

# **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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# **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 additional safeguards. New Texas Trust Code Section 117.011(a) (which is in the uniform act) sets the initial requirements for a trustee wishing to delegate and avoid liability: the trustee must exercise reasonable care, skill and caution in (1) selecting the trustee, (2) establishing the scope and terms of the delegation (which terms must be consistent with the purposes and terms of the trust), and (3) monitoring the performance of the trustee. The uniform act provided that a trustee who complies these three requirements is not liable to a beneficiary or the trust for the decisions or actions of the agent. The Texas legislature added three additional requirements, so that, in Texas, not only must the trustee comply with the three requirements of Section 117.011(a) to avoid liability for the acts of the agent, but also these three additional requirements must be met:

- The agent to whom the authority is delegated cannot be an affiliate of the trustee;
- The terms of the delegation cannot require the trustee or beneficiary to arbitrate disputes; or
- The terms of the delegation cannot shorten the statute of limitations.

See new Texas Trust Code Section 117.011(c).

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. It may be harder to override the uniform act that one thinks, however, since the new law primes the pump a little by providing that certain provisions that might be found in a trust instrument do not override the act but instead *invoke* the new act. Here is what new Texas Trust Code §117.012 says invokes the prudent investor rule and the new act:

"investments permissible by law for investment of trust funds," "legal investments," "authorized investments," "using the judgment and care under the circumstances then prevailing that persons of 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 as well as the probable safety of their capital," "prudent man rule," "prudent trustee rule," "prudent person rule," and "prudent investor rule."

As noted above, there are differences between the old "prudent man rule" and the new "prudent investor rule," but Section 117.012 says that a trust instrument specifically providing for the "prudent man rule" in fact invokes the new prudent investor rule. It's time to dust off those old trust instruments to see if the language overrides the new act. In most cases, the only overriding language will be either (a) provisions drafted after the enactment of the new act which specifically refer to the new act (for example, "Settlor specifically provides that the prudent investor rule as espoused in Chapter 117 of the Texas Trust Code shall not apply to this trust") or (b) provisions requiring the trustee to invest in, or refrain from investing in, specific kinds of property (for example, "the trustee shall invest only in accounts insured by FDIC").

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. For example, a trustee who also is a beneficiary of the trust cannot make an adjustment. For this reason, there may be more reasons to use a corporate trustee or other independent trustee (or the trust boilerplate should be changed to permit a trustee/beneficiary to appoint one or more co-trustees who could make the adjustment if necessary). Also, the trustee of a marital deduction (QTIP) trust cannot use the adjustment power to move income away from the surviving spouse, although it can be used to make adjustments which add to trust income. Still, Section 116.005 will permit adjustments 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.

Subsections (a) and (c) of Section 116.006 provide some cover for a trustee who worries that its decision to make (or not make) an adjustment will be second-guessed by a beneficiary. Subsection (a) provides that a court may not change a trustee's decision about an adjustment unless the court finds that the trustee abused its discretion and that it is not an abuse of discretion simply because the court may have decided to make the adjustment differently. This is consistent with caselaw on the subject, but it provides some statutory protection for trustees. Subsection (c) provides that, in cases where an abuse of discretion is found to have occurred, the monetary remedy is to be accomplished in the way that is the least painful to the trustee – future distributions to beneficiaries will be adjusted to compensate for the abuse of discretion, and only if the parties cannot be put back in the right positions by adjusting future distributions will the trustee be tagged personally for damages.

The most controversial part of new Section 116.006 is subsection (d), which permits the trustee to obtain what amounts to an advisory opinion about an adjustment decision the trustee is considering making. The REPTL/TBA compromise language permits the trustee to initiate this proceeding only if 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. The rules make a number of changes to prior law and address many new types of investments, such as asset-backed securities. In general, the new act has a bias toward principal, starting with one of its general principles expressed in new Section 116.004(a)(4) – if no provision of the trust or statute says what an item is, then it's principal.

By and large, 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. Unfortunately, the language REPTL suggested for inclusion in the act was changed during the legislative process, and the changes garble its meaning pretty badly. This is an area where the official Section comments are helpful in construing the statute.

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.

## Appendix A – HB 3503 – Exculpatory Clauses

**Trust Code Sec. 113.059. POWER OF SETTLOR [~~TRUSTOR~~] TO ALTER TRUSTEE'S RESPONSIBILITIES.** (a) Except as provided by [~~Subsection (b) of~~] this section, the settlor by provision in an instrument creating, modifying, amending, or revoking the trust may relieve the trustee from a duty, liability, or restriction imposed by this subtitle.

(b) A settlor may not relieve a corporate trustee from the duties, restrictions, or liabilities of Section 113.052 or 113.053 of this Act.

(c) A settlor may not relieve the trustee of liability for:

(1) a breach of trust committed:

(A) in bad faith;

(B) intentionally; or

(C) with reckless indifference to the interest of the beneficiary; or

(2) any profit derived by the trustee from a breach of trust.

(d) A provision in a trust instrument relieving the trustee of liability for a breach of trust is ineffective to the extent that the provision is inserted in the trust instrument as a result of an abuse by the trustee of a fiduciary duty to or confidential relationship with the settlor.

**Section 142.005, Property Code,** is amended by adding Subsections (h), (i), and (j) to read as follows:

(h) A trust created under this section is subject to Subtitle B, Title 9.

(i) Notwithstanding Subsection (h), this section prevails over a provision in Subtitle B, Title 9, that is in conflict or inconsistent with this section.

(j) A provision in a trust created under this section that relieves a trustee from a duty, responsibility, or liability imposed by this section or Subtitle B, Title 9, is enforceable only if:

(1) the provision is limited to specific facts and circumstances unique to the property of that trust and is not applicable generally to the trust; and

(2) the court creating or modifying the trust makes a specific finding that there is clear and convincing evidence that the inclusion of the provision is in the best interests of the beneficiary of the trust.

**Section 868, Texas Probate Code**, is amended by adding Subsection (c) to read as follows:

(c) A provision in a trust created under Section 867 that relieves a trustee from a duty, responsibility, or liability imposed by this subpart or Subtitle B, Title 9, Property Code, is enforceable only if:

(1) the provision is limited to specific facts and circumstances unique to the property of that trust and is not applicable generally to the trust; and

(2) the court creating or modifying the trust makes a specific finding that there is clear and convincing evidence that the inclusion of the provision is in the best interests of the beneficiary of the trust.

This Act takes effect September 1, 2003, and applies only to a trust existing on or created after that date.

## **Appendix B – Marketing Opportunities**

1. The Uniform Prudent Investor Act and the Uniform Principal and Income Act raise the bar for trustee performance. Trustees cannot sit tight on a conservative portfolio and still comply with the new investment standard. Also, the Uniform Principal and Income Act anticipates that trustees will be much more active, exercising much more discretion, in balancing the rights of the income beneficiaries and remainder beneficiaries. Now may be the time for the trustees of existing trusts – or for settlors and testators considering establishing new trusts – to opt for a corporate trustee (or a corporate co-trustee, or a bank or trust company as agent for an individual trustee).
2. Individual trustees wishing to delegate investment decisions *may* be able to avoid liability for the actions of the agent if the agent does not require arbitration or a shortened statute of limitations in the delegation agreement. Most brokerage firms seem unwilling to remove arbitration provisions and shortened statutes of limitations from their contracts. Banks and trust companies who are willing to do so have a competitive advantage in acting as investment agent for an individual trustee. Banks and trust companies in this position need to make lawyers representing individual trustees aware of this fact, which might tip the scale in the bank/trust company's favor.
3. Trustees who also are beneficiaries cannot exercise the power to make adjustments between principal and income in Section 116.005. Settlors may wish to name a corporate trustee (or a corporate co-trustee, or a corporate trustee as an alternate) so that the power to adjust may be taken advantage of.

## Appendix C – Drafting Issues

### 1. Opting In and Out of the Prudent Investor Act

On January 1, 2004, the Uniform Prudent Investor Act of Texas becomes law. It will apply to new and existing trusts. The prudent investor rule (the heart of the act) and the other provisions of the Act are default rules – they apply unless the trust instrument provides otherwise.

The Uniform Prudent Investor Act provides default rules for investment of trusts. Tex. Trust Code §117.003(b) provides:

The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust.

This is consistent with the Texas Trust Code as a whole. Texas Trust Code §111.002(a) provides:

If the provisions of this subtitle and the terms of a trust conflict, the terms of the trust control except the settlor may not relieve a corporate trustee from the duties, restrictions and liabilities under Section 113.052 and 113.053.

So, settlors in Texas continue to have the ability to override the Trust Code (except in very limited circumstances) and subject their trustees to different rules.

#### a. What language invokes the Uniform Prudent Investor Act?

The Act itself primes the pump a bit, providing that some language which one might otherwise think opted a trust out of the Act in fact makes the Act apply. Texas Trust Code §117.012 provides:

Sec. 117.012. **LANGUAGE INVOKING STANDARD OF CHAPTER.** The following terms or comparable language in the provisions of a trust, *unless otherwise limited or modified*, authorizes *any investment or strategy* permitted under this chapter: "investments permissible by law for investment of trust funds," "legal investments," "authorized investments," "using the judgment and care under the circumstances then prevailing that persons of 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 as well as the probable safety of their capital," "prudent man rule," "prudent trustee rule," "prudent person rule," and "prudent investor rule." [emphasis added]

The official comment of the National Conference of Commissioners on Uniform State Laws (NCCUSL), who wrote the Uniform Prudent Investor Act, says that this provision “is meant to facilitate incorporation of the Act by means of the formulaic language commonly used in trust instruments.” That may be a laudable goal, but Section 117.012 makes some trust language which seems inconsistent with the prudent investor rule effective to invoke the rule. For example, the old Texas investment standard, from former Section 113.056, required a trustee to:

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.

What if a settlor really liked the old standard and included this language in the trust instrument so that future legislative changes would not affect her trust? This language is almost identical to one of the phrases in Section 117.012 which invokes “any investment or strategy permitted” by the Uniform Prudent Investor Act. Therefore, it seems almost certain that a court would construe this language, without any other limiting language, as invoking the new Act, whether or not this is consistent with the settlor’s intent.

Because of Section 117.012, opting *into* the new Act will be much easier than opting *out*.

#### **b. Examining Existing Documents To See If They Contain Opt-out Language.**

Because of the wide variety in which trust instruments are drafted, a careful reading of each trust instrument is going to be necessary to determine if the instrument contains language which might opt the trust out of the new Prudent Investor Act. While nothing can take the place of this general review, here are three particular things to look for:

**i. A General Opt-Out Provision.** For the reasons stated above, most trust instruments will not contain a general provision which overrides the new statutory language. As drafters get used to the new act, trust instruments occasionally will begin to include general opt-out provisions of the type described in subparagraph c. below. In the meantime, keep on the lookout for provisions which essentially contain *no* standard, as they may be considered to override the Prudent Investor Act. Consider this provision:

Settlor authorizes the trustee to invest in any investments which the trustee may choose in his sole and absolute discretion, and any such investment will be considered an appropriate investment for the trust.

Does this override the Prudent Investor Act? Probably so, although one could argue that this language is, at its base level, very similar to some of the examples of provisions which do not opt out of the act under Section 117.012 – “legal investments,” etc.

**ii. Authorization to Hold Investments Without Diversification.** Perhaps the most common provision which will opt out of part, but not all, of the Prudent Investor Act, is a provision specifically authorizing the trustee to hold assets comprising a part of the trust estate without being required to diversify and without risk of loss or liability. For example, this type of provision is fairly common in trusts containing detailed trustee powers:

The trustee shall have the power to acquire, by purchase or otherwise, retain, invest, reinvest and manage, temporarily or permanently, any realty or personalty, without diversification as to kind, amount or risk of nonproductivity and without limitation by statute or rule of law.

The Uniform Prudent Investor Act repealed former Section 113.003, which formerly made this the default rule in Texas. While the default rule has changed, a trust instrument containing a specific provision permitting the trustee to hold trust property without diversification should be sufficient to override this part of the Uniform Prudent Investor Act. Other parts of the Act would still apply, however.

**iii. Authorizing or Prohibiting Specific Investments.** Another provision in existing trusts which would appear to override the Uniform Prudent Investor Act is a provision requiring the trust to be invested in a particular asset or type of asset or prohibiting the trust from being invested in a particular asset or type of asset. For example, the trust instrument may require all of the trust assets to be invested in stocks traded on the New York Stock Exchange or prohibit the trustee from investing in bonds rated AA or less. Often these are the bane of the corporate trust department, and the new act will not sweep them away.

### **c. How Can One Opt Out of the Uniform Prudent Investor Act?**

Because of Trust Code §117.012, a settlor wishing to opt out of the Uniform Prudent Investor Act must be very specific. The best approach would be to specifically refer to the Uniform Act and/or the prudent investor rule, such as:

Settlor expressly provides that this trust is not subject to, and the trustee is not required to comply with, the prudent investor rule and the provisions of Chapter 117 of the Texas Trust Code. Rather, this trust and the trustee shall be subject to the following standard: [describe standard].

## **2. Opting In and Out of the Uniform Principal and Income Act**

Like the Uniform Prudent Investor Act, the Uniform Principal and Income Act imposes default rules. The settlor of a trust can override the Act in whole or in part by including appropriate language in the trust instrument. For example, the following provision was effective to override the old allocation rules, and it should be effective to override the new allocation rules:

The trustee may allocate receipts and disbursements to income and principal as

the trustee in its discretion determines is appropriate.

Under prior Texas law, no inference arose from the fact that a trustee made an allocation other than according to the statute, if the trust instrument gave the trustee discretion to make the allocation. Texas Trust Code §113.101(b). The new statute does not include this “no inference” language, but it makes clear that a trustee may exercise discretionary powers granted by the instrument even if the result of such discretion is different than the result under this statute. Under the old standard, an appellate court held that it was not an abuse of discretion for a trustee to exercise its discretion to allocate a capital gain to income, but it was an abuse of discretion for the trustee to call a trust asset “income” and distribute it to the income beneficiary. *Thorman v. Carr*, 408 S. W. 2d 259 (Tex. Civ. App. – San Antonio 1966), *aff’d per curiam*, 412 S. W. 2d 45 (Tex. 1967). Of course, in many cases where allocation is left to the trustee’s discretion, the trustee chooses to follow the statutory allocation rules as an informal safe harbor, operating on the theory that if the trustee follows the statute in exercising its discretion, it is unlikely to be deemed to have abused its discretion.

### **3. Co-Trustee Provision to Make Section 116.005 Power to Adjust Available**

Consider adding the following provision to trust boilerplate to assure that a trustee/beneficiary can make the power to adjust granted by Texas Trust Code §116.005 available to the trust by appointing a co-trustee:

Any individual serving as trustee of any trust may appoint one or more co-trustees meeting the requirements of this instrument to serve with the individual as co-trustee of the trust. If there are two co-trustees, the co-trustees must act unanimously, except (1) the co-trustees may unanimously delegate certain decisions and powers to act to either co-trustee (for example, the co-trustees may unanimously agree that either co-trustee may make withdrawals from a particular account without the joinder of the other co-trustee) and (2) if one of the co-trustees also is a beneficiary of the trust, the co-trustee who is not a beneficiary shall be empowered to make any decisions under Chapter 116 of the Texas Trust Code (including but not limited to the power to make adjustments under Section 116.005) which the co-trustee who also is a beneficiary of the trust may be prohibited from making because he or she is a beneficiary. If there are three or more co-trustees, the co-trustees must act by majority vote, except (1) the co-trustees may by majority vote delegate certain decisions and powers to act to any one or more co-trustees (for example, the co-trustees may by majority vote agree that any co-trustee may make withdrawals from a particular account without the joinder of the other co-trustees) and (2) if one or more of the co-trustees also are beneficiaries of the trust, the co-trustee or co-trustees who are not beneficiaries shall be empowered to make any decisions under Chapter 116 of the Texas Trust Code (including but not limited to the power to make adjustments under Section 116.005) which the co-trustee or co-trustees who also are beneficiaries of the trust may be prohibited from making because they are beneficiaries.

### **4. Notice to Beneficiaries of Trustee’s Intent to Make an Adjustment to Principal and Income.**

Consider using this as a form for notice to beneficiaries when the trustee wishes to make an



adjustment between principal and income under Texas Trust Code §116.005:

Dear \_\_\_\_\_:

As you know, \_\_\_\_\_ (“Trustee”) is trustee of \_\_\_\_\_ (the “Trust”). The Trust provides that all of the net income of the Trust will be paid to \_\_\_\_\_ (the “Income Beneficiary”). In investing the assets in the Trust, Trustee is required to comply with the prudent investor rule stated in Chapter 117 of the Texas Trust Code. In order to comply with the prudent investor rule, Trustee has invested the assets of the Trust in investments which have generated only \_\_\_\_\_% in net income from traditional income sources (such as dividends and interest) this year, while the Trust has grown in value by a total of \_\_\_\_\_%, taking into account appreciation of capital assets and capital gains in addition to traditional trust income.

Section 116.005 of the Texas Trust Code permits Trustee to make an adjustment to the income and principal of a trust if in the Trustee determines in its discretion that the requirements of that statute are met. Trustee believes that an adjustment from principal to income of the Trust should be made so that the net income of the Trust for this year is \$\_\_\_\_\_, which would represent a \_\_\_\_\_% return on the Trust for the Income Beneficiary. Trustee intends to make this adjustment in the following manner: [describe manner of making adjustment].

If Trustee makes this adjustment, your rights as a beneficiary of the Trust will be affected. Adjusting principal to income reduces the amount of the principal of the Trust, which adversely affects the interests of the persons who will receive benefits from the Trust after the death of the Income Beneficiary. On the other hand, the Income Beneficiary may believe that an even larger adjustment is appropriate and, therefore, the Income Beneficiary’s interests are adversely affected.

Any beneficiary can file a lawsuit after Trustee makes the adjustment and attempt to prove that Trustee abused its discretion in how it made the adjustment. Texas law also permits Trustee to petition a court to determine *in advance* whether the proposed adjustment would be an abuse of Trustee’s discretion. If Trustee petitions the court for such a determination:

- A. Trustee must reasonably believe that one or more beneficiaries will object to the proposed adjustment;
- B. Assuming Trustee’s petition includes the required elements, any beneficiary who objects to the proposed adjustment would have the burden to prove in the court proceeding that the proposed adjustment will be an abuse of Trustee’s discretion;

- C. Trustee is required to advance from the trust principal all costs incident to the proceeding, including the reasonable attorney's fees and costs of the trustee, any beneficiary or beneficiaries who are parties to the action and who retain counsel, and any guardian ad litem appointed by the court; and
- D. At the conclusion of the proceeding, the court in its discretion may order that the costs of the proceeding, including the attorneys' fees of the trustee, each beneficiary who retains counsel and each guardian ad litem, be paid all or in part from: the Trust principal; the Trust income; any beneficiary's interest in the Trust; any beneficiary, personally; or Trustee personally.

Trustee wishes to determine if any beneficiary will object to the proposed adjustment. If any beneficiary objects, Trustee at its option (1) go ahead and make the adjustment without filing a petition described above; (2) decide not to make the adjustment without filing a petition described above; or (3) file a petition as described above and seek a judicial determination as to whether or not the proposed adjustment would be an abuse of discretion.

**At the bottom of this letter is a space for you to indicate if you object to the proposed adjustment or if you waive and release any claim, lawsuit or right to object to the proposed adjustment. Taking either action could affect your legal rights, and you may wish to consult an attorney. You are not required to choose either option (object or waiver and release). Texas law provides that trustee may not use a beneficiary's failure or refusal to sign a waiver or release as a basis for its belief that a beneficiary will object to an adjustment.**

Enclosed with this letter is information about the current condition of the Trust. If you have any questions or would like further information about the Trust, please contact Trustee.

Sincerely,

---

Trustee

I object to the proposed adjustment.

Signature: \_\_\_\_\_

Printed Name: \_\_\_\_\_

I do not object to the proposed adjustment, and I waive and release any and all claim or right I may now have or may have in the future to object or to hold Trustee liable with respect to its actions or inactions related to the proposed adjustment.

Signature: \_\_\_\_\_

Printed Name: \_\_\_\_\_

## **5. Exculpation Clause**

HB 3503, passed by the Texas legislature in 2003, not only limits the effectiveness of some exculpation clauses, it also gives the settlor guidance as to how to draft an exculpation clause which exculpates the trustee to the fullest extent permitted by Texas law. Here is an exculpation clause which may do this:

Settlor intends for the trustee to be exculpated from loss, damage and liability to the fullest extent permitted by applicable law. Accordingly, the trustee shall not be liable for any action or inaction, even if that action or inaction is a breach of trust or a breach of any duty owed by the trustee, except for:

(1) a breach of trust committed:

(A) in bad faith;

(B) intentionally; or

(C) with reckless indifference to the interest of the beneficiary; or

(2) any profit derived by the trustee from a breach of trust.

## Appendix D – Principal and Income Old vs. New Comparison Table

<i>Item</i>	<i>Old (Through 12/31/03)</i>	<i>New (On and After 1/1/04 Forward)</i>
<b>Accountings.</b>	Charge to income, unless the court directs otherwise (Trust Code §113.111).	One-half income, one-half principal [Trust Code §116.201(2), unless Trust Code §116.051(2)(B) or (C) applies [related to decedent’s estates and when income interests end].
<b>Business Exception</b> (Trust Code §116.153).	N/A.	Other allocation rules do not apply if the trustee is accounting for properties as a separate business under Trust Code §116.153.
<b>Deferred Compensation Receipts.</b>	Five percent (5%) of the “inventory value” of the right is income, the rest is principal [Trust Code §113.109].	Four percent (4%) of the fair market value of the “future payment asset” is income, the rest is principal (in other words, unitrust-type calculation), but note that the statutory language is garbled [Trust Code §116.172].
<b>Depreciation.</b>	Mandatory if the improvements are subject to depreciation under generally accepted accounting principles [Trust Code §113.111].	Discretionary [Trust Code §116.203].
<b>Discounted Bonds and Notes.</b>	The difference between the purchase price and the sales price of a discounted bond or note “in accordance with a fixed schedule of appreciation in excess of the price at which it was issued” was income, regardless of the maturity date of the bond or note [Trust Code §113.105(b)].	The difference between the purchase price and the sales price of a discounted bond or note is principal, unless the maturity date is less than one year from the purchase price, in which case the difference is income [Trust Code §116.163(b)].

<i>Item</i>	<i>Old (Through 12/31/03)</i>	<i>New (On and After 1/1/04 Forward)</i>
<b>Dividends</b> and Other Receipts from Entities.	Cash dividends are income, stock dividends are principal, distributions in “total or partial liquidation of the corporation” are principal, capital gains “dividends” are principal [Trust Code §113.104].	<p>1. When in doubt and the receipt is money, it is income. Exceptions:</p> <p>a. Capital gains “dividends” are principal.</p> <p>b. Payments received in “partial liquidation” (20% or more of entity’s value) are principal.</p> <p>2. When in doubt and the receipt is <i>not</i> money, it is principal.</p> <p>Trust Code §116.151.</p>
<b>Environmental Expenses.</b>	N/A.	Charge to principal [Trust Code §116.202(a)(7).]
<b>Fees – Custodial.</b>	Not specifically addressed, but probably charged to income under Trust Code §113.111(a)(5).	One-half income, one-half principal [Trust Code §116.201), unless Trust Code §116.051(2)(B) or (C) applies [related to decedents’ estates and when income interests end].
<b>Fees – Investment Advisor’s.</b>	Not specifically addressed, but probably charged to income under Trust Code §113.111(a)(5).	One-half income, one-half principal [Trust Code §116.201), unless Trust Code §116.051(2)(B) or (C) applies [related to decedents’ estates and when income interests end].

<i>Item</i>	<i>Old (Through 12/31/03)</i>	<i>New (On and After 1/1/04 Forward)</i>
<b>Fees – Attorney’s.</b>	Follows the costs of the judicial proceeding, if there is one, or else they are divided between income and principal as the trustee determines to be just and equitable [Trust Code §113.111(a)(6) and (b)(1)].	<p>Attorney’s fees are specifically addressed only in two cases:</p> <p>(1) Attorney’s fees related to a decedent’s estate (or the end of an income interest) may be allocated to principal and income in the fiduciary’s discretion; and</p> <p>(2) Attorney’s fees related to a judicial proceeding under Section 116.006(d) must be advanced from principal and allocated as the court finally determines.</p> <p>Except for these two cases, attorney’s fees are not distinguished from the reason they are incurred, so presumably one looks to the allocation rules for underlying reason the attorney was retained. For example, presumably the attorney’s fees associated with a judicial proceeding are allocated as one of the costs of the judicial proceeding, while the attorney’s fees associated with an accounting are allocated as one of the costs of the accounting.</p>
<b>Fees – Trustee’s.</b>	Divided between income and principal as the trustee determines to be just and equitable [old Trust Code §113.111(a)(6) and (b)(1)].	<p>Regular compensation: One-half income, one-half principal [Trust Code §116.201], unless Trust Code §116.051(2)(B) or (C) applies [related to decedents’ estates and when income interests end].</p> <p>Compensation calculated on principal as a fee for acceptance, distribution, or termination, and disbursements made to prepare property for sale: Charge to principal [Trust Code §116.202(a)(2)].</p>
<b>Insubstantial Receipts.</b>	N/A.	Add to principal, but there is no statutory presumption or safe harbor to determine what is “insubstantial” [Trust Code §116.171].

<i>Item</i>	<i>Old (Through 12/31/03)</i>	<i>New (On and After 1/1/04 Forward)</i>
<b>Insurance Premiums.</b>	Charged to income [Trust Code §113.111(a)(1)], although life insurance premiums were not specifically addressed and expenses to “assure the title of trust property” (which probably includes title insurance) are allocated to principal [Trust Code §113.111(b)(3)].	Charge premiums on policies covering the loss of a principal assets (for example, casualty and liability insurance) or the loss of income from use or use of the trust (for example, business interruption insurance) to income [Trust Code §116.201(4)]. Charge premiums on all other types of insurance (for example, title insurance and life insurance) to principal [Trust Code §116.202(a)(5)].
<b>Interest Expense.</b>	Charge to income [Trust Code §113.111(a)(1)].	Charge to income [Trust Code §116.201(3)].
<b>Interest Income.</b>	Allocate to income [Trust Code §113.102(a)(2)].	Allocate to income [Trust Code §116.163(a)]. Exceptions:  (1) If the discounted bond and note rule applies [Trust Code §116.163(b)].  (2) If the periodic payment at inception rule applies [Trust Code §116.102].
<b>Judicial Proceedings (Costs).</b>	If proceeding primarily concerns the income interest, charge to income (unless the court directs otherwise); and if proceeding primarily concerns the principal interest, including expenses incurred in maintaining or defending any action to construe the trust or to protect the trust property (unless the court directs otherwise) [Trust Code §113.111]. Costs for proceedings involving both the income and principal interests is not specifically addressed, but attorney’s fees can be allocated as the trustee determines are equitable and just [Trust Code §113.111].	If proceeding involves both the income and principal interests, charge one-half to income and one-half to principal [Trust Code §116.201(2)]; if proceeding involves “primarily” the income interest, charge to income [Trust Code §116.201(3)]; and if proceeding involves “primarily” principal, “including a proceeding to construe the trust or to protect the trust or its property,” charge to principal [Trust Code §116.202(a)(4)].  Exceptions:  (1) If Trust Code §116.051(2)(B) or (C) applies [related to decedent’s estates and when income interests end], then the fiduciary has discretion to allocate between income and principal; or  (2) If the judicial proceeding is under Section 116.006(d), in which case the trustee must advance all costs from principal and the court will determine at the end of the proceeding how the costs will finally be allocated..

<i>Item</i>	<i>Old (Through 12/31/03)</i>	<i>New (On and After 1/1/04 Forward)</i>
<b>Oil and Gas Receipts – Royalties and Bonus Payments.</b>	27.5% allocated to principal, the 72.5% allocated to income [Trust Code §113.107].	Receipts to be allocated “equitably,” and the allocation is presumed to be equitable if the amount allocated to principal is equal to the depletion deduction permitted for federal income tax purposes [Trust Code §116.174].  Exception: If the trust held the oil and gas interests on January 1, 2004, and if the trustee was following a “lawful” allocation procedure prior to January 1, 2004, the trustee may keep using the former “lawful” method.
<b>Oil and Gas Receipts – Delay Rentals.</b>	Allocate to income [Trust Code §113.107].	“Nominal” delay rentals are income, but delay rentals that are “more than nominal” must be allocated “equitably,” and the allocation is presumed to be equitable if the amount allocated to principal is equal to the depletion deduction permitted for federal income tax purposes [Trust Code §116.174].
<b>Other Expenses</b> in the administration, management or preservation of trust property.	Charge to income [Trust Code §113.111(a)].	Charge to income, unless another specific allocation rule applies [Trust Code §116.201(3)].
<b>Periodic Payment At Inception Rule</b> (interest payments and rent received, etc.).	Payments received after death which were due before death are principal [Trust Code §113.103(b)(1)].  Payments received after death which were due after death are accrued on a daily basis [Trust Code §113.103(b)(2)].	Payments received after death which were due before death are principal [Trust Code §116.102(a)].  Payments received after death are accrued on a daily basis <i>only if</i> the due date is not periodic or there is no due date; otherwise, the payments are income [Trust Code §116.102(b) and (c)].
<b>Principal Payments on Debts.</b>	Charge to principal [Trust Code §113.111(b)].	Charge to principal [Trust Code §116.202(a)(3)].
<b>Rent</b> on real and personal property, including amounts received for cancellation or renewal of lease.	Income [Trust Code §113.102(a)(1)].	Income [Trust Code §116.162] unless:  (1) the trustee is accounting for the rental properties as a separate business under Trust Code §116.153 (see “Business Exception” in this table); or  • the periodic payment at inception rule applies [Trust Code §116.102].



<i>Item</i>	<i>Old (Through 12/31/03)</i>	<i>New (On and After 1/1/04 Forward)</i>
<b>Repairs – Ordinary.</b>	Charge to income [Trust Code §113.111(a)].	Charge to income [Trust Code §116.201(3)].
<b>Repairs – Extraordinary and Capital Improvements.</b>	Charge to principal, but the trustee may establish an allowance for depreciation out of income [Trust Code §113.111].	Not specifically chargeable to income under Trust Code §116.201, but Trust Code §116.204 seems to say that payments for extraordinary repairs are “chargeable” to income but may be paid from principal, with the trustee given the discretion to make transfers from income to principal to cover the expenses or to establish a reserve for these expenses.
<b>Taxes – Inheritance, Estate, GST.</b>	Charge to principal [Trust Code §113.111(b)(6)].	Charge to principal [Trust Code §116.202(a)(6)]. If expenses are deducted on income tax return instead of estate tax return, resulting in reduction of marital or charitable deduction, principal estate must be reimbursed [Trust Code §116.206(b)].
<b>Taxes – Capital Gains.</b>	Charge to principal [Trust Code §113.111(b)(5)].	Charge to principal [Trust Code §116.205], but equitable adjustments may apply [Trust Code §116.206].
<b>Taxes – Ordinary Income.</b>	Charge to income [Trust Code §113.111(a)(7)].	Charge to income [Trust Code §116.205], but equitable adjustments may apply [Trust Code §116.206].
<b>Taxes – Ad Valorem.</b>	Charge to income [Trust Code §113.111(a)(1)].	Charge to income [Trust Code §116.201(3)].
<b>Taxes – Other.</b>	“Regularly recurring taxes assessed against any portion of the principal” are charged to income [Trust Code §113.111(a)(1)].	“Regularly recurring taxes assessed against principal” are charged to income [Trust Code §116.201(3)].
<b>Timber.</b>	Allocated reasonably and equitably. [Trust Code §113.108].	To the extent the harvesting rate does not exceed the growth rate, proceeds are income. The rest of the proceeds (including proceeds from standing timber) is principal. [Trust Code §116.175]

<i>Item</i>	<i>Old (Through 12/31/03)</i>	<i>New (On and After 1/1/04 Forward)</i>
<b>When in Doubt.</b>	If the trust instrument nor the statute specified how an item was to be allocated, the trustee was to allocate “in accordance with what is reasonable and equitable in view of the interests of those entitled to income and to principal” [Trust Code §113.101(a)(3)].	If neither the trust terms nor the statute provide an answer, the trustee shall add a receipt to principal and charge a disbursement to principal [Trust Code §116.004(a)(4)].