

# **The Two UPIAs**

## **The Uniform Prudent Investor Act and The Uniform Principal and Income Act – How They Will Change the World**

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You can't stop us on the road to freedom. You can't stop us 'cause our eyes can see  
Men with insight, men in granite, Knights in armor intent on chivalry.  
She's as sweet as *UPIA* honey. She's an angel of the first degree.  
She's as sweet as *UPIA* honey, just like honey from the bee.

– Van Morrison

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The Texas Legislature has enacted two significant trust bills in 2003 – the Uniform Prudent Investor Act of 1994 and the Uniform Principal and Income Act of 1997. These bills will bring significant changes to the default rules governing how trusts are administered and accounted for in Texas.

### **1. The Uniform Prudent Investor Act**

A substantial majority of states have adopted versions of the Uniform Prudent Investor Act of 1994. Based on the Restatement (3rd) of Trusts: Prudent Investor Rule (1992) promulgated by the American Law Institute, the first "UPIA" modernizes the investment standard for trusts which do not specify another standard.

Currently, the default investment standard applicable to Texas trusts is found in Texas Trust Code § 113.056(a):

. . . [A] trustee shall exercise the judgment and care under the circumstances then prevailing that persons of ordinary prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income from as well as the probable increase in value and the safety of their capital. In determining whether a trustee has exercised prudence with respect to

an investment decision, such determination shall be made taking into consideration the investment of all of the assets of the trust . . . over which the trustee had management and control, rather than a consideration as to the prudence of the single investment of the trust. . . .

This is a Texanization of the prudent man rule (or, to be more politically correct, the prudent person rule) first espoused in *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446, 461 (1830) (trustees should "observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested") and later included in a slightly different form in the Model Prudent Man Rule Statute (1942) and the Restatement (2nd) of Trusts (1959). Texas added the last sentence quoted above in 1991 to make the standard of prudence applicable to investments as a whole rather than each separate investment.

The Real Estate, Probate and Trust Law Section (REPTL) of the State Bar of Texas recently concluded a multi-year study of the new Uniform Trust Code. It concluded that the Uniform Trust Code as a whole is not an improvement over the current Texas Trust Code. However, it concluded that one part of the UTC -- the Uniform Prudent Investor Act -- should be adopted, with a few Texas-oriented changes.

The Texas version of the Uniform Prudent Investor Act replaces the prudent person rule with the prudent investor rule. The key objectives of the Act are:

- The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. UPIA § 2(b) [new Texas Trust Code Section 117.004(b)]. (This is similar to the 1991 amendment to Section 113.056.)
- The tradeoff in all investing between risk and return is identified as the fiduciary's central consideration. UPIA § 2(b) [new Texas Trust Code Section 117.004(b)].
- All categoric restrictions on types of investments have been abrogated; the trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing. UPIA § 2(e) [new Texas Trust Code Section 117.004(e)]. (Note, however, that several self-dealing prohibitions remain (e.g., Texas Trust Code §§ 113.052, 113.053, 113.054, 113.055 and 113.057).)
- The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing. UPIA § 3 [new Texas Trust Code Section 117.005].

Most of these objectives are reflected in Section 2 of the Act [new Texas Trust Code

Section 117.004]:

**SECTION 2. STANDARD OF CARE; PORTFOLIO STRATEGY; RISK AND RETURN OBJECTIVES.**

(a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

(b) A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

(c) Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:

(1) general economic conditions;

(2) the possible effect of inflation or deflation;

(3) the expected tax consequences of investment decisions or strategies;

(4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;

(5) the expected total return from income and the appreciation of capital;

(6) other resources of the beneficiaries;

(7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and

(8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

(d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.

(e) A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act].

(f) A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.

The Texas version of the Uniform Prudent Investor Act varies very little from the uniform version of the Act. One variation is in the section of the Act which permits a trustee to delegate authority to make investment decisions and escape liability in some situations. Texas adopted the uniform act's delegation standard (which makes it easier for the trustee to avoid liability than the current Texas delegation statute – Texas Trust Code Section 113.060), but the Texas version provides that the trustee doesn't escape liability if:

- The agent to whom the authority is delegated is an affiliate of the trustee;
- The terms of the delegation require the trustee or beneficiary to arbitrate disputes;  
or
- The terms of the delegation shorten the statute of limitations.

See new Texas Trust Code Section 117.011.

Under the new Uniform Prudent Investor Act, trustees will have an affirmative duty to diversify investments [UPIA §3/new Texas Trust Code Section 117.005] and an affirmative duty to review the trust assets and to make and implement decisions concerning the retention and disposition of assets in order to bring them in compliance with the prudent investor rule [UPIA §4/new Texas Trust Code Section 117.006]. Gone will be the old Texas provision permitting retention of trust assets held at the inception of the trust without liability for diversification (see Texas Trust Code §113.003).

Like most of the current Texas Trust Code, the Uniform Prudent Investor Act imposes default rules -- rules which apply if the trust instrument is silent. Settlers of trusts may override these new rules and impose whatever standards they wish, within the limits of public policy, statutes and the common law.

The Texas Uniform Prudent Investor Act becomes effective January 1, 2004. It will apply not only to trusts created after that date, but also to existing trusts.

## **2. The Uniform Principal and Income Act**

The freedom to invest in a wide variety of investments granted by the prudent investor rule creates a serious accounting problem for the trustee: If the risk/return analysis makes it prudent to invest primarily in growth-oriented low-income-producing assets, how can the

interests of the income beneficiary be protected? Harken back to yesteryear when a trustee free to invest in growth stocks could generate an annual return of 20% or more, but a trustee bound to generate income could hope for no more than a 5-6% return. Does the trustee have to forego these gains (and incur the wrath of the remainder beneficiaries) in order to assure the income beneficiary a reasonable return?

Under the Uniform Principal and Income Act of 1997, the answer is no (at least in some cases). Section 104 of the second "UPIA" permits the trustee to adjust between principal and income to the extent the trustee considers necessary if the trustee is following the prudent investor rule and cannot otherwise balance the interests of the income beneficiary and the remainder beneficiaries fairly. There are restrictions on this power to adjust if the trustee also is a beneficiary or if marital deduction trust (QTIP) considerations are involved, but UPIA Section 104 [new Texas Trust Code Section 116.005] -- the heart of the new principal and income act -- will permit the adjustment in many cases.

REPTL considered the Uniform Principal and Income Act to be a necessary adjunct to the Uniform Prudent Investor Act -- if the Legislature was going to adopt the prudent investor rule, it also needed to adopt accounting rules to assure that the relative rights of the beneficiaries are protected. The result is that Texas has two new uniform acts -- the Uniform Prudent Investor Act and the Uniform Principal and Income Act.

Several states have considered addressing the need to adjust between income and principal which arises under the prudent investor rule by allowing trustees to convert income-only trusts into unitrusts. This approach was considered in Texas and rejected it for now. The unitrust conversion statutes are evolving. Eventually there may be a generally accepted, fair way to permit trustees to convert income-only trusts into unitrusts, but the current attempts in other states seem flawed in that they are overly complicated or likely to be unfair to beneficiaries.

While the unitrust conversion concept was left out, the Texas version of the Act contains a provision [new Texas Trust Code Section 116.007] which permits a settlor to draft a non-charitable unitrust. This provision is intended to take advantage of Proposed Treasury Regulation 1.643(b)-1, 66 Fed. Reg. 10396 (February 15, 2001), which provides that amounts allocated between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust. Under the proposed regulation, a state law that provides for the income beneficiary to receive each year a unitrust amount of between 3% and 5% of the annual fair market value of the trust assets is a reasonable apportionment of the total return of the trust. New Texas Trust Code Section 116.007 provides support in Texas law for a settlor who wishes to create a non-charitable unitrust paying a unitrust amount of between 3% and 5% by defining such amount as "income" for state fiduciary accounting purposes. If the proposed regulation becomes final, this should make it unnecessary for a settlor to provide for the payment of the greater of the unitrust amount or actual income in order to meet tax requirements for a trust which requires the distribution of all income to a beneficiary (for example, a marital deduction

(QTIP) trust). The provision does not require that trust income be defined in terms of a unitrust percentage, nor does it provide a means for converting an all-income trust into a unitrust. Because other rules apply to charitable unitrusts, this proposal does not apply to them.

While the Texas version of the Uniform Principal and Income Act does not contain a unitrust conversion provision, it does contain another controversial provision – Section 105 of the uniform act. Section 105 was not a part of the Uniform Principal and Income Act as first adopted by the National Conference of Commissioners on Uniform State Laws (NCCUSL). It was added as an afterthought when states such as California started adopting provisions permitting a trustee to cut off a beneficiary's rights by giving him or her notice of the trustee's intention to make an adjustment under Section 104. REPTL considered the provision ill-conceived and unnecessary and did not include it in the version of the act originally introduced in the Legislature. However the Trust Services Division of the Texas Bankers Association (TBA) insisted on inserting the provision. Until very late in the legislative session, it appeared that the two UPIAs would fail to be enacted because of this provision. However, REPTL and TBA reached a compromise to save the two bills, resulting in a modified version of Section 105 being included as new Texas Trust Code Section 116.006.

Under new Section 116.006(d), a trustee can initiate a proceeding to obtain an advisory opinion about whether a proposed adjustment under UPIA Section 104/new Texas Trust Code Section 116.005 is an abuse of discretion. The trustee cannot initiate the proceeding unless it has reasonable grounds for believing that one or more beneficiaries will object to the adjustment, and a beneficiary's failure or refusal to sign a waiver or release cannot form the basis of this belief. If a proceeding is initiated, the trustee is required to fund the beneficiaries' legal fees from the trust, and the court is permitted at the conclusion of the proceeding to determine which party should bear the attorney's fees and costs. It could let the costs come from the trust, assess them against the trustee, make one or more beneficiaries pay the costs, or use some combination of the above.

The Uniform Principal and Income Act comprehensively treats the subject of allocating receipts and disbursements between principal and income and, therefore, replaces Subchapter D of Chapter 113 of the Texas Trust Code (§§113.101 -- 113.111). This means that trustees, their lawyers and their accountants will have to learn some new rules. In general, the Texas version of the Act sticks with the allocation rules contained in the uniform act. However, the Texas version varies from the uniform version in these two key areas:

- ***Oil, Gas and Mineral Income*** -- How could a bunch of Yankee lawyers expect to draft a rule about allocating oil, gas and mineral receipts which Texans could embrace and approve? The uniform act's rule on oil, gas and mineral receipts was that 90% were principal and only 10% were income. This is a far cry from Texas's current rule, which in general is that 27½ % of gross proceeds is principal and the rest (72½%) is income (Texas Trust Code §113.107). The new Texas version provides that the trustee must allocate these receipts "equitably." It further provides that an allocation is presumed to be equitable if the amount allocated to principal equals the amount allowed as a deduction by the Internal Revenue Code

for depletion of the interest. Perhaps most importantly, the Texas version includes a grandfather provision for existing trusts -- if oil and gas receipts were being allocated under the old 27½ / 72½ % rule, the trustee can keep using that allocation formula.

- ***Retirement Plans*** -- Similarly, the uniform act's rule on distributions from IRAs and other retirement plans was that 90% of each distribution was principal and 10% was income. It is rare for the IRA or retirement plan to be in an income-only trust (although it is not unheard of for the IRA to be placed in a marital deduction (QTIP) trust benefitting the second spouse for life with remainder to children of the first marriage), but in cases where this happens the uniform act would provide very little for the income beneficiary. The current Texas provision (Texas Trust Code §113.109) is fairer to the income beneficiary, but its approach (5% of the inventory value of the deferred payment right) was confusing, difficult to apply and did not adequately take into account changes in the value of the underlying asset. The Texas version of UPIA contains a unique Texas provision which borrows from unitrust principles: a payment is income to the extent of 4% of the asset's value and is principal to the extent it exceeds 4% of the asset's value.

Like the Texas Uniform Prudent Investor Act, the Texas Uniform Principal and Income Act is a default statute -- if the trust instrument is silent, its rules apply, but if the trust instrument specifies other rules, those other rules apply. Also, like the prudent investor act, it will become effective on January 1, 2004, and apply to existing as well as new trusts. There are some grandfather provisions (the most significant being the one that applies to mineral interests), but in general the accounting rules for existing trusts will change on January 1, 2004.