TRUSTS & ESTATES SECTION

THE STATE BAR OF CALIFORNIA

POWERS OF APPOINTMENT

LEGISLATIVE PROPOSAL (T&E-2016-05)

TO: Office of Governmental Affairs

FROM: Jeff G. Carchidi and Julie Miraglia Kwon, Members of the Executive Committee, Trusts and Estates Section

DATE: June 13, 2015

RE: A proposal to add Probate Code Sections 675 (Selective Allocation Doctrine) and 676 (Taker in Default of Exercise of Power of Appointment), and to amend Probate Code Sections 610 defining "power of appointment," and 681 and 683, relating to the rights of creditors in property subject to a power of appointment.

SECTION ACTION AND CONTACTS

Date of Approval by Section Executive Committee: June 13, 2015
Approval Vote: Aye 21, No 0, Abstain 4

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PURPOSE

Part 14 of Division 2 of the California Probate Code ("CPC") (§§ 600-695) addresses powers of appointment and supplements existing California common law regarding powers of appointment. In the course of reviewing the Uniform Powers of Appointment Act ("UPOAA") recently approved by the Uniform Law Commission (not adopted in California), members of the Estate Planning Subcommittee of the Executive Committee of the State Bar of California Trusts and Estates Section identified certain deficiencies in the CPC provisions regarding powers of appointment and has concluded that the enactment of certain provisions of the UPOAA in would improve California law in this area.

This proposal has the following objectives:

(1) To define the term "power of appointment," consistent with the definition contained in the UPOAA. At present, that term is not defined in the CPC.

(2) To codify the doctrine of selective allocation.

(3) To provide guidance regarding the disposition of unappointed property in the case of partial exercise of a power of appointment ("taker in default").

(4) To clarify the rights of creditors to reach property subject to a general power of appointment held by the debtor.

(5) To clarify the rights of creditors to reach property subject to a special power of appointment held by the debtor.

PROPOSAL AND REASONS FOR PROPOSAL

1. Definition of "Power of Appointment"

For purposes of Part 14 of Division 2 of the CPC, the definitional provisions are contained in CPC § 610. However, noticeably absent from these provisions is any definition of the term "power of appointment." Therefore, we propose amending CPC § 610 to add a subdivision (g) containing the same definition of power of appointment that appears in the UPOAA, as follows:

> "(g) Power of appointment" means a power that enables a powerholder acting in a nonfiduciary capacity to designate a recipient of an ownership interest in or another power of appointment over the appointive property. The term does not include a power of attorney."

2. Doctrine of Selective Allocation

The CPC currently does not address the doctrine of selective allocation. This doctrine is helpful when the powerholder disposes of property to permissible and impermissible appointees. Allocation of the powerholder's own assets to impermissible appointees and of appointive assets to permissible appointees maximizes the effectiveness of appointment. This allocation typically reflects the powerholder's actual original intention in exercising the power of appointment. The

application of selective allocation is always one that the powerholder could have provided for in specific language, but likely failed to provide for due to oversight or errors in drafting the exercise of the power of appointment. Selective allocation allows courts to facilitate the intended dispositive plan that was frustrated by the powerholder's (or powerholder's attorney's) ignorance or poor drafting.

Example (from ULC comments): D died, leaving a will that devised property worth $100,000 to T in trust. T is directed to pay the net income to S (Donor's son) for life and then "to pay the principal to S's descendants as S shall by will appoint, and in default of appointment to pay the principal by representation to S's descendants then living, and if no descendant of S is then living, to pay the principal to X-Charity." S dies. The property over which S has the nongeneral power is worth $200,000 at his death. S's owned property at his death is worth $800,000. S's will provides as follows: "All property I own or over which I have any power of appointment shall be used first to pay my debts, expenses of administration, and death taxes, and the balance I give outright to my daughters." S's debts plus the death taxes payable on S's death plus the expenses of administering S's estate total $200,000. If S's owned property is allocated ratably to the payment of such $200,000, one-fifth of the $200,000 would be an ineffective appointment, because it would be to impermissible appointees. That one-fifth of $200,000 ($40,000 of the appointive assets) would pass in default of appointment, and the owned property would have to pick up the full payment of the debts, taxes, and expenses of administration. A selective allocation in the first instance of owned assets to the payment of debts, taxes, and expenses of administration leaves the appointive assets appointed only to permissible appointees of the nongeneral power and nothing passes in default of appointment.

In view of the above, we recommend adding Section 675 to the CPC in order to codify the doctrine of selective allocation which is helpful when powerholder disposes of property to permissible and impermissible appointees. This doctrine allocates owned assets to impermissible appointees and appointive assets to permissible appointees to maximize effectiveness of appointment. See UPOAA § 308. The text of proposed CPC § 675 is as follows:

> "**§ 675. Selective Allocation.** If a powerholder exercises a power of appointment in a disposition that also disposes of property the powerholder owns, the owned property and the appointive property must be allocated in the permissible manner that best carries out the powerholder's intent."

3. Disposition of Unappointed Property if Partial Appointment to Taker in Default

The CPC currently does not address the issue of the ability of a taker in default to share in unappointed property after operation of a partial appointment to that taker. If a powerholder makes a valid partial appointment to a taker in default, leaving some property unappointed, it may be unclear whether that taker in default also may receive a share of the unappointed property. The donor's intent always controls but if the donor's intent is not clear, this statute reflects the assumption that the donor intended for the taker to share fully in any unappointed property, even if the powerholder partially exercises a power of appointment in favor of that taker. As a result, the powerholder is free to exercise the power in favor of a taker in default who is a permissible appointee. This rule assumes that the powerholder does not intend to affect in any way the disposition of any unappointed property, unless the powerholder demonstrates a contrary intent in the exercise of the power. The donor can override this default rule by demonstrating a contrary intent in the terms creating the power of appointment, and restricting

the powerholder's freedom to benefit an appointee who is also a taker in default.

Example: D died, leaving a will that devised property worth $100,000 to T in the XYZ Trust for the benefit of S (Donor's son) for life and then "to pay the principal to S's descendants as S shall by will appoint, and in default of appointment to pay the principal by representation to S's descendants then living, and if no descendant of S is then living, to pay the principal to X-Charity." S dies. S's will provides as follows: "I exercise my power of appointment over the XYZ Trust by directing that 25% of the trust property of the XYZ Trust shall be distributed outright to my daughter, D." S partially exercised his power of appointment to give 25% of the XYZ Trust to D. This proposed statute would clarify that D also shares in the distribution of the unappointed 75% balance of XYZ Trust along with S's other living descendants, and that the partial appointment of 25% to D does not preclude her from sharing in that 75% distribution.

In view of the above, we recommend adding Section 676 to the CPC in order to address disposition of unappointed property where the powerholder partially appoints property to the taker in default. This resolves questions of whether the taker in default also may fully share in unappointed property. See UPOAA § 312 reflecting assumption that powerholder does not intend to affect disposition of unappointed property unless manifesting contrary intent. The text of proposed CPC § 676 is as follows:

> "**§ 676. Takers in Default.** Unless the terms of the instrument creating or exercising a power of appointment manifest a contrary intent, if the powerholder makes a valid partial appointment to a taker in default of appointment, the taker in default of appointment may share fully in unappointed property."

4. Creditors' Rights – Property Subject to General Power of Appointment Held by the Debtor

CPC § 683 currently provides that property subject to an unexercised general power of appointment created by and exercisable by the powerholder is subject to the claims of creditors of the powerholder or his/her estate, and to the expenses of administration of the powerholder's estate. By limiting the scope to an "unexercised" general power of appointment, CPC § 683, as presently drafted, leaves open the possibility that a powerholder may "exercise" a general power of appointment in anticipation of possible creditor action against the powerholder, but then later revoke the exercise of the power. While a court may void such an "exercise" of a power of appointment as a fraudulent transfer, we believe the better approach is to have § 683 apply to all general powers of appointment unless the power has already been irrevocably exercised in favor of a third party. Thus, we recommend that CPC § 683 be amended as follows:

> "**§ 683. Property subject to ~~unexercised~~ general power of appointment created by ~~donor~~ powerholder in ~~donor's~~ powerholder's favor.** Property subject to a~~n~~ ~~unexercised~~ a general power of appointment created by the ~~donor~~ powerholder in the ~~donor's~~ powerholder's favor, whether or not presently exercisable, is subject to the claims of the ~~donor's~~ powerholder's creditors or the ~~donor's~~ powerholder's estate and to the expenses of administration of the ~~donor's~~ powerholder's estate, except to the extent the powerholder effectively irrevocably appointed the property subject to the general power of appointment in favor of a person other than the powerholder or the powerholder's estate."

5. Creditors' Rights – Property Subject to Special Power of Appointment Held by the Debtor

Under California law, a power of appointment is "general" only to the extent that it is exercisable in favor of the powerholder, the powerholder's estate the powerholder's creditors or creditors of the powerholder's estate, regardless of whether the power is also exercisable in favor of others. (CPC § 611(a)). Any "power of appointment that is not 'general' is 'special'" (CPC § 611(d)). While this bright-line definition is helpful to drafters for estate tax purposes, in the creditor rights context, coupling this definition with the "black and white" rule of CPC § 681 makes it easier for creative debtors to engage in effective (fraudulent) creditor avoidance planning.

UPOAA § 504 identifies two circumstances where a creditor may reach property subject to a special power. The first of these is where the powerholder transfers property in violation of applicable state fraudulent transfers laws, and reserves to himself or herself a special power of appointment. The second circumstance is where the initial gift in default of the exercise of the special power of appointment is to the powerholder or the powerholder's estate (treats the special power of appointment as a general power for creditors' rights purposes).

We recommend that these two exceptions be incorporated into amended CPC § 681, which would read as follows:

"**§ 681. Property covered by special power of appointment**

(a) Except as provided in subdivision (b), property covered by a special power of appointment is not subject to the claims of creditors of the ~~donee~~ powerholder or of the ~~donee's~~ powerholder's estate or the expenses of administration of the ~~donee's~~ powerholder's estate.

(b) Notwithstanding subdivision (a) above, property subject to a special power of appointment shall be subject to the claims of creditors of the powerholder or of the powerholder's estate or the expenses of administration of the powerholder's estate (i) to the extent that the powerholder owned the property and, reserving the special power, transferred the property in violation of the California Fraudulent Transfers Act; or (ii) if the initial gift in default of the exercise of the power is to the powerholder or the powerholder's estate.

HISTORY:

The Trusts and Estates Section Executive Committee is not aware of any similar bill that has been introduced.

IMPACT ON PENDING LITIGATION:

None known.

LIKELY SUPPORT AND OPPOSITION:

Creditor's rights organizations are likely to support the proposals to amend CPC §§ 681 and 683 as such proposals would make it more difficult for debtors to use powers of appointment in an attempt to avoid creditors. The provisions of this proposal regarding takers in default, the selective allocation doctrine, and the addition of a definition of "power of appointment" are

likely to be supported by trusts and estates practitioners because those provisions clarify California law and provide statutory guidance to practitioners in this area.

FISCAL IMPACT:

There is no anticipated fiscal impact.

GERMANENESS:

The members of the Trusts and Estates Section Executive Committee have an interest in and expertise concerning these issues in that, particularly in the course of the administration of trusts, they frequently advise clients in deciding whether, when and how to exercise or not exercise general and special powers of appointment.

DISCLAIMER:

This position is only that of the Trusts and Estates Section of the State Bar of California. This position has not been adopted by either the State Bar's Board of Trustees or overall membership, and is not to be construed as representing the position of the State Bar of California.

Membership in the Trusts and Estates Section is voluntary and funding for section activities, including all legislative activities, is obtained entirely from voluntary sources.

TEXT OF PROPOSAL:

SECTION 1. Section 610 of the Probate Code is amended to read:

As used in this part:

(a) "Appointee" means the person in whose favor a power of appointment is exercised.

(b) "Appointive property" means the property or interest in property that is the subject of the power of appointment.

(c) "Creating instrument" means the deed, will, trust, or other writing or document that creates or reserves the power of appointment.

(d) "Donee" means the person to whom a power of appointment is given or in whose favor a power of appointment is reserved.

(e) "Donor" means the person who creates or reserves a power of appointment.

(f) "Permissible appointee" means a person in whose favor a power of appointment can be exercised.

(g) "Power of appointment" means a power that enables a powerholder acting in a nonfiduciary capacity to designate a recipient of an ownership interest in or another power of appointment over the appointive property. The term does not include a power of attorney.

SEC. 2. Section 675 is added to the Probate Code, to read:

675. Selective Allocation. If a powerholder exercises a power of appointment in a disposition that also disposes of property the powerholder owns, the owned property and the appointive property must be allocated in the permissible manner that best carries out the powerholder's intent."

SEC. 3. Section 676 is added to the Probate Code, to read:

676. Takers in Default. Unless the terms of the instrument creating or exercising a power of appointment manifest a contrary intent, if the powerholder makes a valid partial appointment to a taker in default of appointment, the taker in default of appointment may share fully in unappointed property.

SEC. 4. Section 681 of the Probate Code is amended to read:

681. Property covered by special power of appointment

(a) Except as provided in subdivision (b), property covered by a special power of appointment is not subject to the claims of creditors of the ~~donee~~powerholder or of the ~~donee's~~ powerholder's estate or the expenses of administration of the ~~donee's~~powerholder's estate.

(b) Notwithstanding subdivision (a) above, property subject to a special power of appointment shall be subject to the claims of creditors of the powerholder or of the powerholder's estate or the expenses of administration of the powerholder's estate (i) to the extent that the powerholder owned the property and, reserving the special power, transferred the property in violation of the California Fraudulent Transfers Act; or (ii) if the initial gift in default of the exercise of the power is to the powerholder or the powerholder's estate.

SEC. 5. Section 683 of the Probate Code is amended to read:

683. Property subject to ~~unexercised~~ general power of appointment created by ~~donor~~ powerholder in ~~donor's~~powerholder's favor. Property subject to ~~an unexercised~~ a general power of appointment created by the ~~donor~~ powerholder in the ~~donor's~~ powerholder's favor, whether or not presently exercisable, is subject to the claims of the ~~donor's~~ powerholder's creditors or the ~~donor's~~ powerholder's estate and to the expenses of administration of the ~~donor's~~ powerholder's estate, except to the extent the powerholder effectively irrevocably appointed the property subject to the general power of appointment in favor of a person other than the powerholder or the powerholder's estate.