Study FHL-911 September 26, 2000

First Supplement to Memorandum 2000-60

Estate Planning During Dissolution of Marriage
(Comments on Draft Recommendation)

After distributing Memorandum 2000-60, the staff contacted those persons and groups who had previously submitted written comments on this study and specifically requested input on the alternative approach described in the memorandum (at pp. 8-13). We received a letter from the Family Law Section Executive Committee of the State Bar (Flexcom) expressing opposition to the proposed alternative approach. We also received a letter from Marshal A. Oldman commenting on the alternative approach and offering a drafting suggestion. Finally, we received a letter from James R. Birnberg commenting on other issues. These letters, which are discussed below, are attached as an Exhibit:

This supplement concludes with a discussion of a minor drafting change to accommodate recent legislation that would create a new form of title: community property with right of survivorship.

FLEXCOM COMMENTS

The draft recommendation provides that the automatic temporary restraining order in effect during a marital dissolution proceeding (ATRO) restrains "modifying a nonprobate transfer in a manner that affects the disposition of property subject to the transfer." This is intended to avoid an unauthorized transfer of community property if one of the spouses dies during dissolution of marriage. As discussed in the main memorandum, other existing legal remedies (e.g., the requirement of spousal consent to any nonprobate transfer of community property) may be sufficient to address this problem, and the restraint on modification of a nonprobate transfer may be unnecessary. In order to explore this possibility, the staff proposed an alternative approach, where the ATRO

would not restrain the creation or modification of a nonprobate transfer, and requested public comment on that alternative.

Flexcom unanimously supports the draft recommendation, including a modification to allow creation of an unfunded living trust. It unanimously opposes the proposed alternative approach (see Exhibit pp. 5-6):

> Flexcom is of the opinion that permitting the creation or modification of a nonprobate transfer would create too great a risk that community property could be lost to the jurisdiction of the court. For example, suppose, as is often the case, a husband holds a large individual retirement account which represents more than half the value of the community property, and the wife is the beneficiary. Even though the account is community property, and the wife has a present interest as to one-half of that account, the husband could revoke the beneficiary designation and substitute, say, his child by a prior marriage. If the child lived in another jurisdiction there could be serious difficulties recovering the proceeds for the community estate. At the least, a separate civil action in another jurisdiction to impose a constructive trust could be involved, with its attendant expense and delay. There could be further problems involving service of process, personal jurisdiction and conflict of laws.
>
> While Flexcom understands the desirability of probate avoidance in estate planning generally, it is our position that probate court jurisdiction affords the best protection for the family in case of death during a divorce. Where the circumstances of a particular case warrant a different result, the burden should be on the party affected to seek relief in the family court by noticed motion.

This is helpful input, as it gives a family law practitioner's point of view on the proper balancing of the interests.

COMMENTS OF MARSHAL OLDMAN

Mr. Oldman offers his observations regarding the proposed alternative approach and also offers a drafting suggestion. These are discussed below:

Restraint on Modification of Nonprobate Transfer

With respect to jointly created marital trusts, Mr. Oldman believes that the ATRO should restrain unilateral modification (see Exhibit pp. 3-4):

> Almost every marital trust that I have seen allows one spouse to revoke the trust as to any community property, but both spouses are required to amend the trust. The former reflects that each spouse has the ability to manage community property while the

> latter reflects that changes to a joint trust require both spouses to concur. Since most married persons engaging in estate planning and the creation of marital trusts expect that any amendments will require joint action, I believe on balance that the statutory law should reflect this as a default position. While this increases the complexity of the statute, I believe that it will be closer to current practice than allowing one spouse to amend a jointly created instrument.

As to other types of instruments:

> I suggest the rule that a jointly created designation should require both spouses to make a change while a designation created by one spouse should be subject to change by that spouse. My reasoning is that banks and stock brokerages should not be placed in the position of guessing whether the person on title to an account has the sole authority to change the account in a marital situation. Since both spouses have equal management and control of the community property, third parties should be able to rely on the actions of either spouse in the management of a particular account. A simple bright line rule that follows the title of the account in the absence of a specific court order to the contrary would reflect commercial practice and expectations.

The staff agrees with Mr. Oldman's first point, that requiring spousal consent to a modification of a marital trust is probably consistent with most spouses' expectations. It may also reflect the best rule in terms of protecting the spouses from unauthorized transfers of community property.

However, the staff is not sure that spouses should be free to unilaterally modify a nonprobate transfer that was created unilaterally. A unilaterally created nonprobate transfer may purport to dispose of both halves of a community property asset. For the reasons discussed previously, a modification that can result in a transfer of community property should probably be restrained.

It is true that third party property holders may not expect that a unilaterally created nonprobate transfer is restrained in any way and may permit changes despite the existence of a restraint. However, this shouldn't cause any problem for the property holders. Under Probate Code Section 5003, a property holder is protected from liability for transferring property according to the terms of a nonprobate transfer, whether or not the transfer is consistent with the beneficial ownership of the property (except where the property holder has been served with a contrary court order or a written notice of a person claiming an adverse interest in the property). Similar protection is provided for financial institutions specifically. Prob. Code § 5405.

Drafting Suggestion

The main memorandum proposes adding language providing that the ATRO does not restrain: "The creation of an unfunded living trust." Mr. Oldman suggests that this be redrafted to read: "The creation of one or more revocable or irrevocable unfunded living trusts."

His proposal has two parts. First, he is concerned that the singular article "an" will be read literally to restrict application of the provision to a single trust, despite the fact that multiple trusts may be useful in some circumstances. This shouldn't be a problem, as the Family Code includes a rule of construction providing that the singular includes the plural, and the plural the singular. See Fam. Code § 10. Thus, the provision should be construed as applying to one or more trusts. Second, Mr. Oldman wants to make it clear that the trust created can be revocable or irrevocable, according to the needs of the settlor. As drafted, the provision is silent on the question of revocability and would probably not be construed to limit creation to either revocable or irrevocable trusts. However, the proper construction of the provision could be made clearer in the Comment:

> Subdivision (b)(4) provides that the ATRO does not restrain creation of one or more revocable or irrevocable unfunded living trusts.

This would probably be a helpful clarification.

COMMENTS OF JAMES R. BIRNBERG

In its letter of July 7, 2000 (see main memorandum, Exhibit pp. 3-4), the Beverly Hills Bar Association's Probate, Trust, & Estate Planning Section proposes a number of exceptions to the restraint on modification of a nonprobate transfer. The staff's conclusion, as discussed in the main memorandum, is that many of the proposed exceptions would create the potential for an unauthorized transfer of community property and should not be adopted. Mr. Birnberg disagrees with some of the staff's conclusions. His comments are discussed below:

Changing Beneficiary of Revocable Trust

The Beverly Hills Bar Association proposes that the ATRO should not restrain a change in beneficiary of a living trust. As discussed in the main memorandum (at p. 4), if one spouse changes the beneficiary of a living trust containing community property and then dies, the property may be transferred contrary to

the surviving spouse's intentions, without the surviving spouse's consent. Mr. Birnberg comments (at Exhibit pp. 1-2):

> Since the disposition under a revocable trust is only of a decedent's one-half community or his or her separate property (absent the knowing consent of the spouse), I think the Beverly Hills Bar proposal would be reasonable unless there were a contractual obligation between the spouses. Perhaps the easiest way to accomplish the desired objectives would be to permit the changing of a beneficiary of a revocable trust as to that spouse's one-half community property and separate property interests only, unless there were a contractual obligation not to amend the trust or revoke the trust. As you have it now, the preclusion of such amendments is greater than is needed to protect the other spouse.

A living trust can be used to transfer both halves of community property. If done with spousal consent, the transfer is valid. If done without spousal consent the transfer is *legally* ineffective and can be set aside. However, administration of a trust is typically not judicially supervised. It is therefore possible that a trust will result in an unauthorized transfer of both halves of community property. If the recipient of the property cannot be found, or has dissipated or concealed the property, the fact that the surviving spouse has a legal right to one half of the transferred property may offer little *practical* benefit to the spouse whose property has been transferred. Is the likelihood of this situation occurring sufficiently large to justify restraining modification of nonprobate transfers during marital dissolution? If not, then the Commission should consider the alternative approach described in the main memorandum. However, **if the risk is sufficient to justify the restraint on modification, then the staff recommends against adding an exception for designation of a beneficiary of a living trust.**

Mr. Birnberg's specific suggestion, that a change of beneficiary be allowed as to one half of a spouse's community property or all of the spouse's separate property presents practical difficulties. Characterization of property as community or separate involves complex questions of law and fact. To invite the parties (especially pro se parties, which are common in dissolution proceedings) to make these determinations and act on them is to invite error. The Commission previously decided against qualifying the ATRO's restraint based on the character of the property at issue. **The staff believes that was the correct decision.**

Designating Personal Representative as Beneficiary

The Beverly Hills Bar Association proposed that the ATRO should not restrain changing the beneficiary of a nonprobate transfer to the personal representative of one's estate. The staff noted that this change would be unobjectionable, because the property transferred to the personal representative would be subject to probate and its protections. However, the staff noted that the same result could be achieved simply by revoking the nonprobate transfer, in which case the property would be part of the person's probate estate. The staff recommended against the Beverly Hills Bar Association's proposal. See main memorandum at p. 5. Mr. Birnberg questions the logic of this recommendation. See Exhibit p. 2.

The staff's recommendation was based on a preference for simpler drafting. Many divorcing persons are not represented by counsel. If they are to read and understand the ATRO language on the summons, it should be as straightforward as possible. If the same result can be achieved by relatively simple language ("the ATRO does not restrain revocation of a nonprobate transfer") or by more complex language ("the ATRO does not restrain (1) revocation of a nonprobate transfer, or (2) naming the personal representative of the spouse's estate as beneficiary of a nonprobate transfer") the staff will recommend the simpler language.

Designating Trustee as Beneficiary

The Beverly Hills Bar Association proposed that the ATRO should not restrain changing the beneficiary of a nonprobate transfer to the trustee of the party's living trust. However, as discussed in the main memorandum (at p. 5), this would create a risk of unauthorized transfer of community property. The staff recommended against the proposed exception.

Mr. Birnberg objects and offers the same basic suggestion that he proposed in the context of changing the beneficiary of a living trust (see Exhibit p. 2):

> My reaction is that absent any agreement between the spouses, either of them should be free to engage in changes in his or her estate plan as to his or her separate property and his or her one-half of community property.

Because this would require the parties to make their own determinations as to the character of community property and separate property, **the staff recommends against this proposal.**

Note that many of the proposed exceptions involve fairly sophisticated transactions. A person who is contemplating changing the beneficiary of a nonprobate transfer to name the person's trustee or personal representative is probably being advised by an attorney. It shouldn't be too difficult for such a person to take the extra step to get a court order permitting whatever estate planning changes the person desires. Although inconvenient, this would allow for appropriate estate planning changes while protecting the other spouse from any improper transactions.

Modification of Power of Appointment

The Beverly Hills Bar Association proposed that the proposed law not restrain modification of a power of appointment. In the main memorandum (at p. 6), the staff discusses how modification of a power of appointment can affect the disposition of property subject to the power, ultimately resulting in an unauthorized nonprobate transfer of community property. The staff recommended against adding the proposed exemption.

Mr. Birnberg writes (see Exhibit p. 2):

> Powers reserved by the spouses as donors in a trust created from community property can be a problem as suggested by you, but powers created by third parties or with the separate property of either spouse should not be of concern, since the property is not the community property of either spouse. For example, if I have a general or special power of appointment under my father's trust and I had named my now-divorcing spouse as beneficiary, why should I not be free to change it to accomplish my revised objectives? Therefore, I believe that your recommendation should only apply to trusts created by the spouse funded with community property.

Mr. Birnberg's suggested distinction between separate and community property would create the same problems discussed above. **The staff recommends against drawing such a distinction.** The distinction between a power created by a spouse and a power created by a third party is important and should perhaps be clarified. This could be done by revising the proposed Comment as follows:

> Subdivision (a)(4) restrains modification of a nonprobate transfer "in a manner that affects the disposition of property subject to the transfer." Modifications that are restrained as affecting the disposition of property include a change of beneficiary or <u>a donor's modification of the terms of a</u> power of appointment <u>(this would not include exercise of a power of appointment by a donee)</u>.

> Modifications that are not restrained include naming a new trustee or successor trustee (so long as the change does not affect the trustee's powers or duties with respect to disposition of trust property).

The staff believes that this would be a helpful clarification.

COMMUNITY PROPERTY WITH RIGHT OF SURVIVORSHIP

The draft recommendation provides that the ATRO does not restrain "Elimination of a right of survivorship to property that is owned jointly by the parties." See proposed Fam. Code § 2040(b)(3). A recent bill would create a new form of title, community property with right of survivorship. AB 2913 (Kuehl) (awaiting action by the Governor). It is uncertain whether community property with right of survivorship would fall within the draft recommendation's language (because it isn't entirely clear whether community property is "owned jointly"). Probably, the language would work as is, but out of caution, **the staff proposes revising it to read**: "Elimination of a right of survivorship ~~that is owned jointly by the parties~~." The deleted portion appears to be surplus anyway and could conceivably create problems.

Respectfully submitted,

Brian Hebert
Staff Counsel

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August 15, 2000

Brian Hebert, Esq.
Staff Counsel
California Law Revision Commission
4000 Middlefield Road, Room D-1
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Re: Memorandum 2000-60
Study FHL-911

Dear Mr. Hebert:

Thank you for your August 11, 2000 letter and Memorandum 2000-60. I appreciate the consideration you have given to my comments in my July 18, 2000 letter.

The new Memorandum brings generates some further concerns—not as to what you have agreed to but what you seem unwilling to consider of the suggestions made by the Beverly Hills Bar Association.

Starting on page 4 of the Study you discuss proposed exemptions from the scope of an ATRO. I will comment only on those recommended for disapproval:

(1) **Changing beneficiary of revocable trust**. Since the disposition under a revocable trust is only of a decedent's one-half community or of his or her separate property (absent the knowing consent of the spouse), I think the Beverly Hills Bar proposal would be reasonable unless there were a contractual obligation between the spouses. Perhaps the easiest way to accomplish the desired objectives would be to permit the changing of a beneficiary of a revocable trust as to that spouse's one-half community property and separate property interests only, unless there were a contractual obligation not to amend the trust or revoke the trust. As you have it now,

the preclusion of such amendments is greater than is needed to protect the other spouse.

(2) **Designating the Personal Representative as Beneficiary.** I do not understand the logic of saying that a spouse can revoke the designation and permit the nonprobate transfer to pass to a decedent's estate and not letting the spouse designate the personal representative as beneficiary. In both instances the property ends up in the decedent's probate estate, subject to administration and the protections mentioned in the Memorandum.

(3) **Designating Trustee as Beneficiary**. My problem with your response is similar to those above, you presuppose agreements between the spouses which, of course, should not be abrogated, in applying a restriction on designations or changes generally. My reaction is that absent any agreement between the spouses, either of them should be free to engage in changes in his or her estate plan as to his or her separate property and his or her one-half of community property.

(4) **Modification of Power of Appointment**. I think there is some confusion in your mind due to the lack of detail provided by the Beverly Hills Bar Association. Powers reserved by the spouses as donors in a trust created from community property can be a problem as suggested by you, but powers created by third parties or with the separate property of either spouse should not be of concern, since the property is not the community property of either spouse. For example, if I have a general or special power of appointment under my father's trust and I had named my now-divorcing spouse as a beneficiary, why should I not be free to change it to accomplish my revised objectives? Therefore, I believe that your recommendation should only apply to trusts created by the spouses funded with community property.

Very truly yours,

James R. Birnberg

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cc: Kenneth G. Petrulis, Esq.

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August 28, 2000

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Re: Memorandum 2000-60

Dear Mr. Hebert:

I read with interest your latest memorandum regarding the complex subject of ATRO's and estate planning and its discussion of the competing policies arising from estate planning and family law proceedings. In this letter, I hope to avoid adding to the complexity of the subject and will limit myself to pointing out some matters from an estate planning prospective.

In regard to the proposed change at subparagraph (4), I would like to suggest broader language so that the paragraph would read as follows:

"(4) The creation of one or more revocable or irrevocable unfunded living trusts."

A literal reading of the proposed language in the memorandum might restrict a testator to the creation of one trust at a time that good estate planning might require more than one trust. The language should be clarified to state that the trust can be irrevocable or revocable depending on the estate planning objectives of the testator. So long as the trusts cannot be funded without an order in a family law proceeding, I do not believe that the additional language and flexibility in the statute will increase the risk of a diversion of community property.

In regard to the question of exempting all changes in revocable beneficiaries designations from the ATRO, I have the following thoughts:

1. Almost every marital trust that I have seen allows one spouse to revoke the trust as to any community property but both spouses are required to amend the trust. The former reflects

that each spouse has the ability to manage community property while the latter reflects that changes to a joint trust should require both spouses to concur. Since most married persons engaging in estate planning and the creation of marital trusts expect that any amendments will require joint action, I believe on balance that the statutory law should reflect this as a default position. While this increases the complexity of the statute, I believe that it will be closer to current practice than allowing one spouse to amend a jointly created instrument.

2. As to other beneficiary designations, I suggest the rule that a jointly created designation should require both spouses to make a change while a designation created by one spouse should be subject to change by that spouse. My reasoning is that banks and stock brokerages should not be placed in the position of guessing whether the person on title to an account has the sole authority to change the account in a marital situation. Since both spouses have equal management and control of the community property, third parties should be able to rely on the actions of either spouse in the management of a particular account. A simple bright line rule that follows the title of the account in the absence of a specific court order to the contrary would reflect commercial practice and expectations.

Please let me know if I can be of further help in this matter.

Very truly yours,

MARSHAL A. OLDMAN

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FAMILY LAW SECTION
THE STATE BAR OF CALIFORNIA

September 21, 2000

Brian Hebert, Esq.
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Dear Mr. Hebert:

At its meeting on September 15, 2000, the Family Law Section Executive Committee of the State Bar ("Flexcom") considered the proposal by the Law Revision Commission staff for amendment of Family Code Section 2040 regarding ATROs. Flexcom unanimously supports the proposed legislation and opposes the alternative proposal, which would permit the creation or modification of nonprobate transfers. Flexcom does not, however, oppose permitting the creation of an unfunded living trust as proposed in your alternative, an we would propose that that provision be included.

Flexcom agrees that clarifying the ATRO statute is invaluable for all parties concerned. Any clarification should balance the need for preserving the marital estate pending resolution of the litigation against the legitimate need of each party to do estate planning for his or her share of the estate while litigation is pending.

Flexcom is of the opinion that permitting the creation or modification of a nonprobate transfer would create too great a risk that community property could be lost to the jurisdiction of the court. For example, suppose, as is often the case, a husband holds a large individual retirement account which represents more than half the value of the community property, and the wife is the beneficiary. Even though the account is community property, and the wife has a present interest as to one-half of that account, the husband could revoke the beneficiary designation and substitute, say, his child by a prior marriage. If the child lived in another jurisdiction there could be serious difficulties recovering the proceeds for the community estate. At the least, a separate civil action in another jurisdiction to impose a constructive trust

could be involved, with its attendant expense and delay. There could be further problems involving service of process, personal jurisdiction and conflict of laws.

While Flexcom understands the desirability of probate avoidance in estate planning generally, it is our position that probate court jurisdiction affords the best protection for the family in case of death during a divorce. Where the circumstances of a particular case warrant a different result, the burden should be on the party affected to seek relief in the family court by noticed motion.

On behalf of Flexcom, please let me express my thanks for the excellent work the Law Revision Commission is doing on this subject, for keeping us informed and for soliciting our views. We look forward to working with you on this project in the future.

Very truly yours,

Suzanne Harris, Chair
State Bar Family Law Section