



TRUSTS & ESTATES SECTION

THE STATE BAR OF CALIFORNIA

LEGISLATIVE PROPOSAL (T&E-2006-06): INCAPACITY: GUARDIANSHIP AND CONSERVATORSHIP INVESTMENT STANDARDS

TO: State Bar Office of Governmental Affairs

FROM: Peter S. Stern, Co-Chair, Trusts and Estates Section Incapacity Subcommittee

Date: February 12, 2005

RE: Legislative Proposal: Revision of Guardianship and Conservatorship Investment Standards, Probate Code §§2570-75

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Date of Approval by Section Executive Committee: 2/12/05 , by unanimous vote.
Date of Approval by Incapacity Subcommittee: 2/7/05, by unanimous vote.

DIGEST:

California's present legislation governing investment of conservatorship assets has not been changed to reflect the current trends in investing by individuals and by corporate fiduciaries. The present law, at Probate Code §§ 2570-2574, has been unchanged since the recodification of the Probate Code in 1990 (Stats. 1990, ch. 79, AB 759) and does not permit investment in securities listed on Nasdaq or in mutual funds without a prior court order. The current law is often disregarded by fiduciaries, and it is not well understood even by attorneys. The Uniform Prudent Investor Act (Probate Code §§16045-16054), which establishes standards and principles that govern investments by trustees, was adopted in 1995. Guardians and conservators also need investment standards and principles, and where it is prudent to do so, they should have investment guidelines that allow them to invest in a wide variety of common alternatives without the need to obtain prior court approval. The present law is self-contradictory, as it

requires prior court approval before investing in certain classes of debt instruments but permits investments in the same and similar securities without court order by authorizing investments that are listed in Government Code Section 16430.

PURPOSE:

1. This proposal establishes flexible standards for investment principles for guardians and conservators.

The current law provides the guardian or conservator with only general direction and states that the fiduciary must consider the circumstances of the estate, indicated cash needs, and date of termination of the guardianship or conservatorship. Probate Code § 2574(b). There are no principles set forth that will guide fiduciary's choice of investments. All guardians and conservators are of course bound by the standards of Probate Code Sect. 2401 ("The [fiduciary] . . . shall use ordinary care and diligence. What constitutes ordinary care and diligence is determined by the circumstances of the particular estate.") This proposal states that the guardian's or conservator's duty is to preserve the estate, but it also allows the fiduciary to apply the standards of the Uniform Prudent Investor Act and expose the estate to modest risk in order to achieve greater investment return. The proposal also makes it clear that the interests of the conservatee or ward should generally be the fiduciary's exclusive focus, and indicates when the needs of persons other than the conservatee may be considered

2. The proposal explicitly permits co-ownership of assets, with court approval, including assets other than real property.

The present law permits co-ownership of real property by the conservatorship estate and a third party. This restriction to real property is unreasonably narrow. The proposal would authorize co-ownership of other investment assets.

3. The proposal expands the list of investments permitted without prior court order to most commonly marketed securities, removes the requirement that equities be purchased through a stock exchange, eliminates obsolete investments, and explicitly permits purchase of mutual funds.

The present list of investments that are permitted without court order under Probate Code section 2574 is overly restrictive. Section 2574 restricts investment in government securities, requires purchase of securities on stock exchanges (and thus does not permit investments in nontraditional markets such as Nasdaq) and does not authorize the purchase of mutual funds. It permits investments in flower bonds, which are no longer available. And it incongruously permits investment in any securities authorized under Government Code section 16430 without prior court order, which would permit purchase of municipal bonds without regard to quality, duration, or interest rate. The proposal would eliminate these flaws in the present list.

4. The proposal allows the use of well established hedging techniques to reduce investment risk.

The current law does not provide a guardian or conservator who assumes management of an estate with the appropriate tools to manage investment risk. A fiduciary who holds highly appreciated securities may determine that it is unreasonably risky to continue to hold the securities. However, the conservator or guardian may be reluctant to sell the securities, since the sale might generate substantial income tax liability. Or, the fiduciary may hold a stock that pays a very high dividend, but that might experience significant price decline. If the fiduciary sells the stock to reduce the risk of price decline, the dividend will also be lost. A put option would allow the fiduciary to retain the securities, while eliminating the risk of price decline. The fiduciary may also want to sell or “write” call options on securities owned in the estate (commonly referred to as covered calls.) The premiums collected by writing covered calls provides additional income to the estate. When one writes a covered call on a security, the upside participation in the underlying security is limited to the exercise or “strike” price since the option will likely be exercised if the security appreciates beyond the strike price. In such case, there is no loss to the estate since the fiduciary will sell the underlying security to the option holder at the strike price. A fiduciary may only write a call option when the estate owns the underlying security (i.e. the call is covered.) Covered calls are also commonly used in conjunction with put options for securities positions so that the premium collected on the call offsets the cost of the premium on the put. This strategy (commonly referred to as a zero premium collar) allows the fiduciary to obtain protection against a drop in the price of the security in exchange for appreciation above the strike price of the call at no cost to the estate. Covered call options and puts are commonly used in the investment community to reduce investment risk. Under current law, the fiduciary must first obtain court permission before using these well established hedging techniques. The proposal permits the use of covered call options and puts, not to exceed the estate’s holdings in the underlying security, as a protection against investment risk.

5. The proposal incorporates language from the accounting statute (Probate Code §1064(a)(5)) and requires that the fiduciary keep cash in interest bearing accounts or other investments permitted by law other than what is necessary for the orderly administration of the estate. The proposal also requires the fiduciary to submit an investment plan to the court at the time of each accounting.

There should be clear guidelines for the fiduciary and counsel regarding the need to invest in interest bearing accounts. The requirement that the investment plan be submitted to the court with the accounting provides an opportunity for the court to review the plan and note any discrepancies with the law. There are no such requirements in current law.

ILLUSTRATIONS:

It is all too common in conservatorships or guardianships for fiduciaries to purchase mutual funds without court order, and be forced to seek retroactive court approval for their actions.

Many of the most frequently used investments for fiduciary accounts, such as Nasdaq securities, municipal bonds, federal and state debt for terms of longer than five years, and mutual funds are not available for investment under current law without a prior court order, and many times the fiduciaries and their brokers do not know the law--or choose to ignore it--when investing for conservatorship or guardianship estates. These practices lead to embarrassing court hearings, disapproval of accountings by court staff and unnecessary petitions for what otherwise would be commonsense investing under modern principles of portfolio diversification. Further, with no governing principles set forth in the investment statute, fiduciaries are often uninformed when deciding what to do with the investments and cash they assume responsibility for at the commencement of a guardianship or conservatorship. Most counsel in this field are familiar with the Uniform Prudent Investor Act, and this proposal's reference to that Act gives counsel the tools to establish guidelines for their clients, who can then evaluate a portfolio in the context of the needs of the ward or conservatee and decide whether it is more prudent to preserve the assets under their control or accept some risk in exchange for potential growth. When a fiduciary becomes responsible for a portfolio containing highly appreciated stock, or a stock that produces excellent dividend income but has substantial market risk, the proposal allows the fiduciary to utilize covered calls and puts in order to protect the existing investment, and thus limit risk while retaining a valued asset in the portfolio for possible step-up in basis or continued receipt of dividends.

DOCUMENTATION:

The authors of this proposal are not aware of studies of investment patterns in conservatorships and guardianships. These proposals come from the experiences of the authors in advising fiduciaries over the quarter century since adoption of the present conservatorship statute.

HISTORY:

No other proposals are known.

PENDING LITIGATION:

None known.

LIKELY SUPPORT/OPPOSITION:

The authors expect most professional fiduciaries and trust companies to support the proposed legislation, which will expand investment possibilities and permit the use of investment instruments not presently permitted without court order. Attorneys who represent family-member conservators and guardians are also likely to support this proposal, since it provides clearer guidelines than existing law and permits investments that their clients would make in any case, absent instruction from counsel. There may be some who oppose the proposal, either client advocates who fear that the proposal gives too much leeway to fiduciaries, or courts that have witnessed gross mismanagement of investments when fiduciaries have been allowed to operate without court scrutiny.

FISCAL IMPACT:

The authors foresee negligible fiscal impact from the proposed legislation. Any additional court staff time incurred in reviewing investment plans to be submitted as part of required accountings would be offset by reduction of staff time to review petitions seeking approval of what will become routine investments.

GERMANENESS:

This bill relates to the practice of conservatorship and guardianship law, and the State Bar's Trusts and Estates Section Executive Committee is experienced with the administration of conservatorships and guardianships. The working group for this project has included two experienced trust company attorneys with substantial background in fiduciary investments.

TEXT OF PROPOSED LEGISLATION:

SECTION 1. Section 2570 of the Probate Code is amended to read:

2570. ~~(a) The guardian or conservator, after authorization by order of the court, may invest the proceeds of sales and any other money of the estate as provided in the order. (b) To obtain an order of the court authorizing a transaction under subdivision (a) of this section, the guardian or conservator, ward or conservatee, or any other interested person may file a petition with the court.~~

~~(c) Notice of the hearing on the petition shall be given for the period and in the manner provided in Chapter 3 (commencing with Section 1460) of Part 1. The court may order that the notice be dispensed with.~~

~~(d) The court may require such proof of the fairness and feasibility of the transaction as the court determines is necessary.~~

~~(e) If the required showing is made, the court may make an order authorizing the transaction and may prescribe in the order the terms and conditions upon which the transaction shall be made.~~

Except as otherwise provided by statute, a guardian or conservator may make investments with income and assets of the estate of the ward or conservator only after authorization by order of the court. Such an order may be obtained in the manner provided in Section 2575.¹

SEC. 2. Section 2570.5 is added to the Probate Code, to read:

2570.5. (a) A guardian of the estate shall manage estate investments solely for the benefit of the minor without consideration for the interests of any other person. Except as hereinafter provided, or unless otherwise directed by the court, the guardian may manage the estate primarily to preserve the estate, or, applying relevant principles of the Uniform Prudent Investor Act as set forth in Part 4 of Division 9, commencing with section 16045, may seek a greater investment return generally consistent with a moderate risk of loss to the estate.

(b) A conservator of the estate shall generally manage estate investments solely for the benefit of the conservatee without consideration for the interests of any other person. The interests of other persons may be considered if the reasonably foreseeable needs of the

¹ Comment: Derived from Probate Code Sec.2550.

conservatee will not exceed the amount of the estate, considering from time to time the size of the conservatee's estate, state of health, and life expectancy. Except as hereinafter provided, or unless otherwise directed by the court, the conservator may manage the estate primarily to preserve the estate, or, applying relevant principles of the Uniform Prudent Investor Act as set forth in Part 4 of Division 9, commencing with section 16045, may seek a greater investment return generally consistent with a moderate risk of loss to the estate.

(c) A guardian or conservator of the estate shall file, with each accounting, a statement of the guardian's or conservator's investment goals and objectives during the period of the account, and currently.

(d) In making and retaining investments made under this section, the guardian or conservator shall take into consideration the circumstances of the estate, indicated cash needs, and, if reasonably ascertainable, the date of the prospective termination of the guardianship or conservatorship.

SEC. 3. Section 2571 of the Probate Code is amended to read:

2571. When authorized by order of the court under Section ~~2570~~ 2575, the guardian or conservator may purchase:

(a) Real property in this state as a home for the ward or conservatee if such purchase is for the advantage, benefit, and best interest of the ward or conservatee.

(b) Real property as a home for those legally entitled to support and maintenance from the ward or conservatee if such purchase is for the advantage, benefit, and best interest of the ward or conservatee and of those legally entitled to support and maintenance from the ward or conservatee.

SEC. 4. Section 2572 of the Probate Code is amended to read:

2572. An order authorizing the guardian or conservator to ~~purchase real property~~ make an investment, including a purchase of real property, may authorize the guardian or conservator to join with the spouse of the ward or the spouse or domestic partner of the conservatee or with any other person or persons in the purchase of the real property or other investment, or an interest, equity, or estate therein, in co-ownership severalty, in common, in community, or in joint tenancy, for cash or ~~upon a~~ for credit, or for part cash and part credit. When the court authorizes the purchase of real property, the court may order the guardian or conservator to execute all necessary instruments and commitments to complete the transaction.²

SEC. 5. Section 2573 of the Probate Code is amended to read:

~~2573. An order authorizing investment in bonds issued by any state or of any city, county, city and county, political subdivision, public corporation, district, or special district of any state may authorize the guardian or conservator to select from among bonds issued by any such issuer, without specifying any particular issuer or issue of bonds, if the type of issuer is designated in general terms and the order specifies as to such bonds a minimum quality rating as shown in a recognized investment service, a minimum interest coupon rate, a minimum yield to maturity, and the date of maturity within a five year range.~~

² (Comment: The section is intended to permit co-ownership. Although most investment assets purchased by a conservator or guardian would be held in the name of the estate only, it was thought that the courts should have discretion to permit co-ownership where it was appropriate. The last sentence of the existing statute was judged to be superfluous.)

(a) ~~Subject to subdivision (b)~~ The guardian or conservator, without authorization of the court, may invest funds of the estate pursuant to this section in:

~~(1) Direct obligations of the United States, or of the State of California, maturing not later than five years from the date of making the investment.~~

~~Any security issued or guaranteed by the United States, or any agency of the United States.~~³

~~(2) United States Treasury bonds redeemable at par value on the death of the holder for payment of federal estate taxes, regardless of maturity date.~~

~~General obligations of the State of California.~~⁴

~~(3) Securities listed on an established stock or bond exchange in the United States which are purchased on such exchange.~~ Investment grade corporate debt securities registered under the Securities Exchange Act of 1933.⁵

~~(4) Eligible securities for the investment of surplus state moneys as provided for in Section 16430 of the Government Code~~ An interest in a mutual fund registered under the Investment Company Act of 1940 (15 U.S.C. Sec. 80a-1, et seq.).⁶

~~(5) An interest in a money market mutual fund registered under the Investment Company act of 1940 (15 U.S.C. Sec. 80a-1, et seq.) or an investment vehicle authorized for the collective investment of trust funds pursuant to Section 9.18 of Part 9 of title 12 of the Code of Federal Regulations, the portfolios of which are limited to United States government obligations maturing not later than five years from the date of investment and to repurchase agreements fully collateralized by United States government obligations~~ Securities listed on the New York Stock Exchange, American Stock Exchange, or Nasdaq.⁷

~~(6) Units of a common trust fund described in Section 1564 of the Financial Code. The common trust fund shall have as its objective investment primarily in short term fixed income obligations and shall be permitted to value investments at cost pursuant to regulations of the appropriate regulatory authority.~~⁸

(7) Any other securities identified in Government Code Section 16430.⁹

³ Comment: There will no longer be a requirement for US obligations to be of short duration.)

⁴ Comment: Flower bonds are no longer available. It was judged desirable to list California debt securities in a separate subsection.

⁵ Comment: Corporate debt purchases of investment grade deemed to be satisfactory investment. See new subsection (5), below, for investment of exchange-listed securities.

⁶ Comment: See below for investment in securities as permitted by Government code Section 16430. This subsection now permits investment in all registered mutual funds.

⁷ Comment: Permits purchase of any security listed on the two exchanges and Nasdaq. Purchase "on the exchange" (see former subsection 3) not required.

⁸ Comment: The common trust fund is a specialized instrument used by trust companies. It was thought unnecessary to limit such trust funds to specific investment objectives.

⁹ Comment: This new subsection incorporates securities listed in GC 16430, including most government issued debt instruments at any level, without regard to maturity date. The list is so exhaustive that the authors did not think it reasonable to attempt to carry it over in full from the Government Code, reasoning that counsel for conservators and guardians will become familiar with the details and will thus be able to advise their clients.

~~(b) In making and retaining investments made under this section, the guardian or conservator shall take into consideration the circumstances of the estate, indicated cash needs, and, if reasonably ascertainable, the date of the prospective termination of the guardianship or conservatorship.~~¹⁰

(b) Guardians and conservators shall be able establish a prudent strategy for risk mitigation and are permitted in effectuating such strategy to use covered call options and put options on long positions of any securities held in the guardianship or conservatorship estate.¹¹

(c) Nothing in this section limits the authority of the guardian or conservator to seek court authorization for any investment, or to make other investments with court authorization, as provided in this division.

SEC. 6. Section 2574 is added to the Probate Code, to read:

2574. The guardian or conservator shall keep all cash invested in interest-bearing accounts or other investments authorized by law, except any amount reasonably necessary for orderly compliance with the guardian's or conservator's duties.¹²

SEC. 7. Section 2575 is added to the Probate Code, to read:

2575. (a) The guardian or conservator, after authorization by order of the court, may invest any money of the estate as provided in the order.

(b) To obtain an order of the court authorizing a transaction under subdivision (a) of this section, the guardian or conservator, ward or conservatee, or any other interested person may file a petition with the court.

(c) Notice of the hearing on the petition shall be given for the period and in the manner provided in Chapter 3 (commencing with Section 1460) of Part 1. The court may order that the notice be dispensed with.

(d) The court may require such proof of the fairness and feasibility of the transaction as the court determines is necessary.

(e) If the required showing is made, the court may make an order authorizing the transaction and may prescribe in the order the terms and conditions upon which the transaction shall be made.¹³

¹⁰ Comment: This text carried over into new Section 2570.5

¹¹ Comment: This new subsection permits fiduciaries to manage risk by using covered call and put options. By providing these opportunities to fiduciaries the proposed law gives much greater flexibility to guardians and conservators who may be faced with such dilemmas as keeping a highly appreciated security that carries great risk or of selling the security and facing substantial capital gains tax consequences.

¹² Comment: This section is new to the investment provisions. It is borrowed from Probate Code Section 1064(a)(5). The authors believe it is prudent to place this section among the investment provisions, where it may have more effect on fiduciary practices during the period of the guardianship or conservatorship accounting rather than at the end of the accounting period, when the fiduciary might become aware of it from the accounting statute.

¹³ Comment: Section 2575 incorporates most of Section 2570. It deletes that section's reference to proceeds of sales, deemed to be superfluous.