Study L-4130 November 21, 2017

Memorandum 2017-57

Disposition of Estate Without Administration: Interest Rate

In this study, the Commission[1] is considering a number of technical issues relating to Probate Code procedures for the disposition of a decedent's estate, without administration.

The study was prompted by comments from the Executive Committee of the State Bar Trusts and Estates Section ("TEXCOM"). Among other things, TEXCOM was commenting on perceived deficiencies in the creditor claim provisions of the Revocable Transfer on Death Deed ("RTODD") statute.[2] The RTODD statute was largely based on a Commission recommendation,[3] and the Commission has been charged with conducting a follow-up study of its efficacy.[4]

In discussing TEXCOM's comments, the staff noted that the RTODD provisions at issue had been modeled very closely on provisions that govern the disposition of an estate without administration. The Commission decided to separately study TEXCOM's issues in the context of the procedures for disposition of an estate without administration.

This memorandum considers one of the issues raised by TEXCOM, the propriety of the 10 percent interest rate used when certain funds are required to be returned to a decedent's estate.

While this memorandum does not discuss the RTODD statute further, any decisions that the Commission makes in this study will likely also be relevant to the Commission's study of the RTODD statute.

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

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 Memorandum 2017-35.
3. *Revocable Transfer on Death (TOD) Deed*, 36 Cal. L. Revision Comm'n Reports 103 (2006).
4. 2015 Cal. Stat. ch. 293, § 21.

BACKGROUND

The Probate Code includes several mechanisms for transferring real and personal property on death without administration. These provisions include Sections 13100-13116 (affidavit procedure for the collection or transfer of personal property, if the gross value of the estate is $150,000 or less), Sections 13200-13210 (transfer of real property if value of real property in the estate is $50,000 or less), and Sections 13500-13660 (transfer of decedent's property to surviving spouse).

In each of those procedures, a beneficiary who receives property without administration may be required to return that property to the estate, if administration proceedings are later commenced.[5]

If the beneficiary is no longer in possession of the property when it is recalled, the beneficiary must instead return (a) the fair market value of the property at the time of disposition, (b) any income received from the property, and (c) interest on the fair market value from the date that the beneficiary disposed of the property.[6] The interest is to be charged at the statutory rate applicable to a money judgment.[7] That rate is currently 10 percent.[8] (Equivalent rules exist in the RTODD statute).[9]

In a letter to the Commission, TEXCOM suggests that the interest rate of 10 percent may be too high.[10] This memorandum considers whether the provisions discussed above should be revised to adjust how interest is charged.

PURPOSE SERVED BY CHARGING INTEREST

In order to evaluate whether a statutory interest rate is set at the correct level, it is first necessary to determine the purpose served by charging interest.

The staff could not find any authority discussing the purpose served by charging interest in the provisions at issue in this memorandum. However, the Commission has discussed the purpose of statutory interest in other contexts.

5. See Sections 13111, 13206, 13562.
6. See Sections 13111(a)(2), 13206(c)(2), 13562(a)(2).
7. *Id.*
8. See Code Civ. Proc. § 685.010.
9. See Section 5676(a).
10. See Memorandum 2017-35, p. 5.

Enforcement of Judgments

When the Commission recommended the Enforcement of Judgments Law in 1980, it approved a separate recommendation on the interest to be charged on a judgment.[11] The Commission recommended increasing the then-existing rate of 7 percent to the constitutional maximum[12] rate of 10 percent.[13]

In discussing that recommendation, the Commission identified two purposes served by charging interest on a judgment:

- Interest compensates the judgment creditor for the loss of use of the money.[14] Repaying the judgment with interest allows the debtor to compensate the creditor for any value the creditor would have obtained if the creditor had been in possession of the money from the date of judgment forward.
- Interest creates an incentive for the debtor to repay the money promptly.[15]

Both purposes are served, the Commission noted, "when the rate of interest on judgments approximates the prevailing interest rate in the money market."[16]

At the time of the Commission's recommendation, the market rate was approximately 12 percent.[17] A judgment interest rate of 7 percent was therefore insufficient to achieve either of the identified purposes. A judgment creditor would not be fully compensated for the loss of use of the money and there would be no incentive for prompt payment by the judgment debtor (in fact, the judgment debtor would have an incentive to postpone payment as long as possible, as the rate of return on investment was five percent higher than the interest paid on the judgment).

Raising the judgment interest rate to the California constitutional maximum of 10 percent was intended to bring the interest rate as close to the market rate as legally possible.[18]

11. *Interest Rate on Judgments,* 15 Cal. L. Revision Comm'n Reports 1 (1980).
12. Cal. Const. art. XV, § 1.
13. See *Recommendations Relating to Enforcement of Judgments,* 15 Cal. L. Revision Comm'n Reports 1, 11 (1980).
14. *Id.*
15. *Id.*
16. *Id.*
17. *Id.*
18. *Id.;* Cal. Const. art. XV, § 1.

Interest on Undistributed Pecuniary Devise

In 1987, the Commission considered the interest rate to be charged to a probate estate, when a pecuniary devise is not distributed within one year.[19] At the time, the interest rate was 10 percent. The Commission found that rate to be too high: "The rate is higher than the likely return on funds being held by the estate and therefore imposes an unfair penalty on the estate."[20]

The Commission recommended that the interest rate be lowered to "one percentage point above the minimum rate that would be payable on a Series EE United States savings bond."[21] This would "maintain the interest rate at a level close to that available to the personal representative in a passbook savings account, but will be sufficiently higher that the personal representative has an inducement to distribute and close the estate."[22]

In other words, the Commission concluded that the interest rate should approximate the market rate, to ensure that devisees do not lose the value of the money they are owed while waiting for distribution, but with an additional one percent on top of the market rate, to serve as an incentive for prompt distribution. An interest rate set significantly higher than the market rate would be unfairly punitive.

What Purpose is Served by Charging Interest in the Statutes at Issue?

As noted above, the staff could not find any authority discussing the purpose served by the charging of interest in the statutes at issue in this memorandum. However, an analysis of the text of those statutes suggests that the predominant purpose of charging interest is to make the estate whole, rather than to create an incentive for prompt payment. The staff's reasoning in support of that conclusion is discussed below.

Interest Not Charged in all Circumstances

In each of the procedures under review, interest is only charged if the beneficiary no longer has the property when its return is requested.[23] If, instead,

19. See *Recommendation Relating to Interest and Income During Administration*, 19 Cal. L. Revision Comm'n Reports 1019 (1988).
20. *Id*. at 1023.
21. *Id.* at 1024.
22. *Id.*
23. See Sections 13111(a)(2), 13206(b)(2), 13562(a)(2).

the beneficiary returns the requested property to the estate, no interest is charged on the value of the property.

If the interest is intended to serve as an incentive for prompt action by the beneficiary, then it should be charged in all circumstances, not just when the beneficiary is returning the fair market value of the property, rather than the property itself.

However, this inconsistent treatment makes sense if the purpose of the interest is to compensate the estate for loss in value. Interest is necessary to achieve that purpose when the property has been reduced to cash. Interest is not required when the property itself is returned to the estate, because the market value of the returned property will include any change that occurred while the property was in the beneficiary's control.

This suggests that the purpose of the interest is to make the estate whole, rather than creating an incentive for the beneficiary to act promptly.

Return of Income

In addition to returning the property or its fair market value, a beneficiary is also required to return any income that was derived from the property.[24] This restores beneficiaries to the position they were in prior to receiving the property, and compensates the estate by providing it with income it could have earned had it been in control of the estate during the same period.

This too supports the idea that the statutes are predominantly concerned with making the estate whole.

Lack of Beneficiary Knowledge

If a beneficiary disposes of property before its return is requested, the interest begins accruing on the date of disposition of the property.[25]

Because interest begins accruing on the date of disposition, in nearly all cases the beneficiary will begin accruing interest before becoming aware of the need to return property to the estate. Interest that accrues before one has knowledge of an obligation cannot act as an incentive to fulfill that obligation. It seems irrational to penalize a beneficiary for failing to act before receiving notice of a duty to act.

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24. *Id.*
25. *Id.*

If the purpose of the interest were to create an incentive for prompt beneficiary action, it would be best for the interest to begin accruing when the beneficiary is first notified of the need to return property to the estate. Once the beneficiary is aware of a legal obligation to act, it would be reasonable to impose interest as an incentive to fulfill that obligation. (That is one of the possible reforms discussed further below)

Market Rate at Time of Enactment

When the Commission recommended enactment of the provisions on disposition of an estate without administration, the 10 percent interest rate used in those statutes approximated the prevailing market rate. The recommendation was approved in December 1985.[26] At that time, the average interest rate charged by banks for short term loans to businesses was 9.5 percent.[27]

This suggests that the 10 percent rate was chosen to compensate the estate for loss in value while the property was out of its control, rather than to impose a punitive incentive for prompt beneficiary action.

Proper Interest Rate to be Used in Provisions that Govern Disposition of Estate Without Administration

If the primary purpose for charging interest in the provisions at issue is to compensate the estate for any loss in value of the asset during the time it was under the beneficiary's control, then the interest rate should roughly correspond to the rate of return on a monetary investment. In other words, it should match the current market rate.

The existing statutory interest rate of 10 percent[28] is much higher than is needed to achieve that purpose. For example, an online listing of three-year CD interest rates found the current high to be two percent.[29]

While some additional rate above the market rate might be appropriate to provide an incentive for prompt action (e.g., the one percent over market recommended by the Commission for unpaid devises), an additional 8 percent seems excessive. As TEXCOM observed, such a rate seems "harsh" and unduly punitive, especially when applied to a beneficiary who has done nothing wrong.

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26. *Disposition of Estate Without Administration*, 18 Cal. L. Revision Comm'n Reports 1005 (1986).
27. *Available at* <https://www.federalreserve.gov/datadownload/Choose.aspx?rel=H15>.
28. Code Civ. Proc. § 685.010.
29. < https://www.depositaccounts.com/cd/3-year-cd-rates.html>

Recall that the interest will typically begin accruing before the beneficiary is notified of the need to return the property.

As an extreme example, suppose that a beneficiary receives title to property worth $50,000 under Section 13200.[30] The beneficiary sells the property immediately after receiving it, receives notice that the property must be returned to the estate three years later,[31], and immediately complies. Under those facts, the beneficiary has done nothing wrong. Nonetheless, the beneficiary would owe roughly $15,000 in interest (not taking into account compounding). If the beneficiary had invested the proceeds of sale in a two-percent CD for those three years, the interest earned on that investment would be roughly $3,000 (again, not taking compounding into account). Thus, the beneficiary would have a net loss of $12,000, despite having acted as promptly as possible.

The staff agrees with TEXCOM that the existing interest provisions can produce harsh results, that are not required either to make the estate whole or to create an incentive for prompt payment. The Commission should consider reforming those provisions. Possible alternative reforms are discussed below.

VARIABLE RATE TIED TO THE MARKET

One possible reform would be to replace the 10 percent fixed interest rate with a rate that is tied to some external market index that changes over time as the market changes.

This approach would be the most accurate way to compensate the estate for the loss of value, without creating a windfall for the estate and an unfair loss to the beneficiary.

The main drawback of this approach is that it could be slightly difficult to administer. It would require the estate and beneficiary to look up the publicly available information about the governing index, determine the interest rate on the date (or period of time) at issue, and then apply that rate to the amount owed.

In order to implement this approach, it would be necessary to select an appropriate market index. The staff sees two broad alternatives, a public investment index or a private investment index. Those possibilities are discussed further below.

30. See Section 13200(a)(5).
31. The beneficiary remains liable to the estate for up to three years. See Sections 13111(e), 13206(f), 13562(e).

Public Investment Index — The Pooled Money Investment Account

A statute could incorporate the interest rate that is reported for investments made by public entities. A good example of this is the state's Pooled Money Investment Account ("PMIA"), which is made up of funds from the state's general fund, deposits from state agencies, and deposits from cities, counties, and other local entities. The PMIA includes the Surplus Money Investment Fund, which is comprised of the money the state earned on its investments of state surplus funds. The State Treasurer posts monthly, quarterly, and annual reports of those earnings.[32]

While the PMIA provides accurate information about the return on the investment of money held by the state, that rate is probably lower than could be achieved through private investments. The state is subject to more conservative requirements in its investment choices than a private investor.[33] The fund is limited to investments in "U.S. government securities, securities of federally-sponsored agencies, domestic corporate bonds, interest-bearing time deposits in California banks, savings and loan associations and credit unions, prime-rated commercial paper, repurchase and reverse repurchase agreements, security loans, banker's acceptances, negotiable certificates of deposit and loans to various bond funds."[34]

The rate of return on investments in the PMIA has decreased dramatically in the last few decades. For example, the rate was 10.72 percent for the 1984-85 fiscal year, but only .43 percent in the 2015-16 fiscal year.

The PMIA has been used as a basis for statutory interest rates in situations where the state is a creditor or debtor. It is well-suited to that use, because it reflects the amount the state gains while it has the use of money that it owes to another, or the amount that the state loses while a debt to the state goes unpaid.

For example, in inverse condemnation actions, where the state must repay a property owner for a taking of property, the state is required to pay interest at a rate equal to the rate of earnings of the PMIA for the quarter immediately preceding the quarter in which the interest is due.[35] In doing so, the state

32. See Gov't Code § 16480.7; Pooled Money Investment Account Reporting Documents, *available at* <http://www.treasurer.ca.gov/pmia-laif/pmia.asp#reporting>.
33. Gov't Code § 16430.
34. *Id.;* Pooled Money Investment Account Program Description, *available at* <http://www.treasurer.ca.gov/pmia-laif/pmib-program.asp>.
35. Code Civ. Proc § 1268.350.

disgorges any benefit that it received while it was in possession of money that should have been in the possession of a property owner.

Welfare and Institutions Code Section 14009.5(d) demonstrates the use of the Surplus Money Investment Fund to calculate interest on a debt that is owed to the state. When the Department of Health Care Services places a lien on a decedent's estate for recovery of Medi-Cal services, the interest rate on the liened amount is "equal to the annual average rate earned on investments in the Surplus Money Investment Fund in the calendar years preceding the year in which the decedent died," up to a cap of 7 percent.[36] This compensates the state for the value it could have realized through investment of the money that it is owed.

One significant advantage of using the PMIA as a market index is that it is subject to predictable reporting requirements. The State Treasurer publicly reports PMIA rates on a monthly, quarterly, and annual basis.[37]

Private Investment Index

Another option would be to incorporate some private investment index as a basis for the statutory interest rate. This could produce a more realistic measure of market conditions than the conservative investment practices that govern the PMIA. For example, a survey of mutual fund accounts offered by the prominent investment banking firm PIMCO reflect one-year yields ranging from one percent to a high of over 20 percent.[38] Those returns are significantly higher than the PMIA's recent .43 percent rate.

However, the PIMCO data also reveals one of the drawbacks of reliance on private investment data, volatility. The PIMCO data shows very high variation between different investment funds. The staff does not see an obvious way to decide which of those private funds would provide the best measure of prevailing market rates.

If the Commission is interested in the possibility of using a private investment index as the basis for the statutory interest rates, the staff would need to do further research to identify possible candidates.

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36. Welf. & Inst. Code § 14009.5(b).

37. Pooled Money Investment Fund Reporting Documents, *available at* <http://www.treasurer.ca.gov/pmia-laif/pmia.asp>.

38. PIMCO Performance Report: *available at* <https://www.pimco.com/en-us/investments/mutual-funds>.

Conclusion

There would be significant advantages to incorporating a variable market index as the basis for the interest rate charged in the statutes at issue. The rate would adequately reimburse the estate for the value of the property while it is in the control of the beneficiary, without imposing a punitive burden on the beneficiary.

Despite a logical rationale for such a change, it seems likely that dropping the interest rate from 10 percent to 2 percent (or lower) could be controversial. It would be a fairly dramatic and one-sided change from the status quo.

FIXED INTEREST RATE

Another possibility would be to charge a fixed interest rate, specified by statute. This is the approach taken under existing law, which fixes the rate at 10 percent.

A fixed interest rate has the benefit of simplicity, but this comes at a cost. A fixed rate will often do a poor job of approximating the prevailing market rate, which can lead to unintended consequences.

The Commission recognized that risk when it set a fixed interest rate of 10 percent for judgments:

> Fixing the rate at 10 percent creates a danger of inequity should the market rate drop below 10 percent and the debtor in fact be unable to pay the judgment. But the proposed law allows the Legislature to enact legislation to change the interest rate on judgments and to make the new rate applicable to all judgments, whether entered before or after the rate change. This will avoid the inequity that might otherwise result.[39]

If the existing fixed rate approach is preserved, the rate itself could be changed to better approximate the prevailing market rate (thereby avoiding the inequity the Commission anticipated). If the Commission decides to take this approach, it would need to decide what rate to use.

As noted above, reducing the rate from 10 percent to two percent or less could be controversial. The selection of any point between those two poles would be somewhat arbitrary.

One possibility would be to set the rate at 7 percent. That is the default rate for judgments set by the California Constitution (subject to change by the

39. *Interest Rate on Judgments*, 15 Cal. L. Revision Comm'n Reports 1, 13-14 (1980).

Legislature, up to a maximum of 10 percent).[40] In a recent case, the court held that prejudgment interest on a mechanics lien should be charged at the constitutional default rate of 7 percent, rather than the 10 percent rate charged for amounts owed on a contract. The court reasoned that a property owner who is liened by a subcontractor is an "innocent" party who has done nothing wrong and should not be charged the higher rate imposed on a person who has breached an obligation.[41]

Seven percent was also the rate chosen by the Legislature for interest on unpaid devises, when it decided to replace the Commission's recommended rate based on the interest paid on a Series EE United States Savings Bonds, plus one percent.[42]

Finally, for transfers involving real property, there is an argument for setting the interest at a rate that approximates the real estate appreciation rate, rather than the rate of return on monetary investments. The average appreciation rate for real estate was 8.33 percent in California in 2016.[43] Because markets fluctuate, and vary by individual markets and types of real estate, it is difficult to determine a reliable figure that would be appropriate for all real property. Because of that difficulty, a fixed rate within a few percentage points of the average (such as 7 percent), can also be seen as a way to approximate the real estate appreciation value of property that has been sold.

In sum, while the selection of any fixed rate is somewhat arbitrary, there is precedent for using 7 percent as a fixed interest rate, when the person being charged interest has done nothing wrong.

CHANGE THE DATE OF ACCRUAL

Another possibility, mentioned briefly above, would be to revise the interest provisions so that interest does not begin accruing until a beneficiary has been notified of an obligation to return property.

40. Cal. Const. art. XV, § 1.

41. See Palomar Grading & Paving, Inc. v. Wells Fargo Bank, N.A., 230 Cal. App. 4th 686 (2014).

42. Section 12001 ("If interest is payable under this chapter, the rate of interest is three percentage points less than the legal rate on judgments in effect one year after the date of the testator's death and shall not be recomputed in the event of a change in the applicable rate thereafter.").

43. Federal Housing Finance Agency Seasonally Adjusted House Price Index for U.S., 18 (2017).

This would put the beneficiary in a similar position to a judgment debtor; the beneficiary would have actual knowledge of a legal obligation to pay the estate. In that situation, imposing a high interest rate is more defensible.

Furthermore, this approach would have two practical advantages:

(1) It would be relatively simple to administer.
(2) Because it does not depend on an attempt to approximate market conditions, it would not need to be adjusted in the future, if market conditions dramatically change.

One downside of this approach is that it would deny the estate compensation for the loss of value of the property from the period between when the beneficiary disposed of the property and when the beneficiary was notified of an obligation to return the property. But under current market conditions, that loss would be relatively modest. Unless the beneficiary acts immediately after receiving notice, the loss would likely be offset by charging 10 percent for the period after the beneficiary receives notice to return the property.

CONCLUSION

There are good arguments for revising the interest provisions discussed in this memorandum. When an estate recalls property that was distributed without administration, it should be made whole. But the estate should not receive a significant windfall at the expense of a beneficiary who has done nothing wrong.

The existing interest rate of 10 percent was set at a time when it approximated the prevailing market rate. That is no longer the case. The statutory interest rate is now much higher than the market rate, creating the "inequity" that the Commission warned against in 1980 (with the express expectation that such inequity would be cured legislatively, by lowering the statutory rate).

This memorandum presents four possible reforms to address that problem:

- Change the statutory interest rate to match the rate of return in the state's Pooled Money Investment Account (currently .43 percent).
- Change the statutory interest rate to match the rate of return on an appropriate private investment index. Further research would be required to determine the best index to use.
- Preserve the existing fixed rate approach, but change the rate (perhaps to 7 percent).

- Change the date of accrual, so that interest does not begin accruing until the beneficiary has been notified of the obligation to return property.

How would the Commission like to proceed?

Respectfully submitted,

Karin Bailey
Law Student Extern

Brian Hebert
Executive Director