unsecured creditors, why should the decedent's other beneficiaries be made to bear the liability in favor of the decedent's joint tenants? Of course it could be argued that the decedent intended to favor the joint tenant, which is why the decedent selected that form of tenure. The staff would look into the possibility of subjecting joint tenancy property to the decedent's debts on the same proportionate basis as other nonprobate property.

In this connection it should be noted that the vast majority of joint tenancies are spousal, and in truth may actually be disguised forms of community property. Community property may be a more beneficial form of tenure for the surviving spouse for tax reasons, and a community property presumption may be appropriate. The Commission has contracted with a consultant--Professor Kasner--to prepare a background study on this matter for it, and the staff recommends that the issue of community property in joint tenancy form be deferred until the study is received. The study is due by August 31, 1991.

#### FAMILY PROTECTIONS FOR NONPROBATE PROPERTY

In addition to the exemptions from debts, there are other protections for probate assets that should be extended to nonprobate property if the nonprobate property is to be made liable for debts. Probate beneficiaries have protections such as the probate homestead and family allowance. Why should the decedent and beneficiaries lose

protections such as these by using the device of a nonprobate transfer? The staff would make clear that the rights of creditors in nonprobate property are subject to the protections in favor of beneficiaries.

#### SHOULD OBLIGATIONS FOR WHICH NONPROBATE PROPERTY IS LIABLE BE LIMITED?

Should nonprobate property be subject to general creditor claims or should it be collected only if necessary to satisfy priority claims or special claims such as support obligations of the decedent? The staff's basic feeling is that, although limiting the debts for which nonprobate property may be used has some facial attraction, it is preferable to track general probate policy by making the property subject to all unsatisfied claims in their statutory order of priority. It would also make the drafting of the statute simpler.

With respect to liability of nonprobate property for the decedent's estate and income taxes, we do not propose any special rules. The tax laws are adequate to allow the taxing authorities to reach any property 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.

A related question is whether nonprobate property should be subject to seizure for purposes other than payment of debts. Specifically, should it be subject to seizure for various family protection purposes, such as family allowance, probate homestead, share of an omitted spouse or child, etc. The competing considerations here are the right of the decedent to create an estate plan that is honored by the law versus the policy of the law to protect persons dependent on the decedent from actions by the decedent that would leave them without the necessities of life. The staff approach here would be to cover only debts of the decedent, 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.

#### PROCEDURE FOR REACHING NONPROBATE PROPERTY

The existing statutes use one of four different procedures to enable a creditor to reach nonprobate property:

(1) The creditor may proceed directly against the holder of the property. No prior probate is necessary; in fact, this remedy is available only if there is no probate. If probate is commenced, the property must be restored to the estate. This procedure applies to small estates taken by affidavit and community property taken by a surviving spouse.

(2) The personal representative in probate recovers the assets for the estate. This procedure applies to fraudulent conveyances, gifts in view of impending death, and vehicles transferred on death.

(3) The personal representative in probate recovers the proportionate value of property passing outside probate. This procedure applies to collection and proration of estate taxes.

(4) The property is declared to be liable for the decedent's debts to the extent the estate is inadequate, but no procedures are specified. This characterizes the situation for trust assets and general powers of appointment.

Should creditors be allowed direct access to the assets or only through the personal representative? Although direct creditor access may at first appear simpler, there are many problems with it:

(1) How is the holder of the nonprobate property to know that the decedent's estate is in fact insolvent, so that payment of the creditor is proper?

(2) There is no mechanism apart from lawsuit and judgment for resolving disputes.

(3) Allowing direct access would give creditors a means of avoiding compliance with probate procedures.

(4) If the nonprobate property is insufficient to satisfy all creditors, should the holder pay on a first-come, first-served basis, on a pro rata 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 decedent's personal representative to reach the nonprobate property and bring it 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. The major drawback to this system is that it requires there to be a probate proceeding in order for it to work.

One alternative would be to run the procedure through the trustee, when the decedent's basic estate passes by way of trust. But this would require the trustee to marshal non-trust assets and would involve the court in trust administration, something the whole concept of a trust is intended to avoid. In addition, basic due process notices and hearings would be necessary; i.e., probate law would have to be replicated in the trust process.

#### WHAT IF THERE IS NO PROBATE PROCEEDING?

If there is no probate proceeding, creditors will be forced to commence probate merely to assert claims against nonprobate property. This does not appear to be particularly satisfactory.

However, the staff notes that this problem is no different from that faced by a creditor generally where no one elects to open a probate. In such a 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 works okay. In fact, the filing of a petition by a creditor, or the mere threat of it, probably will prompt the estate beneficiaries to do their duty and activate the probate proceeding.

#### PROCEDURE TO FORCE PROMPT FILING OF CLAIMS

Suppose the nonprobate beneficiaries wish to flush out possible creditors so they can pay off the decedent's debts and get on with their lives. The obvious answer is that the beneficiary can and should commence a probate proceeding, give notice to creditors, and discharge debts or cut off unfiled claims. But this has the very effect the parties were seeking to avoid by setting up a nonprobate transfer—it results in the property being probated anyway!

An alternate approach could be to set up a procedure whereby a holder of nonprobate property publishes a notice of death and requires claims to be filed within a short period of time. In essence, we're talking about developing a mini-probate procedure. Of course, the

procedure would have to provide for determining the validity of claims and resolving disputes, for priorities among creditors, etc. In other words, we'd be reinventing the wheel of probate procedure.

The State Bar Probate Section has done exactly that for living trusts. Under the State Bar proposal, which they intend to submit to the 1991 Legislature, after the death of the settlor the trustee would be authorized to publish notice to creditors, receive claims, obtain approval for payment from the court, and bar unfiled claims, just as in a probate proceeding.

The staff can see doing that for trusts, since trusts are often will substitutes, and the decedent's entire estate may pass through the trust. But developing a claims filing procedure for other individual nonprobate transfers of individual assets is not a worthwhile endeavor. The standard probate proceeding is always available if desired, and in any case the statute of limitations will automatically cut off creditor claims one year after the decedent's death (assuming the the legislation just enacted on Commission recommendation proves to be constitutional). The staff would recognize the State Bar's trust claims procedure, but would not provide a notice and claim procedure outside of probate for other nonprobate property.

#### TRACING PROBLEMS

If the personal representative is to be able to recover nonprobate property for the probate estate from the beneficiary or holder of the property, must it be the exact item of property? Suppose it has been sold; is a bona fide purchase protected? If so, must the beneficiary pay the value of the property rather than restore it? Suppose the property has been exchanged for other property; must the beneficiary turn over the replacement property to the estate? Suppose the property is still in the possession of the beneficiary, but it has been damaged or has otherwise depreciated in value; is it sufficient to restore the property to the estate, or is the beneficiary liable for its value on the date of death?

Tracing problems such as these tremendously complicate the situation. They are inherent in any scheme allowing the personal representative to recover specific assets. One way to minimize such problems is to impose a 40-day freeze on nonprobate transfers from the

death of the decedent, analogous to the 40-day limitation on the small estate affidavit procedure and on the surviving spouse accession provisions. However, the staff has suggested the concept of a 40-day freeze in the past, and it has not been well-received. For this reason the staff does not now recommend it.

One way to avoid tracing problems is simply to make the recipient of the nonprobate property liable for its value, rather than requiring it to be restored to the estate. This is the approach of the estate tax proration statute, which requires the personal representative to collect from each recipient of property in the decedent's taxable estate (including nonprobate property in the taxable estate) the proportionate value of the property received. This scheme is also analogous to the affidavit and surviving spouse statutes, which make the recipients of property liable to creditors for the value of the property, rather than for the property itself. And this approach is used to enforce the general creditors' remedies of claim and delivery and judgment for possession of property.

The staff believes it will simplify matters to provide for collection of the value of the property by the personal representative, rather than for recovery of the property itself if the property itself is not reasonably available, and would draft the statute accordingly. Please note that this is not a perfect solution, since it may necessitate some sort of valuation of the property. Also, it could involve hardship if the property has already been consumed. However, the probate court would be available to superintend these matters, and the staff would provide specifically that the court could excuse repayment on a showing of hardship.

The staff is not overly concerned about the transactional costs involved here, since it is likely that these situations will come up relatively rarely. We understand from practitioners that, for whatever reasons, unpaid creditors are generally not a problem in most estates. This may be because most estates are solvent, or because creditors are careful when extending credit to obtain adequate security, or because they are willing to write off a certain number of bad debts as one of their costs of doing business.

#### APPORTIONMENT AMONG NONPROBATE BENEFICIARIES

One recipient of nonprobate property alone should not be required to bear the full burden of satisfying creditor claims. This could easily happen if the personal representative is allowed to pick and choose among nonprobate beneficiaries. The personal representative obviously will go for the asset that is most readily accessible and can most easily make up the deficit in the estate without undue effort.

One way to ensure equity is to permit any nonprobate beneficiary required to reimburse the estate to join, or require contribution from, any other nonprobate beneficiary. But then that beneficiary in turn should be able to rope in others, etc. A better approach would be to require the personal representative to charge all beneficiaries, proportionately, right from the start. The personal representative is in a better position to discover all nonprobate property than individual recipients of the property. Also, this is the theory of the estate tax apportionment process, where the personal representative is charged with the apportionment duty, and it seems to work well.

#### ABATEMENT AMONG NONPROBATE BENEFICIARIES

But, should all nonprobate property share equally, or should there be some sort of hierarchy or abatement among types of property? By comparison, probate assets are not all equally liable for debts. Residuary gifts are taken to pay debts first, followed by general gifts to nonrelatives, followed by general gifts to the decedent's relatives, then specific gifts to nonrelatives, and finally specific gifts to relatives. Prob. Code § 21402. That section, by its terms, applies to nonprobate as well as probate transfers, so we would expect that the personal representative would follow it in apportioning liability of nonprobate property.

Is this appropriate for nonprobate property? It might be possible to make a different hierarchy of nonprobate property. For example, trust property might be preferred to a beneficiary designation in a bank account, which in turn would be preferred to property taken by affidavit. This doesn't make a lot of sense to the staff. We see no reason to prefer one type of asset to another. The ordinary probate abatement scheme makes some sense, and the staff would not change it.

## DUE PROCESS FOR NONPROBATE BENEFICIARIES

What procedures are there for a nonprobate beneficiary to object to a proposed assessment to pay debts? The first time the beneficiary may hear of the problem is when a notice is received from the personal representative ordering the beneficiary to return the property to the estate or pay a proportionate share of the debts. The beneficiary may claim that the particular nonprobate property is exempt, or that it has priority over other nonprobate property, or that not all nonprobate property has been assessed. More fundamentally, the beneficiary may claim that the debts being charged were improperly allowed and approved, or that sales of estate property were made improperly and should have yielded greater amounts for payment of debts.

One solution would be to give nonprobate beneficiaries the same notice of probate that probate beneficiaries receive and allow nonprobate beneficiaries to participate to the same extent as probate beneficiaries, on the theory that they could be liable and therefore have an interest in the proceeding. The staff does not recommend this, since it would increase probate costs and complexity in nearly every case for very little gain, becoming relevant only in the case of an insolvent estate. An alternative would be to provide notice only where the probate petition indicates likely insolvency.

A simpler and probably better approach would be to make clear that a nonprobate beneficiary ordered to pay a proportionate share of the debt should receive notice of any settlement of account or payment of debts and should be permitted to contest matters relating to the account or payment of the debts as provided for in administration proceedings under the Probate Code.

## STATUTE OF LIMITATIONS

At some point, a nonprobate beneficiary should be free of the obligation to return the property or pay its value to the decedent's estate. There is a natural limiting factor in the requirement that the decedent's creditors are forever barred if they have not filed claims in probate within a year after the decedent's death. Nonetheless, some probate proceedings may continue for a long period of time after claims have been properly filed, and it may not be clear for many years

whether the estate is insolvent. In fact, an estate initially solvent may become insolvent through prolonged family allowance payments and the like.

Is this a significant problem, or may we assume that for the most part a nonprobate beneficiary will learn reasonably early whether there is a potential claim by the decedent's estate? The staff does not know, but it would be a relatively simple matter to include an absolute statute of limitations for recovery from a nonprobate beneficiary, e.g. one year after the decedent's death. This would allow the personal representative enough time to determine whether insolvency of the estate is likely. The staff suggests that this be done.

#### TRANSITIONAL PROBLEMS

There are potential constitutional problems in taking nonprobate property for a decedent's debts if the property is not presently liable. Also, debtors may wish to revise their estate plans, for example to specify certain property that should be used to pay debts, in light of the new legislation. For these reasons the staff would both defer the operative date for a year and apply the legislation to property that passes by nonprobate transfer on or after the deferred operative date.

#### CONCLUSION

It is clear that there are a number of difficult policy decisions confronting us in preparing a statute to subject nonprobate property to creditor claims where the probate estate is inadequate. Nonetheless, the staff believes this is an important matter that is well worth the Commission's time to address.

This memorandum presents some of the main issues for Commission resolution. We will address some of the more detailed or technical issues in the process of preparing a draft statute, once the Commission has given the main direction.

The staff-suggested approach for providing creditor access to nonprobate property is along the following lines:

(1) A beneficiary of nonprobate property, including joint tenancy property, should be liable with all other nonprobate beneficiaries for

a proportionate share of the decedent's debts to the extent the decedent's estate is insufficient.

(2) Exemptions available to the decedent would continue to apply to property received by the nonprobate beneficiaries in the discretion of the court.

(3) The liability should not be enforced by creditors directly but only by a personal representative through a probate proceeding. The nonprobate beneficiary would be entitled to notice of, and could object to, any court-ordered settlement of account or payment of debts. The nonprobate beneficiary would be authorized to initiate a probate proceeding if probate beneficiaries do not.

(4) The nonprobate beneficiary's liability is for the proportionate value of the property received, rather than for the property itself. The court could excuse payment on a hardship basis.

(5) There should be a relatively short statute of limitations (e.g., one year) for the personal representative to assert nonprobate beneficiary liability.

(6) The staff visualizes a one-year phase-in for the new statute in order for persons to revise estate plans in light of it. After the one-year period, the new statute would begin to apply to nonprobate transfers that occur (deaths that occur) thereafter.

Respectfully submitted,

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