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Second Supplement to Memorandum 2019-17

Revocable Transfer on Death Deed — Follow-Up Study: Issues Identified by the Commission

In this study, the Commission[1] is evaluating the revocable transfer on death deed ("RTODD") statute, as directed by the Legislature.[2]

Memorandum 2019-17 discusses two RTODD issues that were identified by the Commission for study. This supplement addresses another, whether property received by a RTODD beneficiary during a bankruptcy proceeding commenced by that beneficiary should be considered part of the bankruptcy estate.

Unless otherwise indicated, all statutory references in the memorandum are to the Probate Code.

SUMMARY OF ISSUE

In 2016, the Commission directed the staff to analyze the following issue:

> The extent to which property transferred by RTODD is part of the bankruptcy estate of a beneficiary who commenced bankruptcy proceedings before the RTODD operated.[3]

That issue is discussed below.

CURRENT APPLICABLE LAW

Federal Bankruptcy Statute

The relevant federal statute provides that commencement of a bankruptcy proceeding creates a bankruptcy "estate" on the part of the debtor, comprised of

1. Any California Law Revision Commission document referred to in this memorandum can be obtained from the Commission. Recent materials can be downloaded from the Commission's website (www.clrc.ca.gov). Other materials can be obtained by contacting the Commission's staff, through the website or otherwise.

The Commission welcomes written comments at any time during its study process. Any comments received will be a part of the public record and may be considered at a public meeting. However, comments that are received less than five business days prior to a Commission meeting may be presented without staff analysis.

2. See 2015 Cal. Stat. ch. 293 (AB 139 (Gatto)); see also 2016 Cal. Stat. ch. 179.

3. *Id*.

several listed categories of property interests.[4] After adjudication of exemptions and other statutory treatment, this estate (unless depleted) will be used to pay creditors and other claimants, as provided by other provisions of the statute.[5]

In general, RTODD property that is acquired by a debtor-beneficiary after commencing a bankruptcy proceeding is potentially includible in a bankruptcy estate — and thus potentially available later on to pay creditors — only if found to fall in one of the following two listed categories of property interests:

> (Category 1) All *legal or equitable interests* of the debtor in property, as of the commencement of the case.[6]
>
> (Category 2) Any interest in property that would have been property of the estate if such interest had been an interest of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date *by bequest, devise, or inheritance*.[7]

Although federal law specifies the categories of property interests that are included in a bankruptcy estate, the question of whether a particular property interest of a debtor falls *within* one of those categories is normally a question of applicable *state* law, absent controlling federal authority to the contrary.[8]

Therefore, a determination of whether RTODD property acquired by a California beneficiary after the commencement of a bankruptcy proceeding is a property interest includible in either of the two categories above requires analysis and application of California state law.

California Law

To date, there appears to be no published decision that has made that determination relating to a California RTODD transfer. However, a relatively straightforward application of California law to the federal statutory language, in particular the language the staff has italicized above, strongly suggests how a

4. See 11 U.S.C. § 541(a).
5. See 11 U.S.C. §§ 726, 1321-1330.
6. See 11 U.S.C. § 541(a)(1) (emphasis added).
7. See 11 U.S.C. § 541(a)(5)(A) (emphasis added). If a debtor files a petition for reorganization under Chapter 11 or 13 of the bankruptcy statute — rather than the more common petition for liquidation under Chapter 7 — the 180 day period is extended until the case is closed, dismissed, or converted to a case under another chapter of the bankruptcy statute. See 11 U.S.C. §§ 1115((a)(1), 1306(a)(1).
8. See Butner v. U.S., 440 U.S. 48, 54-55, 99 S. Ct. 914, 59 L. Ed. 2d 136 (1979), Kosmala v. Cook (In re Cook), 2008 Bankr. LEXIS 4728 (B.A.P. 9th Cir. Nov. 3, 2008), *affirmed by* Kosmala v. Cook (In re Cook), 370 F. App'x 791 (9th Cir. 2010); In re Farmers Markets, Inc., 792 F.2d 1400, 1402 (9th Cir. 1986).

court would answer that question at the present time.[9] As explained below, the staff believes that existing California law would likely compel a court to find that RTODD property acquired by a California beneficiary subsequent to filing a bankruptcy petition would *not* be includible in either of the two categories above, and therefore unavailable to a claimant in the bankruptcy proceeding.

Category 1

The first category of property interests listed above encompasses any "legal or equitable interest" a debtor has in property, *at the time a bankruptcy proceeding is commenced*. However, the scenario addressed by this supplement involves a transfer of RTODD property occurring *after* commencement of the proceeding. Therefore, this first listed category of property interests would only include whatever "legal or equitable interest" an RTODD beneficiary might have in RTODD property before that property is transferred (i.e., while the RTODD transferor is still alive).

And, the California RTODD statute expressly provides:

> During the transferor's life, execution and recordation of a revocable transfer on death deed:
>
> ...
>
> (b) *Does not create any legal or equitable right* in the beneficiary, and the property is not subject to process of the beneficiary's creditors.
>
> (c) *Does not transfer or convey any right, title, or interest* in the property.[10]

Based on this California statutory language, at the time a bankruptcy proceeding is commenced, the hypothetical RTODD beneficiary that is the subject of this supplement would have *no* right, title, or interest in the RTODD property, legal, equitable, or otherwise. Therefore, this beneficiary would have no property interest includible in this first category of property interests.

Category 2

The second category of property interests listed above encompasses property interests acquired by a debtor within 180 days following commencement of a bankruptcy proceeding. This category would therefore seem to include the RTODD property transferred to the hypothetical beneficiary in our scenario, if

9. The staff's research has revealed no federal controlling authority addressing the presented underlying issues.

10. Section 5650 (emphasis added).

the transfer occurred within 180 days after the beneficiary had filed the bankruptcy petition. However, an additional express requirement for any property interest in *this* category is that the interest, or the entitlement to the interest, had to have been conveyed to the beneficiary by "bequest, devise, or inheritance."

What is a "bequest, devise, or inheritance"? None of the terms are defined by applicable federal law. However, under California law, none would appear to include a transfer pursuant to an RTODD.

The term "devise" is defined by the California Probate Code as a disposition of real or personal property "by will."[11] The terms "bequest" and "inheritance" are not defined by a California statute, but an unpublished federal bankruptcy court evaluating the meaning of the terms under California state law — for purposes of construing this federal statute — held that the term "bequest" means a "gift (transfer) by will of personal property," and the term "inheritance" means "property which descends to an heir on the intestate death of another."[12] These definitions are also consistent with those appearing in a leading legal dictionary.[13]

As an RTODD transfer involves neither a disposition by will nor the passing of property via intestacy, property acquired via an RTODD transfer in California would therefore appear to also fall outside this second category of property interests includible in a bankruptcy estate.

To reiterate, under existing California law, it appears that property received by a debtor by RTODD, after the commencement of a bankruptcy proceeding, would not be part of the debtor's bankruptcy estate.

LAW OF OTHER JURISDICTIONS

RTODD Decisions

The staff found three decisions from other jurisdictions addressing whether RTODD property transferred to a debtor following the commencement of a

11. Section 32.

12. Kosmala v. Cook (In re Cook), 2008 Bankr. LEXIS 4728 (B.A.P. 9th Cir. 2008) (considering property transferred post-petition via inter vivos trust). See also Birdsell v. Coumbe (In re Coumbe), 304 B.R. 378, 383-84 (9th Cir. BAP 2003).

13. See Black's Law Dictionary (2nd) ("Bequest" means "[a] gift by will of personal property," and "inheritance" means "[a]n estate in things real, descending to the heir"). See also Section 44 ("Heir" means "any person, including the surviving spouse, who is entitled to take property of the decedent by intestate succession under this code.").

bankruptcy proceeding is includible in that debtor's bankruptcy estate.

In *Jones v. Mullen*,[14] an unpublished bankruptcy court opinion from the Ninth Circuit applying Arizona law, the court held that in a scenario in which RTODD property was transferred to a bankruptcy debtor three days after the debtor had filed for bankruptcy, based on an application of Arizona law the debtor's interest in the property at the commencement of the proceeding was a "legal or equitable interest," and therefore includible in the debtor's bankruptcy estate as a property interest in "Category 1" described above.

The court reached its decision by applying relevant Arizona common law, as the Arizona statute governing RTODDs contained no provision addressing the nature of any interest an RTODD beneficiary has in RTODD property, before the transfer of the property takes place. In particular, the court relied on a 1990 opinion from the Ninth Circuit, *In re Neuton*,[15] which held that the beneficiary of a trust had a sufficient interest in trust property not yet acquired when bankruptcy commenced to be includible in that beneficiary's bankruptcy estate.

However, the court in *Jones v. Mullen* may have made a significant error in characterizing and presumably relying on an understanding that the trust in *In re Neuton* was a *revocable* trust when the bankruptcy proceeding was commenced, and therefore similar to an RTODD. Nothing in the text of the *Neuton* opinion indicates that the trust involved was revocable at that time, and a subsequent opinion from the Ninth Circuit, which held that a mere contingent interest in revocable trust property is *not* properly includible in a bankruptcy estate, found this distinction crucial:

> There is no Ninth Circuit authority determining whether an interest in a revocable inter vivos trust constitutes estate property. In *In re Neuton*, 922 F.2d 1379, 1381 (9th Cir. 1990), the Court of Appeals considered an irrevocable inter vivos trust in which the debtor's interest vested upon the death of the debtor's mother, 46 days after the Chapter 7 petition was filed. Relying on prior Ninth Circuit case law and general trust principles, the Court of Appeals held that the debtor had a contingent interest in the trust income as of the commencement of the bankruptcy case, which became estate property under [the federal bankruptcy statute]. The instant case differs from *Neuton* in that it involves a revocable trust, a difference we find highly significant.[16]

14. Jones v. Mullen (In re Jones), 2014 Bankr. LEXIS 488 (B.A.P. 9th Cir. 2014).
15. In re Neuton, 922 F.2d 1379 (9th Cir. 1990).
16. Burton v. Ulrich (In re Schmitt), 215 B.R. 417, 421 (B.A.P. 9th Cir. 1997).

The decision of the court in *Jones v. Mullen* was also later distinguished by a published opinion from a bankruptcy court in another circuit, *In re Wilmoth*, [17] which was required to apply Missouri law to RTODD property transferred after a bankruptcy filing. The *Wilmoth* court expressly noted that, unlike Arizona law, the Missouri RTODD statute includes a provision that reads: "Prior to the death of an owner, a beneficiary shall have *no* rights in the property by reason of the beneficiary designation…."[18] Relying on this statutory provision (which is quite similar to the California RTODD provision discussed above), the court held that the Missouri RTODD beneficiary had no interest in RTODD property not yet transferred at the commencement of the bankruptcy proceeding that was properly includible in that beneficiary's bankruptcy estate.

Finally, in *Williamson v. Hall*,[19] a published appellate bankruptcy court decision applying Kansas law, the court found that property transferred pursuant to an RTODD within 180 days after the beneficiary's bankruptcy filing was not includible in the beneficiary's bankruptcy estate, under either "Category 1" or "Category 2" of the federal bankruptcy statute. With regard to the first category, the court held under Kansas law, a beneficiary acquires an interest in "transfer on death" property only upon the death of the owner of the property, and therefore the beneficiary had neither a legal nor equitable interest in the RTODD property at the commencement of the bankruptcy case.

In reaching that conclusion, the court also found no legal or factual basis for treating the contingent interest of an RTODD beneficiary in not yet transferred RTODD property any differently than the contingent interest of a will beneficiary in property that had not yet transferred under the will. And, the court noted, as that latter contingent interest must not be an includible interest in a bankruptcy estate — since Congress included a *realized* transfer under a will as an includible interest only if received within 180 days of filing — the contingent interest of an RTODD beneficiary in not yet transferred property must also not be an includible interest.[20]

As for the second category of includible interests in a bankruptcy estate, the court found that RTODD property, even when transferred within 180 days after commencement of the bankruptcy case, is not an includible interest, because

17. In re Wilmoth, 2014 Bankr. LEXIS 5429 (Bankr. W.D. Ark. 2014).
18. Mo. Ann. Stat. § 461.031(1), See *In re Wilmoth*, 2014 Bankr. LEXIS at 4-5.
19. Williamson v. Hall (In re Hall), 441 B.R. 680 (B.A.P. 10th Cir. 2009).
20. *Id.* at 689-91.

RTODD property is not acquired by way of "bequest, devise, or inheritance."[21] Nevertheless, while adhering to the plain language of the federal statute that the court felt must be changed by Congress if desired, the court did question whether this exclusion made sense:

> [Payable on death] accounts, [transfer on death] accounts, and [transfer on death] deeds, as well as revocable inter vivos trusts, are all devices frequently utilized in estate planning as "will substitutes." Further, interpretation of the terms "bequest, devise, and inheritance" to include only property passing pursuant to will or intestate succession, but not other more modern methods of transferring property on death, may appear to exalt form over substance.
>
> However, we are required to "presume Congress intended for the courts to apply the plain language of the statute unless such interpretation would lead to an absurd result." (Citation omitted.) In this case, the statutory language is plain, and though it may result in disparate treatment of similarly situated debtors and creditors, it is not absurd. If [the federal bankruptcy statute] is to include a broader scope of assets passing to a debtor by reason of another person's death within 180 days of the petition date, then that is for Congress to decide, and not the province of this Court.[22]

Treatment of Revocable Inter Vivos Trusts

An inter vivos trust, also known as a "living trust," is a trust created while the creator of the trust is alive (as contrasted with a testamentary trust that is created by a will). The trust can provide for distribution of assets in the trust during or after the lifetime of the creator of the trust, and can be set up by the creator as revocable, or irrevocable.

When such a trust is set up as revocable, it resembles an RTODD. Both devices provide for asset distribution to a beneficiary at some point in the future, but both can be revoked before that distribution is made. As such, the treatment of a revocable inter vivos trust in a bankruptcy proceeding may offer further insight as to the appropriate treatment of RTODD property.

The staff has found two opinions applying California law in a scenario in which property was transferred to a beneficiary pursuant to a revocable inter vivos trust, in the 180 day window following the filing of a bankruptcy petition.[23]

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21. *Id*. at 687-88.
22. *Williamson*, 441 B.R. at 689.
23. Kosmala v. Cook (In re Cook), 2008 Bankr. LEXIS 4728 (B.A.P. 9th Cir. 2008) (unpublished); Zimmermann v. Spencer (In re Spencer), 306 B.R. 328 (Bankr. C.D. Cal. 2004).

In both cases, the court held that the beneficiary's interest in the acquired property, both at the commencement of the bankruptcy proceeding and at the time of receipt, was not an includible property interest under either of the two categories of property interests described above.

The rationales of the two cases were similar to those of the cases discussed earlier relating to the inclusion of RTODD property in a bankruptcy estate. Because of the revocable nature of the trust, the beneficiary's interest in not-yet transferred property at the commencement of the proceeding was deemed not to be an includible interest in the first category specified in the federal statute. And because the later acquired property was not acquired by way of "bequest, devise, or inheritance," it was not an includible interest in the second category.

Neither opinion offered any extensive discussion in support of their conclusions, beyond application of relevant state law.

DISCUSSION

As discussed above, it appears that federal law leaves some room for states to determine which kinds of at-death transfers will be included in a debtor's bankruptcy estate. That decision would depend on whether a state considers a particular type of transfer on death to be a "bequest, devise, or inheritance."

Property transferred by will would almost certainly fall into that category. But the status of a nonprobate transfer is not as clear. This suggests that federal law establishes a "floor" — property received by will *must* be included in the bankruptcy estate. But states can expand the scope of property in the bankruptcy estate, to include property received by nonprobate transfer. To do so, state law would need to treat a nonprobate transfer as constituting a bequest, devise, or inheritance.

That possibility presents a policy question. Should California law treat property transferred by RTODD as a "bequest, devise, or inheritance" so that it would be included in a debtor-beneficiary's bankruptcy estate?

That question seems to involve two competing interests:

(1) The creditors' interest in being paid.
(2) The debtor's interest in retaining some property to avoid destitution after the bankruptcy process concludes.

Including property received by RTODD in the bankruptcy estate would obviously favor creditors over the debtor. Excluding such property from the bankruptcy estate would favor the debtor.

In considering which approach would be most in line with existing California policy towards debtors and creditors, it is instructive to consider a recent legislative policy decision on a closely analogous matter.

Medicaid Recovery

With exceptions not relevant here, existing federal law provides that when a person receives Medicaid benefits, that person's estate is liable for reimbursement of those benefits to the estate.[24]

As discussed in Memorandum 2019-17,[25] there is an issue as to the meaning of "estate" in this context. Should that term be construed narrowly, as only including the person's probate estate? Or should it be read more broadly as including property transferred by nonprobate transfer (i.e., by trust, RTODD, or other TOD beneficiary designation)?

As with the bankruptcy law, federal law establishes a floor. The term "estate" must include the probate estate. But state law controls whether the term is read more broadly, to include trusts and other nonprobate transfers:

> For purposes of this subsection, the term "estate", with respect to a deceased individual —
>
> (A) shall include all real and personal property and other assets included within the individual's estate, as defined for purposes of State probate law; and
>
> (B) may include, *at the option of the State* (and shall include, in the case of an individual to whom paragraph (1)(C)(i) applies), any other real and personal property and other assets in which the individual had any legal title or interest at the time of death (to the extent of such interest), including such assets conveyed to a survivor, heir, or assign of the deceased individual through joint tenancy, tenancy in common, survivorship, life estate, living trust, or other arrangement.[26]

To reiterate, the Medicaid statute's treatment of at-death transfers establishes a liability floor — assets in the probate estate must be liable — but allows each state to decide which nonprobate assets should be liable.

24. See 42 U.S.C. § 1396p(b)(1)(B)(i).
25. Memorandum 2019-17, pp. 4-5.
26. 42 U.S.C. § 1396p(b)(4) (emphasis added).

This seems closely analogous to the situation with the bankruptcy statute. Federal law establishes a floor — property received by will or intestacy is included in the bankruptcy estate — while allowing each state to decide whether to include assets received by nonprobate transfer.

Until recently, California opted to include nonprobate transfers within the scope of the decedent's estate that was liable for Medicaid recovery. However, in 2016 the law was amended to narrow the meaning of "estate" to include only the probate estate.[27]

That decision works to the strong advantage of Medicaid recipients and their families, allowing them to keep more of their property (so long as it is transferred by nonprobate transfer rather than by will).

Given that recent policy choice, it seems likely that the Legislature would take a similar approach to the bankruptcy question discussed in this memorandum.

CONCLUSION

The Commission needs to decide how to address the issue discussed above.

Making no change to the law would be a reasonable approach. As discussed, existing law seems to exclude property received by trusts, RTODD, or other nonprobate transfer from the bankruptcy estate. That result seems compatible with the 2016 legislation that excluded nonprobate transfer assets from the definition of "estate" for the purposes of Medicaid estate recovery.

The Commission could also codify a rule, one way or the other. To do so, the Commission would first need to choose which approach, inclusion or exclusion of nonprobate assets from the beneficiary's bankruptcy estate, would be the better policy. Then the staff would develop a draft of implementing language for the Commission to consider.

One disadvantage to creating an express rule is that it could introduce a bright line distinction between RTODDs and all other forms of nonprobate transfer. Such a distinction could be hard to explain. For example, why should RTODD property be included in the bankruptcy estate when trust property is not? Such a rule could also create an unintended inference. For example, if the law provides that an RTODD is included in the bankruptcy estate, does that imply that other forms of nonprobate transfer property are not included?

27. See 2016 Cal. Stat. ch. 30, § 22.

With all things considered, the staff is inclined toward making no change in the law. The result under existing law seems consistent with recent legislative policy, and statutory silence will not create any problematic inferences.

How does the Commission wish to proceed?

Respectfully submitted,

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