Study L-637 November 21, 2006

Memorandum 2006-45

Revision of No Contest Clause Statute (Discussion of Issues)

The Commission has been directed by legislative resolution to study the advantages and disadvantages of California's existing no contest clause statute and to weigh the merits of alternatives approaches to the enforcement of a no contest clause. See 2005 Cal. Stat. res. ch. 122.

Based on the information provided to the Commission to date, it appears that existing law on the enforcement of a no contest clause is problematic. The law is overly complex and its operation is sometimes uncertain. As a result, there has been an increase in the use of declaratory relief to determine whether a particular action would violate a no contest clause. This has led to additional costs and delay in many cases that involve a no contest clause.

In addition, a no contest clause can deter a reasonable inquiry into whether an instrument is the product of fraud or undue influence, or is otherwise defective.

The Commission directed the staff to prepare a memorandum discussing possible reforms to the no contest clause statute, including a possibility raised for the first time at the October meeting: a probable cause exception combined with a pre-trial determination of whether probable cause exists.

After considering the information provided in this memorandum, the Commission should decide which reform approach it would like to see developed into a tentative recommendation. The staff would then prepare a draft, with implementing language, for consideration at a future meeting.

Except as otherwise indicated, all statutory references in this memorandum are to the Probate Code.

POLICY OBJECTIVES

In order to weigh the relative merits of the possible reforms, it is helpful to first identify the policy objectives that any reform should promote:

(1) Avoid Contest Litigation Generally

The principal purpose of a no contest clause is to avoid the cost, delay, notoriety, and bad blood that can result from contest litigation. The legitimate desire to avoid contest litigation should be effectuated to the extent that it is compatible with the other policy objectives discussed below.

(2) Allow a Contest that is Brought with Good Cause

A transferor should not be allowed to deter a contest that is brought in good faith and with sufficiently good cause. The public has an interest in the just resolution of such matters, in order to prevent fraud and elder abuse, protect the rights of heirs, and ensure the fair and efficient administration of estates.

(3) Allow a Contest that Serves an Important Public Purpose

A contest may be so important to the integrity of estate administration or the vindication of an individual right that it should be exempt from the operation of a no contest clause as a matter of law; the public's interest in allowing the action to proceed outweighs the transferor's private desire to avoid litigation. For example, the ability to challenge the exercise of a fiduciary power is essential to court supervision of fiduciaries and is therefore exempt from a no contest clause as a matter of law. See Section 21305(b)(6); *Estate of Ferber*, 66 Cal. App. 4th 244, 253, 77 Cal. Rptr. 2d 774 (1998) ("No contest clauses that purport to insulate executors completely from vigilant beneficiaries violate the public policy behind court supervision.").

(4) Reduce Litigation Costs and Delay

One of the problems identified in this study is the increasing cost and delay associated with contest litigation, as a result of the routine use of declaratory relief as a precursor to contest litigation. In developing a reform, the Commission should attempt to minimize the transaction costs and delays involved in the operation of the reform.

(5) Simplify the Law

The existing statute is overly complex. The Commission should explore ways in which the law can be simplified and its operation made more certain.

ALTERNATIVE APPROACHES

The Commission has discussed a number of possible approaches to improving the no contest clause statute. The elements of those approaches, which could be adopted singly or in some combination, are as follows:

- A probable cause exception to the enforcement of a no contest clause.
- A provision limiting the enforcement of a no contest clause to a "direct" contest.
- Elimination of forfeiture as a litigation deterrent, with fee shifting as a substitute deterrent.
- Repeal of the declaratory relief procedure.
- Simplification of the existing statute.

Those elements are discussed below.

Probable Cause Exception

Most states provide an exception to the enforcement of a no contest clause for a contest that is brought with probable cause. This strikes a reasonable compromise between the first two policy objectives: effectuating the transferor's wish to avoid contest litigation while preserving the public's interest in the judicial resolution of legitimate contests.

The Restatement defines "probable cause" as follows:

> Probable cause exists when, at the time of instituting the proceeding, there was evidence that would lead a reasonable person, properly informed and advised, to conclude that there was a substantial likelihood that the challenge would be successful.

Restatement (Third) of Property (Wills & Don. Trans.) § 8.5 (2003). That is an objective standard, based on the evidence that is available at the commencement of the proceeding.

Under that definition, a dissatisfied heir must weigh what is actually known about the merits of the contemplated contest and consider whether a reasonable person with that information, competently advised, would believe that there is a substantial likelihood of success. If so, then the contest would be immune from forfeiture under the no contest clause. If not, then the no contest clause would operate (if it survives the contest).

Assuming that a contestant behaves rationally (which may not always be the case in an emotionally laden family dispute), a plainly unreasonable contest

would be deterred and a plainly reasonable contest could proceed without serious risk of forfeiture. Depending on a contestant's tolerance for risk, a close call may or may not be deterred.

Under existing law, an heir who has good reason to believe that an instrument is defective or was procured through fraud or undue influence may decide against bringing a contest, in order to avoid forfeiture. Unscrupulous actors know this, and can use a no contest clause to shield fraud from effective challenge by the other heirs.

A probable cause exception would be a significant step toward solving that problem, without eliminating the legitimate benefits that a no contest clause can provide in deterring unmeritorious litigation.

Timing of Probable Cause Determination

If a probable cause exception were created, how would it operate? Specifically, would the determination of probable cause be made before trial, with an opportunity for an unsuccessful contestant to withdraw without triggering forfeiture? Or would it occur after a judgment on the merits, when it is too late to escape the operation of the no contest clause? The staff explored both possibilities.

Post-Judgment Determination

The staff sent inquiries to the estate planning bar in Pennsylvania (the most populous state to have adopted the Uniform Probate Code's probable cause exception), Texas (the most populous state with a probable cause exception derived from court decisions), and Montana (a small UPC state in which we have a contact). The staff asked about the timing of the probable cause determination in those jurisdictions. So far, we have only received a response from Pennsylvania.

There is no Pennsylvania case law directly addressing the timing issue, but the bar representative indicates that the determination is made at the end of the trial.

That appears to be consistent with the practice in California, when applying the limited probable cause exceptions that apply to a contest involving revocation, forgery, or certain types of interested beneficiaries. See Prob. Code §§ 21306-21307. In those contests, the determination of probable cause is made after a judgment on the merits of the contest.

It is not clear whether, in making a post-judgment probable cause determination, a court is permitted to consider evidence that comes to light during the trial, or is instead restricted to considering only the evidence that was available at the outset. If the Commission is interested in developing a post-judgment probable cause determination approach, that issue will need to be addressed.

Pre-Trial Determination

Another approach would be to make the probable cause determination at the commencement of the proceeding. This would provide the contestant with an opportunity to prove the reasonableness of the contest before committing to the contest itself.

If the court were to find that probable cause exists, the contest could proceed without violating the no contest clause, even if it were ultimately unsuccessful. That would provide a safe harbor for those with sufficiently good reason to bring a contest.

If the court were to find that probable cause does not exist, the contestant could either drop the matter (thereby avoiding forfeiture) or proceed in the hopes of successfully invalidating the instrument that contains the no contest clause (thereby nullifying its effect and avoiding forfeiture). If the contestant were to proceed and fail to invalidate the instrument, the clause would operate and the contestant would forfeit.

One disadvantage of this approach is that it invites litigation, at least at the preliminary stage. Any heir with a plausible basis for filing a contest could bring an action to see whether the case is strong enough to qualify for the safe harbor, without any risk of forfeiture. The only downside would be the cost of the proceeding.

A pre-trial probable cause determination would necessarily involve consideration of the merits of the contest. That could entail many of the harms that a no contest clause seeks to avoid: litigation costs, delay, invasion of privacy, and acrimony between heirs.

Means of Limiting Overuse of Pre-Trial Determination

The Commission discussed two ways in which use of the probable cause determination process could be limited to appropriate situations: (1) charge all fees and costs to an unsuccessful contestant, and (2) limit discovery.

Fee shifting would deter casual use of the probable cause hearing as a way of testing the merits of a weak case.

Limited discovery rights would prevent a contestant from using the probable cause hearing as a fishing expedition. The contestant would need to evaluate the merits of a contemplated contest based on what is known at the outset, and could not simply file a weak contest and hope that something favorable turns up in discovery.

There are existing models for this approach. For example, the "anti-SLAPP" statute provides a procedure that a defendant may use to strike a claim that is "brought primarily to chill the valid exercise of the constitutional rights of freedom of speech and petition for the redress of grievances." Code Civ. Proc. § 425.16(a). Once the defendant establishes that the underlying lawsuit arises from the defendant's constitutionally protected speech in connection with a public issue, the burden shifts to the plaintiff to prove "that there is a probability that the plaintiff will prevail on the claim." Code Civ. Proc. § 425.16(b). If the plaintiff fails to meet that burden, the underlying claim is struck and the plaintiff must pay the defendant's fees and costs. Code Civ. Proc. § 425.16(c). The determination is made based on the pleadings and supporting affidavits. Discovery is stayed during the anti-SLAPP process, unless the court, on a noticed motion and for good cause shown, orders specific discovery. Code Civ. Proc. § 425.16(g).

Another example is the procedure for requesting a temporary restraining order and preliminary injunction. For the injunction to issue, the moving party must show a reasonable probability of success on the merits. See R. Weil & I. Brown, Jr., California Practice Guide: Civil Procedure Before Trial, *Provisional Remedies* § 9:528 (2006). That determination is made based on the pleadings and any supporting affidavits or declarations. *Id.* at § 9:574. Discovery is unavailable when considering a temporary restraining order, but may be possible in the interval between issuance of a TRO and the hearing on the preliminary injunction, provided that the court agrees to shorten the relevant time periods. *Id.* at §§ 9:581-584.

In summary, there are existing models that could be adapted to provide a pre-trial probable cause hearing procedure. Fee shifting could be included to deter casual use. Limitations on discovery would minimize privacy invasion and prevent the process from being used as a fishing expedition.

Forfeiture Limited to Direct Contests

A large part of the complexity of existing law derives from the fact that the definition of "contest" is open-ended. It encompasses any type of court challenge to an estate plan. See Section 21300(a) ("'Contest' means any action identified in a 'no contest clause' as a violation of the clause."). That catch-all approach is then restrained by a lengthy list of exceptions. See Section 21305. It seems likely that new exceptions will be added over time, as new problems crop up in practice and in the courts.

The "catch-all, with exceptions" approach is complex and creates many points of potential ambiguity and dispute.

A much simpler approach would be to provide an exclusive list of the types of contests that are subject to a no contest clause. A list of exceptions would not be needed. The complexity of the statute would be significantly reduced and there would be far fewer substantive rules to construe and apply.

The existing distinction between a "direct" and "indirect" contest presents a possible basis for distinguishing which types of actions should be subject to a no contest clause. Section 21300(b)-(c) provides:

> (b) "Direct contest" in an instrument or in this chapter means a pleading in a proceeding in any court alleging the invalidity of an instrument or one or more of its terms based on one or more of the following grounds:
> (1) Revocation.
> (2) Lack of capacity.
> (3) Fraud.
> (4) Misrepresentation.
> (5) Menace.
> (6) Duress.
> (7) Undue influence.
> (8) Mistake.
> (9) Lack of due execution.
> (10) Forgery.
> (c) "Indirect contest" means a pleading in a proceeding in any court that indirectly challenges the validity of an instrument or one or more of its terms based on any other ground not contained in subdivision (b), and that does not contain any of those grounds.

A direct contest is an attack on the validity of an instrument, in an attempt to defeat it. It serves no other purpose. Those are the sorts of contests that have traditionally been the main target of a no contest clause. Note that the list of

direct contests should probably also include a contest based on Section 21350 (disqualified beneficiaries).

An indirect contest leaves an estate plan mostly in place, but may circumvent it in some way. For example, an heir may submit a creditor claim against the estate, thereby claiming both a gift under the plan and some other portion of estate assets (to satisfy the alleged debt).

An indirect contest serves a purpose other than defeating an instrument. It may be brought to vindicate an heir's independent property rights, over which the transferor has no legitimate claim of control. Or it may be brought to better effectuate the transferor's actual intentions, by construing an ambiguous instrument or overseeing estate administration. Those are the sorts of actions that serve public purposes and that a transferor should arguably not be able to deter.

What's more, the Legislature has already provided exceptions for most types of indirect contest. See Section 21305. It would not be a huge leap to extend that principle and provide that all indirect contests are exempt.

Note, however, that the exemption of all indirect contests would preclude the application of a no contest clause to two types of contests that may be subject to a no contest clause under existing law: a creditor claim and a property characterization dispute. See Section 21305(a). That would prevent the use of a no contest clause to force an heir to choose between taking a gift under the estate plan or pursuing an independent claim against estate assets.

That change in the law may be good policy. The California Judges Association reports that marital elections fall most often on elderly women, with problematic results. The surviving wife may be forced to choose between two undesirable results (e.g., either the transfer of all of her community property to a trust or forfeiture of any inheritance). The implication is that the harm caused by the use of forced election often outweighs the benefit. See Second Supplement to CLRC Memorandum 2006-42, at 2.

Limiting application of a no contest clause to a direct contest would, by itself, promote two of our objectives: (1) exemption of contests that should not be deterred as a matter of policy, and (2) simplification of the law. It would do nothing to allow a meritorious contest to proceed without forfeiture.

However, the proposed limitation could be combined with a probable cause exception. **That would accomplish all of our objectives.**

Fee Deterrent

The Executive Committee of the Trusts and Estates Section of the State Bar ("ExComm") proposes using fee shifting as a litigation deterrent. Forfeiture would be eliminated.

One advantage of that approach is that it would affect a person who is not an heir. Forfeiture only has a deterrent effect if there is a gift to forfeit. That means that a transferor who wishes to avoid litigation must make a significant gift to each potential contestant, even if the transferor would rather disinherit that person. That would not be necessary if the deterrent were based on fee shifting rather than forfeiture.

There will be cases in which fee shifting is ineffective as a deterrent. If the amount at stake in the contest is sufficiently large, then the risk of paying the other party's costs may be seen as the necessary cost of pursuing a larger prize. For example, a widow leaves $500,000 to her only child and $2,000,000 to an unrelated friend. If the son invalidates the donative instrument, then the estate passes through intestacy. The child takes the total $2.5 million. In that case, the son might well conclude that the risk of paying fees is worth the chance of gaining an additional $2 million.

On the other hand, there will also be cases in which fee shifting is a more effective deterrent than forfeiture: where the amount to be gained from a successful contest is relatively low compared to the cost of litigation.

Note that ExComm's proposal is a combination of the three reforms described above: a **fee shifting** deterrent that is only triggered if a **direct contest** is brought **without reasonable cause**. See CLRC Memorandum 2006-42 at 33. Note also that ExComm's proposal would apply fee shifting to any direct contest, regardless of whether the challenged instrument is governed by a no contest clause. That would take the decision of whether to impose a deterrent out of the hands of the transferor.

Repeal Declaratory Relief

One of the apparent problems with existing law is the cost and delay associated with the existing declaratory relief procedure. Prudent attorneys advise their clients to obtain declaratory relief in any case where there is a risk of forfeiture under a no contest clause. That risk is exacerbated by the complexity of the law, which may make it difficult to determine whether a statutory exception applies in a particular case. As new evidence develops in a contest, the basis of

the contest may change, and it may be prudent to seek further declaratory relief based on the new facts. All of this adds procedural costs and delay.

An obvious way to reduce that cost and delay would be to eliminate the declaratory relief procedure entirely. However, the procedure is used because it is useful. It provides a safe harbor against forfeiture in cases where the no contest clause or the law is unclear in its application. **The Commission should not take that source of clarity away unless other changes are made to the law that obviate the need for clarification.** The extent to which other reforms would allow for repeal of the declaratory relief procedure is discussed below.

Probable Cause Exception

A probable cause exception would not eliminate the need for declaratory relief. There could still be uncertainty as to whether a particular action violates a no contest clause and whether a statutory exception applies.

However, if a contestant is relatively confident that probable cause exists to pursue the contest, then it would not matter whether a no contest clause applies to the contest; the probable cause exception would itself prevent forfeiture. Only in those cases where probable cause is uncertain or absent would the application of the no contest clause need to be known with certainty.

Indirect Contest Exemption

A rule limiting the application of a no contest clause to a direct contest would largely eliminate the need for declaratory relief. If a no contest clause is limited to an action alleging a defect in execution, incapacity, forgery, fraud, undue influence, or a disqualified beneficiary, there should not be any ambiguity about whether the action constitutes a contest. The declaratory relief procedure would not be needed.

Simplify Exceptions

If the Commission decides against exempting all indirect contests from the application of a no contest clause, then the exceptions provided in Section 21305 should be preserved. However, the prospectivity provisions of that section could be simplified.

It would also be advisable to generalize the existing provision that addresses an attempt to disguise a direct contest as one of the exempt classes of indirect contest. See Section 21305(e). Though that provision is sound in concept, it should be broadened.

These changes would make the statute easier to understand and apply.

RECOMMENDATION

The staff recommends that the Commission develop a combination of two reforms: a probable cause exception and a provision exempting all indirect contests from the application of a no contest clause. This would preserve the transferor's intention to limit contest litigation, while allowing a contest to proceed where there is good reason to believe it has merit.

Those reforms should make it possible to eliminate the declaratory relief procedure and the existing set of special limitations and exemptions. That would make the law significantly simpler and easier to apply.

The staff has no recommendation on whether the probable cause determination should be made at the beginning or end of trial. However, if the Commission decides to develop a pre-trial hearing procedure, the staff recommends that it include fee shifting and discovery limitations.

The staff is not inclined to replace forfeiture with fee shifting. While there would be an advantage to having a deterrent that affects non-heirs, it is not clear that fees and costs would be enough of a deterrent in large estates, where contest litigation may be more likely to occur. Note that it would be possible to combine forfeiture and fee shifting. That would hit heirs particularly hard, but would also have an effect on non-heirs.

Once the Commission has decided on an approach, the staff will prepare a draft of a tentative recommendation for review at a future meeting.

Respectfully submitted,

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