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THE FINANCIAL PLANNING ASSOCIATION

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June 4, 2001

Honorable Gary George
State Capitol
P.O. Box 7882
Madison, WI 53707

Re: Senate Bill 109

Dear Senator George:

The Financial Planning Association ("FPA")[1] would like to offer our support for Wisconsin Senate Bill 109 which incorporates the language from the Uniform Prudent Investor Act as promulgated by the Uniform Law Commissioners in 1994. To date, trustees off trusts and like fiduciaries have been subject to rules that severely limit investments of trust assets. The Uniform Prudent Investor Act (the "Act") removes many of the outdated common law restrictions upon the investment authority of trustees of trusts and like fiduciaries. The Act provides rules governing investment that should result in greater protection for a trust's assets while providing a prospect for improved income.

The FPA has spent a considerable amount of time at both the national and local level scrutinizing and discussing the Uniform Prudent Investor Act and the Uniform Trust Code ("UTC") and we believe that both of these uniform acts would benefit consumers and professionals in the financial services profession. The UTC provides a comprehensive model for codifying the law on trusts and it includes and incorporates the provisions of the UPIA. The FPA supports the passage of legislation incorporating both of these uniform acts.

FPA appreciates your efforts on behalf of Wisconsin citizens and we urge you to support

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1 The Financial Planning Association is the largest organization in the United States representing financial planners and affiliated firms. FPA is domiciled in Washington, D.C., with administrative offices in Atlanta and Denver, and represents approximately 29,000 financial planners in the United States.

Senate Bill 109 which will be an invaluable tool for financial planners and their clients as they consider their financial options. We look forward to working with you to inform the Wisconsin legislature about the benefits of the UPIA. Please feel free to contact the undersigned if you have any questions or concerns about these comments.

Sincerely,

Robert H. Neill, Jr.
Legislative Counsel

National Conference of Commissioners on Uniform State Laws

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UNIFORM PRINCIPAL AND INCOME ACT (1997)
- A SUMMARY -

A trustee of a trust and the personal representative of a decedent's estate are called fiduciaries. They have special duties toward those who benefit from their administration. A trustee of a trust has a fiduciary obligation to satisfy both the interests of the trust's income beneficiaries during the life of the trust, and the interests of the remainder beneficiaries at the trust's termination. A personal representative may be required to allocate net income to certain individuals during the administration of the estate and to assure that certain expenses are paid out of an appropriate category of interests before finally distributing the assets of the decedent's estate to the heirs or devisees (heirs if there is no will, devisees if there is a will).

The trustee and the personal representative satisfy their obligations by making the proper allocations of assets to either principal or to income. Generally, assets allocated to principal serve the interests of remainder beneficiaries of a trust, and the interests of the final distributees of the assets in an estate. Assets allocated to income meet the requirements of income beneficiaries during the life of a trust, and those beneficiaries who must be paid out of the income derived during administration of an estate.

But the identification of principal and income, its allocation, and apportionment of assets between income and principal have always been a very tricky business. Distinguishing income from principal is not always self-evident. Therefore, the law has provided trustees with statutory help for a very long period of time. The Uniform Law Commissioners promulgated the first Uniform Principal and Income Act in 1931. A revision was promulgated in 1962. Almost all of the states in the United States have adopted one or the other of these earlier acts by 1997, when a new revision once again has been promulgated.

In 1997, 35 years after the 1962 revision, the Uniform Law Commissioners have promulgated the Uniform Principal and Income Act (1997) (UPIA 1997). Obsolescence over time is not the only stimulus for promulgating UPIA 1997. In the 1990's and especially since the promulgation of the Uniform Prudent Investor Act in 1994, a trustee's obligation to invest the assets of a trust as a prudent investor would invest them, has substantially altered the fiduciary obligations of a trustee. There is a strong relationship between the obligation to invest as a prudent investor and the obligation to satisfy income and remainder beneficiaries. The earlier Uniform Principal and Income Acts do not accommodate prudent investor rules. UPIA 1997 does, as will be discussed a little later in this summary.

UPIA 1997 provides some basic answers to questions that any trustee must ask in dealing with trust assets, and that personal representatives need to ask in the administration of an estate. The first question is whether an asset that becomes a trust or estate asset is either principal or income? Once established as either principal or income, the next question is, when is a beneficiary entitled to receive that asset?

The answers to these questions are strongly affected by the time at which the question is asked. There are three relevant times to consider: the time before creation of an income interest, the time during which an income interest is current, and the time after the income interest ends (an income interest is merely the interest of the income beneficiary—the right to receive current payment). The time influences allocation of assets to principal or to income, and ultimately the rights of income and remainder beneficiaries.

The beginning and the end of the income interest are key, because 1) sometimes assets that would otherwise be income are allocated to principal if there is no current income interest; and 2) even if assets are allocated to income, when there is no current income interest, remainder beneficiaries will be entitled to a share of that income.

INITIAL RULE

The express language of the trust instrument, will, or other applicable document will govern, notwithstanding conflict with any statutory rule. UPIA 1997 is entirely a default statute that operates only when the governing instrument is silent.

ALLOCATION TO PRINCIPAL OR INCOME

Principal is fundamentally defined as the property held in trust for distribution to a remainder beneficiary when the trust terminates. Income is the current return that any fiduciary receives from an asset that is principal. It has never been sufficient to provide a bare general definition in any of the Uniform Principal and Income Acts. There is, therefore, a group of rules that establish what is principal and what is income with respect to specific kinds of assets.

UPIA 1997 refines old rules and provides specific rules for assets that are not accounted for in the earlier acts. An example of the refinement of old rules concerns receipts from an entity. The earlier uniform acts provide for corporate distributions, generally allocating ordinary dividends to income and any other distribution in the form of additional equity to principal. UPIA 1997 addresses the broader category of receipts from an "entity." A corporation is an entity, but so is a partnership, a limited liability company, a regulated investment company and a real estate investment trust. UPIA 1997 allocates the receipts from all entities in the same manner.

UPIA 1997 then simplifies the allocation question. Any "money" received by a fiduciary is regarded as income, unless it fits certain categories. For example, if money is received as part of a liquidation of the entity, it is principal. If money is received from an investment company (mutual fund) that labels a distribution as capital gain, the receipt is principal. All property received that is not money, i.e., a stock distribution, is principal. In addition, UPIA 1997 establishes what qualifies as a partial or complete liquidation of an entity. Fiduciaries will, thus, be better able to make judgments about receipts that are part of a liquidation. This is a more precise and logical set of rules for making allocations than exists in the earlier uniform acts, making fiduciaries' decisions easier and more certain.

There are certain kinds of assets that UPIA 1997 provides for that are just not within the scope of consideration in the earlier acts. One of them is derivatives. Another is asset-based securities. Receipts from derivatives, unless a trustee exercises powers available in the conduct of a business held in trust, are principal. Receipts from asset-based securities are either income or principal, depending upon the categorization of the asset backed security's payor.

APPORTIONMENT ISSUES

The beginning point and the ending point of an income interest in an estate or a trust provide particular problems, even though the incoming assets would clearly be income under the rules applied during the life of the income interest. Depending upon the time of receipt, an asset that is otherwise classified as income may have to be apportioned at least in part to principal to balance beneficiary interests. UPIA 1997 more precisely and simply provides for that apportionment than the earlier acts did.

UPIA 1997 provides, generally, that an income receipt is principal if it is due before a decedent dies in the case of an estate or before an income interest begins in the case of a trust. After death or after an income interest begins, it is classified as income. If there is income that is not distributed at the time the income interest ends, generally it is paid to income beneficiaries. But if the trust is revocable by an income beneficiary at an amount more than five percent of the trust's corpus immediately before the income interest ends, the undistributed income allocable to the revocable part, must be added to principal.

RIGHT TO PAYMENT

UPIA 1997 expressly requires distribution of net income and principal receipts to the appropriate beneficiaries when a decedent dies or when an income interest ends. There is discretion given to pay certain expenses out of either principal or income unless there is an adverse effect on estate tax marital deductions or income tax charitable deductions. General expenses of an estate are paid from principal. A specific pecuniary amount required to be paid, is paid from income unless insufficient. The deficiency is paid from principal. If there is any net income after the fact, it is distributed to remainder beneficiaries according to share in principal.

These rules assure orderly distribution of income when the decedent dies or an income interest ends. The earlier uniform acts make no attempt to deal with this distribution problem.

ADJUSTMENT POWERS

For Prudent Investment

A trustee must use prudent investment rules in any state that has adopted the Uniform Prudent Investor Act or equivalent statute, and in any case governed by the Restatement of the Law of Trusts III. The investment policy governing a trust's assets depends upon making the appropriate risk/return analysis and investing accordingly. Asset growth can be as significant an objective as income in setting the investment policy for a specific trust. Because a trustee may weight either growth or income significantly in making investment decisions, and because either may be greater or less than anticipated, the trustee may have to rebalance the interests of remainder and income beneficiaries as a result.

UPIA 1997 allows the trustee to adjust principal and income to the extent made necessary by prudent investment when a trust provides for a fixed income for the income beneficiary. This must be a careful decision before which "a trustee shall consider all of the factors relevant to the trust and its beneficiaries." The express list of factors includes "the nature, purpose, and expected duration of the trust;" and "the intent of the settlor." This is not a decision to be taken lightly—the list of express factors to consider is long. Adjustments are forbidden in certain circumstances, such as when they diminish "the income interest in a trust that requires all of the income to be paid at least annually to a surviving spouse and for which an estate tax or gift tax marital deduction would be allowed..." or "if the trustee is a beneficiary of the trust..." This list of forbidden situations, also, must be read with some care before a trustee decides to adjust allocations.

The earlier Uniform Acts did not deal with adjustment as a result of prudent investment. The whole notion of prudent investment, modern portfolio theory and total return came later than either of the two earlier acts. UPIA 1997 is absolutely necessary to making prudent investment work to its full capacity.

For Disbursements during the Administration of a Trust

Expenses and taxes must be paid during the administration of a trust. From which side of the ledger are they to be paid? Generally, UPIA 1997 provides for payment of ordinary expenses out of income, for payment of compensation to the trustee and legal proceedings from principal and income, dividing expenses in two, and payment of expenses peculiar to the remainder interest to principal. A trustee may transfer income to principal to make up for depreciation of an asset or to reimburse principal for disbursements that enhance income, i.e., repairs to assets that are necessary to maintain income. A trustee may make adjustments to principal and income to offset "shifting of economic interests or tax benefits between income and remainder beneficiaries" in certain instances.

During the Conduct of a Business Held in Trust

Under UPIA 1997, a trustee who conducts a business held in a trust may separate out the accounting for the business from that for other trust assets. The trustee, also, has the power to allocate net cash receipts to "working capital, the acquisition or replacement of fixed assets, and other reasonably foreseeable needs of the business or activity, and the extent to which the remaining net cash receipts are accounted for as principal or income in the trust's general accounting records."

The earlier uniform acts treated net profit from a business as income, and losses as principal. There is no flexibility.

For Tax Purposes

UPIA 1997 allows a fiduciary to make adjustments between principal and income for tax purposes. Tax liabilities may accrue to either income or remainder beneficiaries. A fiduciary may have to make elections under the tax laws. Imbalances of interests that arise because of taxes can be remedied by the fiduciary.

The earlier uniform acts did not provide such discretion to the fiduciary.

CONCLUSION

It is essential for the drafting and administration of wills and trusts that UPIA 1997 be adopted in every state and jurisdiction as soon as possible. Drafting of instruments becomes considerably harder without a modern set of rules that, among other things, allows adjustment because of prudent investment decisions and because of tax laws. If an instrument is not adequately drafted, trustees will not be able to meet fiduciary obligations. The result will be, higher costs for setting up trusts, more conflict between trustees and beneficiaries and excessive litigation. UPIA 1997 will make life much easier for personal representatives, trustees and beneficiaries alike.

UNITRUST SECTIONS

I. Add new § 701.20(2)(ka) as follows:

(ka) "Sui juris beneficiary" is a beneficiary not under any legal disability, and shall include:

1. a court appointed guardian of an incapacitated beneficiary;

2. an agent for an incompetent beneficiary; and

3. a court-appointed guardian of a minor beneficiary's estate or, if none, the parents of the minor beneficiary.

II. Add new § 701.20(4a) as follows:

(4a) POWER TO CONVERT TO UNITRUST. (a) Conversion. – Unless expressly prohibited by the governing instrument, a trustee may release the power under sub. (4) (relating to the trustee's power to adjust) and convert a trust into a unitrust as described in this subsection if all of the following apply:

1. The trustee determines that the conversion will enable the trustee to better carry out the purposes of the trust.

2. The trustee gives written notice under sub. (4b) of the trustee's intention to release the power to adjust and to convert the trust into a unitrust and of how the unitrust will operate, including the payout percentage as described in par. (d)3. and what initial decisions the trustee will make under this subsection, including those described in par. (e).

3. There is at least one sui juris income beneficiary, either in an individual or representative capacity, under sub. (4b)(a)2.a. and at least one different sui juris remainder beneficiary, either in an individual or representative capacity, under sub. (4b)(a)2.b.

4. No sui juris beneficiary objects to the conversion to a unitrust in a writing delivered to the trustee within the period specified by the notice under sub. (4b).

(b) Judicially approved conversion. –

1. As an alternative to par. (a), the trustee may give written notice under sub. (4b) and petition the court to approve the conversion to a unitrust and the release of the power under sub. (4) whether or not any of the following apply:

a. A beneficiary timely objects to the conversion to a unitrust.

b. The requirement pertaining to sui juris beneficiaries under sub. (4a)(a)3. is met.

2. A beneficiary may request a trustee to convert to a unitrust. If the trustee does not convert, the beneficiary may give written notice under sub. (4b) and petition the court to order the conversion.

3. The court shall approve the conversion or direct the requested conversion if the court concludes that the conversion will enable the trustee to better carry out the purposes of the trust.

(c) Consideration. – The trustee shall apply sub. (4)(b) when deciding whether to exercise the power to convert to a unitrust under par. (a).

(d) Post conversion. – After a trust is converted to a unitrust, all of the following apply:

1. The trustee shall follow an investment policy seeking a total return for the investments held by the trust, whether the return is to be derived:

a. from appreciation of capital;

b. from earnings and distributions from capital; or

c. from both.

2. The trustee shall make regular distributions in accordance with the governing instrument construed in accordance with the provisions of this section.

3. The term "income" in the governing instrument shall mean an annual distribution (the "unitrust distribution") equal to the payout percentage stated in the trustee's written notice under sub. (4b)(a) or in a court order under par. (b)3. (the "payout percentage"), which shall equal a fixed percentage of the net fair market value of the trust's assets, whether such assets would be considered income or principal under other provisions of this section, averaged over the lesser of:

a. the three preceding years; or

b. the period during which the trust has been in existence; provided that, if the payout percentage is determined by the trustee by written notice under par. (a) or par. (d)4., the payout percentage shall not be less than 3% nor more than 5%.

4. The trustee may reconvert a trust from a unitrust or change the payout percentage under par. (d)3. or any of the determinations under par. (e). The

trustee shall reconvert the trust or make such other change after giving written notice as described in par. (a) or upon petition of and approval by the court as described in par. (b).

(e) Discretion of trustee. – The trustee may in the trustee's discretion from time to time determine all of the following:

1. The provisions for prorating a unitrust distribution for a short year in which a beneficiary's right to payments commences or ceases.

2. The frequency of unitrust distributions during the year.

3. The effect of other payments from or contributions to the trust on the trust's valuation.

4. Whether to value the trust's assets annually or more frequently.

5. What valuation dates to use.

6. How frequently to value nonliquid assets and whether to estimate their value.

7. Whether to omit from the calculations trust property occupied or possessed by a beneficiary.

8. Any other matters necessary for the proper functioning of the unitrust.

(f) Allocation. –

1. Expenses which would be deducted from income if the trust were not a unitrust may not be deducted from the unitrust distribution.

2. Unless otherwise provided by the governing instrument, the unitrust distribution shall be paid from net income, as such term would be determined if the trust were not a unitrust. To the extent net income is insufficient, the unitrust distribution shall be paid from net realized short-term capital gains. To the extent income and net realized short-term capital gains are insufficient, the unitrust distribution shall be paid from net realized long-term capital gains. To the extent income and net realized short-term and long-term capital gains are insufficient, the unitrust distribution shall be paid from the principal of the trust.

(g) Court orders. – The trustee or, if the trustee declines to do so, a beneficiary may petition the court to:

1. Select a payout percentage different from that stated in the trustee's written notice under par. (a) or in a prior court order under par. (b).

5. If the conversion would result in the disallowance of a Federal estate tax or gift tax marital deduction which would be allowed if the trustee did not have the power to convert.

6. If the trustee is a beneficiary of the trust.

(j) Permissible conversion when otherwise prohibited. –

1. If par. (i)3., 4. or 6. applies to a trustee and there is more than one trustee, a co-trustee to whom the provision does not apply may convert the trust, unless the exercise of the power by the remaining trustee or trustees is prohibited by the governing instrument.

2. If par. (i)3., 4. or 6. applies to all the trustees, the trustees may petition the court to direct a conversion.

(k) Release of the power to convert. –

1. A trustee may release the power conferred by par. (a) to convert to a unitrust if any of the following apply:

a. The trustee is uncertain about whether possessing or exercising the power will cause a result described in par. (i)3., 4. or 5.

b. The trustee determines that possessing or exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not described in par. (i).

2. The release may be permanent or for a specified period, including a period measured by the life of an individual.

NOTICE PROVISION

III. Add new § 701.20(4b) as follows:

(4b) NOTICE OF PROPOSED ACTION TO BENEFICIARIES. (a) A trustee may, but is not required to, obtain approval of a proposed action under sub. (4) by providing a written notice which complies with all of the following:

1. Notice of the proposed action must be given at least thirty (30) days before the proposed effective date of the proposed action. For purposes of this subsection, a proposed action includes a course of action or a decision not to take action under sub. (4) or (4a).

2. The notice must be given to all the sui juris beneficiaries who are:

a. income beneficiaries currently eligible to receive income from the trust; and

b. remainder beneficiaries who would receive, if no powers of appointment were exercised, a distribution of principal if the trust were to terminate immediately prior to the giving of notice.

3. The notice of proposed action must state that it is given pursuant to this subsection and must disclose the following information:

a. Identification of the trustee.

b. Description of the proposed action to be taken.

c. Time within which the beneficiaries may object to the proposed action, which shall be at least 30 days from the giving of the notice of proposed action. Notice shall be given as provided under Chapter 879.

d. The effective date of the proposed action if no objection under par. (d) is received.

4. The trustee is not required to give notice of a proposed action to any sui juris beneficiary who consents in writing to the proposed action. A sui juris beneficiary may give consent at any time before or after the proposed action it taken.

(b) A sui juris beneficiary may object to the proposed action by making a written objection to the trustee within the time period specified in the notice.

(c) A trustee may decide not to implement a proposed action after the trustee receives a written objection to the proposed action or for any other reason. In that event, the trustee shall give written notification to the sui juris beneficiaries of the decision not to take the proposed action.

(d) If a trustee receives a written objection to the proposed action within the time period specified in the notice, either the trustee or a beneficiary may petition the court to have the proposed action approved, modified or denied. In the court proceeding, the beneficiary objecting to the proposed action shall have the burden of proving that the trustee's proposed action should not be taken. A beneficiary who did not previously object to the proposed action is not estopped from opposing the proposed action in the court proceeding.

TRUSTEE LIABILITY

IV. Add new § 701.20(4c) as follows:

(4c) LIMITS ON TRUSTEE LIABILITY. The liability of a trustee for taking an action or for deciding not to take an action under sub. (4) or (4a) is limited as follows:

(a) Nothing in section 701.20 is intended to create or imply a duty on the part of the trustee to make an adjustment or convert to a unitrust under sub. (4) or (4a). A trustee shall not be liable for not considering whether to make an adjustment or convert to a unitrust or for choosing not to make an adjustment or convert to a unitrust under sub. (4) and (4a).

(b) In a proceeding with respect to a trustee's exercise or non-exercise of the power to make an adjustment or the power to convert to a unitrust under sub. (4) and (4a), the sole remedy is to direct, deny or revise an adjustment between principal and income or the conversion to a unitrust.

(c) A trustee is not liable to any income beneficiary or remainder beneficiary, his, her or its heirs or assigns, or to the trust for any action taken under sub. (4) or (4a) if the trustee gives written notice of the proposed action under sub. (4b) and the trustee does not receive a timely written objection to the notice.

(d) The trustee's decision not to implement a proposed action pursuant to sub. (4b)(c) shall not itself give rise to any liability on the part of the trustee.

V. Delete existing § 701.20(4m), JUDICIAL REVIEW OF DISCRETIONARY POWER.

INTEREST

VI. Replace § 701.20(5)(c) with the following:

(c) Unless the will or the terms of the trust otherwise provides, a beneficiary, including a trustee, of a pecuniary amount not determined by a pecuniary formula shall receive interest on any unpaid portion of the pecuniary amount for the period commencing one year after the decedent's death or after the income interest in the trust ends at the legal rate set forth in s.138.04. Such interest shall be distributed from net income determined under par. (b) or from principal to the extent that net income is insufficient.

VII. Modify § 701.20(5)(d) as follows:

(d) A fiduciary shall distribute the net income remaining after distributions required by par. (c) in the manner described in sub. (6) to all other beneficiaries, including a beneficiary who receives a pecuniary amount determined by a pecuniary formula.

2. Provide for a distribution of net income, as would be determined if the trust were not a unitrust, in excess of the unitrust distribution if such distribution is necessary to preserve a tax benefit.

3. Average the valuation of the trust's net assets over a period other than that specified in par. (d)3.

4. Reconvert from a unitrust. Upon a reconversion, the power to adjust under sub. (4) shall be revived.

(h) Application. – Conversion to a unitrust does not affect a provision in the governing instrument directing or authorizing the trustee to distribute principal or authorizing a beneficiary to withdraw a portion or all of the principal.

(i) Prohibited conversions. – A trustee may not convert a trust into a unitrust in any of the following circumstances:

1. If payment of the unitrust distribution would change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets.

2. If the unitrust distribution would be made from any amount which is permanently set aside for charitable purposes under the governing instrument and for which a Federal estate or gift tax deduction has been taken, unless both income and principal are so set aside.

3. If:

a. possessing or exercising the power to convert would cause an individual to be treated as the owner of all or part of the trust for Federal income tax purposes; and

b. the individual would not be treated as the owner if the trustee did not possess the power to convert.

4. If:

a. possessing or exercising the power to convert would cause all or part of the trust assets to be subject to Federal estate or gift tax with respect to an individual; and

b. the assets would not be subject to Federal estate or gift tax with respect to the individual if the trustee did not possess the power to convert.

VIII. Modify § 701.20(6)(b)2. as follows:

2. The beneficiary's fractional interest in the undistributed principal assets must be calculated without regard to property specifically given to a beneficiary and property required to pay pecuniary amounts not determined by a pecuniary formula.

RETIREMENT PLANS, IRAS, ETC.

IX. Replace § 701.20(18)(c) with the following:

(c) If no part of a payment is allocated to income pursuant to par. (b), then for each accounting period of the trust that any payment is received by the trust, the trustee shall allocate to income that portion of the aggregate value of all payments received by the trustee in that accounting period equal to the amount of plan income as defined herein attributable to the trust's interest in the plan for that accounting period. The trustee shall allocate the balance of that payment or payments to principal.

1. For purposes of this subsection, if a payment is received from a plan that maintains a separate account or fund for its participants or account holders, including, but not limited to, defined contribution retirement plans, individual retirement accounts, Roth individual retirement accounts, and some types of deferred compensation plans, the phrase "plan income" shall mean either the amount of the plan account or fund held for the benefit of the trust that, if the plan account or fund were a trust, would be allocated to income pursuant to the remaining provisions of this subsection for that accounting period, or four percent of the value of the plan account or fund on the first day of that accounting period. The method of determining plan income pursuant to this subsection shall be chosen by the trustee in the trustee's discretion. The trustee may change the method of determining plan income pursuant to this subsection for any future accounting period.

2. For purposes of this subsection if the payment is received from a plan that does not maintain a separate account or fund for its participants or account holders, including by way of example and not limitation defined benefit retirement plans and some types of deferred compensation plans, the term "plan income" shall mean four percent of the total present value of the trust's interest in the plan as of the first day of the accounting period, based on reasonable actuarial assumptions as determined by the trustee.

X. Modify § 701.20(18)(d) as follows:

(d) If, to obtain an estate or gift tax marital deduction for an interest in a trust, a trustee must allocate more of a payment to income than provided for by this subsection, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction.

EFFECTIVE DATE

XI. Modify § 701.24(2) so that new § 701.20 will be effective on the first day of an existing estate's or trust's fiscal year beginning after enactment of Senate Bill 109.

UNIFORM PRUDENT INVESTOR ACT

Drafted by the

NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS

and by it

APPROVED AND RECOMMENDED FOR ENACTMENT
IN ALL THE STATES

at its

ANNUAL CONFERENCE
MEETING IN ITS ONE-HUNDRED-AND-THIRD YEAR
IN CHICAGO, ILLINOIS
JULY 29 - AUGUST 5, 1994

ULC 100 Uniform Law Commissioners

WITH PREFATORY NOTE AND COMMENTS

Approved by the American Bar Association
Miami, Florida, February 14, 1995

UNIFORM PRUDENT INVESTOR ACT

The Committee that acted for the National Conference of Commissioners on Uniform State Laws in preparing the Uniform Prudent Investor Act was as follows:

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JOSEPH KARTIGANER, *American Bar Association*

Copies of this Act may be obtained from:

NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS
676 North St. Clair Street, Suite 1700
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312/915-0195

UNIFORM PRUDENT INVESTOR ACT

PREFATORY NOTE

Over the quarter century from the late 1960's the investment practices of fiduciaries experienced significant change. The Uniform Prudent Investor Act (UPIA) undertakes to update trust investment law in recognition of the alterations that have occurred in investment practice. These changes have occurred under the influence of a large and broadly accepted body of empirical and theoretical knowledge about the behavior of capital markets, often described as "modern portfolio theory."

This Act draws upon the revised standards for prudent trust investment promulgated by the American Law Institute in its Restatement (Third) of Trusts: Prudent Investor Rule (1992) [hereinafter Restatement of Trusts 3d: Prudent Investor Rule; also referred to as 1992 Restatement].

Objectives of the Act. UPIA makes five fundamental alterations in the former criteria for prudent investing. All are to be found in the Restatement of Trusts 3d: Prudent Investor Rule.

(1) The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the trust setting the term "portfolio" embraces all the trust's assets. UPIA § 2(b).

(2) The tradeoff in all investing between risk and return is identified as the fiduciary's central consideration. UPIA § 2(b).

(3) 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).

(4) The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing. UPIA § 3.

(5) The much criticized former rule of trust law forbidding the trustee to delegate investment and management functions has been reversed. Delegation is now permitted, subject to safeguards. UPIA § 9.

Literature. These changes in trust investment law have been presaged in an extensive body of practical and scholarly writing. See especially the discussion and reporter's notes by Edward C. Halbach, Jr., in Restatement of Trusts 3d: Prudent Investor Rule (1992); see also Edward C. Halbach, Jr., Trust Investment Law in the Third Restatement, 27 Real Property, Probate & Trust J. 407 (1992); Bevis Longstreth, Modern Investment Management and the Prudent Man Rule (1986); Jeffrey N. Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U.L. Rev. 52 (1987); John H. Langbein & Richard A. Posner, The Revolution in Trust Investment Law, 62 A.B.A.J. 887 (1976); Note, The Regulation of Risky Investments, 83 Harvard L. Rev. 603 (1970). A succinct account of the main findings of modern portfolio theory, written for lawyers, is Jonathan R. Macey, An Introduction to Modern Financial Theory (1991) (American College of Trust & Estate Counsel Foundation). A leading introductory text on modern portfolio theory is R.A. Brealey, An Introduction to Risk and Return from Common Stocks (2d ed. 1983).

Legislation. Most states have legislation governing trust-investment law. This Act promotes uniformity of state law on the basis of the new consensus reflected in the Restatement of Trusts 3d: Prudent Investor Rule. Some states have already acted. California, Delaware, Georgia, Minnesota, Tennessee, and Washington revised their prudent investor legislation to emphasize the total-portfolio standard of care in advance of the 1992 Restatement. These statutes are extracted and discussed in Restatement of Trusts 3d: Prudent Investor Rule § 227, reporter's note, at 60-66 (1992).

Drafters in Illinois in 1991 worked from the April 1990 "Proposed Final Draft" of the Restatement of Trusts 3d: Prudent Investor Rule and enacted legislation that is closely modeled on the new Restatement. 760 ILCS § 5/5 (prudent investing); and § 5/5.1 (delegation) (1992). As the Comments to this Uniform Prudent Investor Act reflect, the Act draws upon the Illinois statute in several sections. Virginia revised its prudent investor act in a similar vein in 1992. Virginia Code § 2645.1 (prudent investing) (1992). Florida revised its statute in 1993. Florida Laws, ch. 93-257, amending Florida Statutes § 518.11 (prudent investing) and creating § 518.112 (delegation). New York legislation drawing on the new Restatement and on a preliminary version of this Uniform Prudent Investor Act was enacted in 1994. N.Y. Assembly Bill 11683-B, Ch. 609 (1994), adding Estates, Powers and Trusts Law § 11-2.3 (Prudent Investor Act).

Remedies. This Act does not undertake to address issues of remedy law or the computation of damages in trust matters. Remedies are the subject of a reasonably distinct body of doctrine. See generally Restatement (Second) of Trusts §§ 197-226A (1959) [hereinafter cited as Restatement of Trusts 2d; also referred to as 1959 Restatement].

Implications for charitable and pension trusts. This Act is centrally concerned with the investment responsibilities arising under the private gratuitous trust, which is the common vehicle for conditioned wealth transfer within the family. Nevertheless, the prudent investor rule also bears on charitable and pension trusts, among others. "In making investments of trust funds the trustee of a charitable trust is under a duty similar to that of the trustee of a private trust." Restatement of Trusts 2d § 389 (1959). The Employee Retirement Income Security Act (ERISA), the federal regulatory scheme for pension trusts enacted in 1974, absorbs trust-investment law through the prudence standard of ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a). The Supreme Court has said: "ERISA's legislative history confirms that the Act's fiduciary responsibility provisions 'codif[y] and mak[e] applicable to [ERISA] fiduciaries certain principles developed in the evolution of the law of trusts.'" *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 110-11 (1989) (footnote omitted).

Other fiduciary relationships. The Uniform Prudent Investor Act regulates the investment responsibilities of trustees. Other fiduciaries – such as executors, conservators, and guardians of the property – sometimes have responsibilities over assets that are governed by the standards of prudent investment. It will often be appropriate for states to adapt the law governing investment by trustees under this Act to these other fiduciary regimes, taking account of such changed circumstances as the relatively short duration of most executorships and the intensity of court supervision of conservators and guardians in some jurisdictions. The present Act does not undertake to adjust trust-investment law to the special circumstances of the state schemes for administering decedents' estates or conducting the affairs of protected persons.

Although the Uniform Prudent Investor Act by its terms applies to trusts and not to charitable corporations, the standards of the Act can be expected to inform the investment responsibilities of directors and officers of charitable corporations. As the 1992 Restatement observes, "the duties of the members of the governing board of a charitable corporation are generally similar to the duties of the trustee of a charitable trust." Restatement of Trusts 3d: Prudent Investor Rule § 379, Comment *b*, at 190 (1992). See also id. § 389, Comment *b*, at 190-91 (absent contrary statute or other provision, prudent investor rule applies to investment of funds held for charitable corporations).

UNIFORM PRUDENT INVESTOR ACT

SECTION 1. PRUDENT INVESTOR RULE.

(a) Except as otherwise provided in subsection (b), a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule set forth in this [Act].

(b) 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.

Comment

This section imposes the obligation of prudence in the conduct of investment functions and identifies further sections of the Act that specify the attributes of prudent conduct.

Origins. The prudence standard for trust investing traces back to *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446 (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." Id. at 461.

Prior legislation. The Model Prudent Man Rule Statute (1942), sponsored by the American Bankers Association, undertook to codify the language of the *Amory* case. See Mayo A. Shattuck, The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century, 12 Ohio State L.J. 491, at 501 (1951); for the text of the model act, which inspired many state statutes, see id. at 508-09. Another prominent codification of the *Amory* standard is Uniform Probate Code § 7-302 (1969), which provides that "the trustee shall observe the standards in dealing with the trust assets that would be observed by a prudent man dealing with the property of another . . . ."

Congress has imposed a comparable prudence standard for the administration of pension and employee benefit trusts in the Employee Retirement Income Security Act (ERISA), enacted in 1974. ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a), provides that "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims . . . ."

Prior Restatement. The Restatement of Trusts 2d (1959) also tracked the language of the *Amory* case: "In making investments of trust funds the trustee is under a duty to the beneficiary . . . to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived . . . ." Restatement of Trusts 2d § 227 (1959).

Objective standard. The concept of prudence in the judicial opinions and legislation is essentially relational or comparative. It resembles in this respect the "reasonable person" rule of tort law. A prudent trustee behaves as other trustees similarly situated would behave. The standard is, therefore, objective rather than subjective. Sections 2 through 9 of this Act identify the main factors that bear on prudent investment behavior.

Variation. Almost all of the rules of trust law are default rules, that is, rules that the settlor may alter or abrogate. Subsection (b) carries forward this traditional attribute of trust law. Traditional trust law also allows the beneficiaries of the trust to excuse its performance, when they are all capable and not misinformed. Restatement of Trusts 2d § 216 (1959).

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.

Comment

Section 2 is the heart of the Act. Subsections (a), (b), and (c) are patterned loosely on the language of the Restatement of Trusts 3d: Prudent Investor Rule § 227 (1992), and on the 1991 Illinois statute, 760 § ILCS 5/5a (1992). Subsection (f) is derived from Uniform Probate Code § 7-302 (1969).

Objective standard. Subsection (a) of this Act carries forward the relational and objective standard made familiar in the *Amory* case, in earlier prudent investor legislation, and in the Restatements. Early formulations of the prudent person rule were sometimes troubled by the effort to distinguish between the standard of a prudent person investing for another and investing on his or her own account. The language of subsection (a), by relating the trustee's duty to "the purposes, terms, distribution requirements, and other circumstances of the trust," should put such questions to rest. The standard is the standard of the prudent investor similarly situated.

Portfolio standard. Subsection (b) emphasizes the consolidated portfolio standard for evaluating investment decisions. An investment that might be imprudent standing alone can become prudent if undertaken in sensible relation to other trust assets, or to other nontrust assets. In the trust setting the term "portfolio" embraces the entire trust estate.

Risk and return. Subsection (b) also sounds the main theme of modern investment practice, sensitivity to the risk/return curve. See generally the works cited in the Prefatory Note to this Act, under "Literature." Returns correlate strongly with risk, but tolerance for risk varies greatly with the financial and other circumstances of the investor, or in the case of a trust, with the purposes of the trust and the relevant circumstances of the beneficiaries. A trust whose main purpose is to support an elderly widow of modest means will have a lower risk tolerance than a trust to accumulate for a young scion of great wealth.

Subsection (b) of this Act follows Restatement of Trusts 3d: Prudent Investor Rule § 227(a), which provides that the standard of prudent investing "requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust."

Factors affecting investment. Subsection (c) points to certain of the factors that commonly bear on risk/return preferences in fiduciary investing. This listing is nonexclusive. Tax considerations, such as preserving the stepped up basis on death under Internal Revenue Code § 1014 for low-basis assets, have traditionally been exceptionally important in estate planning for affluent persons. Under the present recognition rules of the federal income tax, taxable investors, including trust beneficiaries, are in general best served by an investment strategy that minimizes the taxation incident to portfolio turnover. See generally Robert H. Jeffrey & Robert D. Arnott, Is Your Alpha Big Enough to Cover Its Taxes?, Journal of Portfolio Management 15 (Spring 1993).

Another familiar example of how tax considerations bear upon trust investing: In a regime of pass-through taxation, it may be prudent for the trust to buy lower yielding tax-exempt securities for high-bracket taxpayers, whereas it would ordinarily be imprudent for the trustees of a charitable trust, whose income is tax exempt, to accept the lowered yields associated with tax-exempt securities.

When tax considerations affect beneficiaries differently, the trustee's duty of impartiality requires attention to the competing interests of each of them.

Subsection (c)(8), allowing the trustee to take into account any preferences of the beneficiaries respecting heirlooms or other prized assets, derives from the Illinois act, 760 ILCS § 5/5(a)(4) (1992).

Duty to monitor. Subsections (a) through (d) apply both to investing and managing trust assets. "Managing" embraces monitoring, that is, the trustee's continuing responsibility for oversight of the suitability of investments already made as well as the trustee's decisions respecting new investments.

Duty to investigate. Subsection (d) carries forward the traditional responsibility of the fiduciary investor to examine information likely to bear importantly on the value or the security of an investment – for example, audit

reports or records of title. E.g., *Estate of Collins*, 72 Cal. App. 3d 663, 139 Cal. Rptr. 644 (1977) (trustees lent on a junior mortgage on unimproved real estate, failed to have land appraised, and accepted an unaudited financial statement; held liable for losses).

Abrogating categoric restrictions. Subsection 2(e) clarifies that no particular kind of property or type of investment is inherently imprudent. Traditional trust law was encumbered with a variety of categoric exclusions, such as prohibitions on junior mortgages or new ventures. In some states legislation created so-called "legal lists" of approved trust investments. The universe of investment products changes incessantly. Investments that were at one time thought too risky, such as equities, or more recently, futures, are now used in fiduciary portfolios. By contrast, the investment that was at one time thought ideal for trusts, the long-term bond, has been discovered to import a level of risk and volatility – in this case, inflation risk – that had not been anticipated. Accordingly, section 2(e) of this Act follows Restatement of Trusts 3d: Prudent Investor Rule in abrogating categoric restrictions. The Restatement says: "Specific investments or techniques are not per se prudent or imprudent. The riskiness of a specific property, and thus the propriety of its inclusion in the trust estate, is not judged in the abstract but in terms of its anticipated effect on the particular trust's portfolio." Restatement of Trusts 3d: Prudent Investor Rule § 227, Comment f, at 24 (1992). The premise of subsection 2(e) is that trust beneficiaries are better protected by the Act's emphasis on close attention to risk/return objectives as prescribed in subsection 2(b) than in attempts to identify categories of investment that are per se prudent or imprudent.

The Act impliedly disavows the emphasis in older law on avoiding "speculative" or "risky" investments. Low levels of risk may be appropriate in some trust settings but inappropriate in others. It is the trustee's task to invest at a risk level that is suitable to the purposes of the trust.

The abolition of categoric restrictions against types of investment in no way alters the trustee's conventional duty of loyalty, which is reiterated for the purposes of this Act in Section 5. For example, were the trustee to invest in a second mortgage on a piece of real property owned by the trustee, the investment would be wrongful on account of the trustee's breach of the duty to abstain from self-dealing, even though the investment would no longer automatically offend the former categoric restriction against fiduciary investments in junior mortgages.

Professional fiduciaries. The distinction taken in subsection (f) between amateur and professional trustees is familiar law. The prudent investor standard applies to a range of fiduciaries, from the most sophisticated professional investment management firms and corporate fiduciaries, to family members of minimal experience. Because the standard of prudence is relational, it follows that the standard for professional trustees is the standard of prudent professionals; for amateurs, it is the standard of prudent amateurs. Restatement of Trusts 2d § 174 (1959) provides: "The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has or procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill." Case law strongly supports the concept of the higher standard of care for the trustee representing itself to be expert or professional. See Annot., Standard of Care Required of Trustee Representing Itself to Have Expert Knowledge or Skill, 91 A.L.R. 3d 904 (1979) & 1992 Supp. at 48-49.

The Drafting Committee declined the suggestion that the Act should create an exception to the prudent investor rule (or to the diversification requirement of Section 3) in the case of smaller trusts. The Committee believes that subsections (b) and (c) of the Act emphasize factors that are sensitive to the traits of small trusts; and that subsection (f) adjusts helpfully for the distinction between professional and amateur trusteeship. Furthermore, it is always open to the settlor of a trust under Section 1(b) of the Act to reduce the trustee's standard of care if the settlor deems such a step appropriate. The official comments to the 1992 Restatement observe that pooled investments, such as mutual funds and bank common trust funds, are especially suitable for small trusts. Restatement of Trusts 3d: Prudent Investor Rule § 227, Comments *h*, *m*, at 28, 51; reporter's note to Comment *g*, id. at 83.

Matters of proof. Although virtually all express trusts are created by written instrument, oral trusts are known, and accordingly, this Act presupposes no formal requirement that trust terms be in writing. When there is a written trust instrument, modern authority strongly favors allowing evidence extrinsic to the instrument to be consulted for the purpose of ascertaining the settlor's intent. See Uniform Probate Code § 2-601 (1990), Comment; Restatement (Third) of Property: Donative Transfers (Preliminary Draft No. 2, ch. 11, Sept. 11, 1992).

SECTION 3. DIVERSIFICATION. A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.

Comment

The language of this section derives from Restatement of Trusts 2d § 228 (1959). ERISA insists upon a comparable rule for pension trusts. ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C). Case law overwhelmingly supports the duty to diversify. See Annot., Duty of Trustee to Diversify Investments, and Liability for Failure to Do So, 24 A.L.R. 3d 730 (1969) & 1992 Supp. at 78-79.

The 1992 Restatement of Trusts takes the significant step of integrating the diversification requirement into the concept of prudent investing. Section 227(b) of the 1992 Restatement treats diversification as one of the fundamental elements of prudent investing, replacing the separate section 228 of the Restatement of Trusts 2d. The message of the 1992 Restatement, carried forward in Section 3 of this Act, is that prudent investing ordinarily requires diversification.

Circumstances can, however, overcome the duty to diversify. For example, if a tax-sensitive trust owns an underdiversified block of low-basis securities, the tax costs of recognizing the gain may outweigh the advantages of diversifying the holding. The wish to retain a family business is another situation in which the purposes of the trust sometimes override the conventional duty to diversify.

Rationale for diversification. "Diversification reduces risk . . . [because] stock price movements are not uniform. They are imperfectly correlated. This means that if one holds a well diversified portfolio, the gains in one investment will cancel out the losses in another." Jonathan R. Macey, An Introduction to Modern Financial Theory 20 (American College of Trust and Estate Counsel Foundation, 1991). For example, during the Arab oil embargo of 1973, international oil stocks suffered declines, but the shares of domestic oil producers and coal companies benefitted. Holding a broad enough portfolio allowed the investor to set off, to some extent, the losses associated with the embargo.

Modern portfolio theory divides risk into the categories of "compensated" and "uncompensated" risk. The risk of owning shares in a mature and well-managed company in a settled industry is less than the risk of owning shares in a start-up high-technology venture. The investor requires a higher expected return to induce the investor to bear the greater risk of disappointment associated with the start-up firm. This is compensated risk – the firm pays the investor for bearing the risk. By contrast, nobody pays the investor for owning too few stocks. The investor who owned only international oils in 1973 was running a risk that could have been reduced by having configured the portfolio differently – to include investments in different industries. This is uncompensated risk – nobody pays the investor for owning shares in too few industries and too few companies. Risk that can be eliminated by adding different stocks (or bonds) is uncompensated risk. The object of diversification is to minimize this uncompensated risk of having too few investments. "As long as stock prices do not move exactly together, the risk of a diversified portfolio will be less than the average risk of the separate holdings." R.A. Brealey, An Introduction to Risk and Return from Common Stocks 103 (2d ed. 1983).

There is no automatic rule for identifying how much diversification is enough. The 1992 Restatement says: "Significant diversification advantages can be achieved with a small number of well-selected securities representing different industries .... Broader diversification is usually to be preferred in trust investing," and pooled investment vehicles "make thorough diversification practical for most trustees." Restatement of Trusts 3d: Prudent Investor Rule § 227, General Note on Comments *e-h*, at 77 (1992). See also Macey, supra, at 23-24; Brealey, supra, at 111-13.

Diversifying by pooling. It is difficult for a small trust fund to diversify thoroughly by constructing its own portfolio of individually selected investments. Transaction costs such as the round-lot (100 share) trading economies make it relatively expensive for a small investor to assemble a broad enough portfolio to minimize uncompensated risk. For this reason, pooled investment vehicles have become the main mechanism for facilitating diversification for the investment needs of smaller trusts.

Most states have legislation authorizing common trust funds; see 3 Austin W. Scott & William F. Fratcher, The Law of Trusts § 227.9, at 463-65 n.26 (4th ed. 1988) (collecting citations to state statutes). As of 1992, 35 states and the District of Columbia had enacted the Uniform Common Trust Fund Act (UCTFA) (1938), overcoming the rule against commingling trust assets and expressly enabling banks and trust companies to establish common trust funds. 7 Uniform Laws Ann. 1992 Supp. at 130 (schedule of adopting states). The Prefatory Note to the UCTFA explains: "The purposes of such a common or joint investment fund are to diversify the investment of the several trusts and thus spread the risk of loss, and to make it easy to invest any amount of trust funds quickly and with a small amount of trouble." 7 Uniform Laws Ann. 402 (1985).

Fiduciary investing in mutual funds. Trusts can also achieve diversification by investing in mutual funds. See Restatement of Trusts 3d: Prudent Investor Rule, § 227, Comment *m*, at 99-100 (1992) (endorsing trust investment in mutual funds). ERISA § 401(b)(1), 29 U.S.C. § 1101(b)(1),

expressly authorizes pension trusts to invest in mutual funds, identified as securities "issued by an investment company registered under the Investment Company Act of 1940 . . . ."

SECTION 4. DUTIES AT INCEPTION OF TRUSTEESHIP. Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of this [Act].

Comment

Section 4, requiring the trustee to dispose of unsuitable assets within a reasonable time, is old law, codified in Restatement of Trusts 3d: Prudent Investor Rule § 229 (1992), lightly revising Restatement of Trusts 2d § 230 (1959). The duty extends as well to investments that were proper when purchased but subsequently become improper. Restatement of Trusts 2d § 231 (1959). The same standards apply to successor trustees, see Restatement of Trusts 2d § 196 (1959).

The question of what period of time is reasonable turns on the totality of factors affecting the asset and the trust. The 1959 Restatement took the view that "[o]rdinarily any time within a year is reasonable, but under some circumstances a year may be too long a time and under other circumstances a trustee is not liable although he fails to effect the conversion for more than a year." Restatement of Trusts 2d § 230, comment *b* (1959). The 1992 Restatement retreated from this rule of thumb, saying, "No positive rule can be stated with respect to what constitutes a reasonable time for the sale or exchange of securities." Restatement of Trusts 3d: Prudent Investor Rule § 229, comment *b* (1992).

The criteria and circumstances identified in Section 2 of this Act as bearing upon the prudence of decisions to invest and manage trust assets also pertain to the prudence of decisions to retain or dispose of inception assets under this section.

SECTION 5. LOYALTY. A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.

Comment

The duty of loyalty is perhaps the most characteristic rule of trust law, requiring the trustee to act exclusively for the beneficiaries, as opposed to acting for the trustee's own interest or that of third parties. The language of Section 4 of this Act derives from Restatement of Trusts 3d: Prudent Investor Rule § 170 (1992), which makes minute changes in Restatement of Trusts 2d § 170 (1959).

The concept that the duty of prudence in trust administration, especially in investing and managing trust assets, entails adherence to the duty of loyalty is familiar. ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B), extracted in the Comment to Section 1 of this Act, effectively merges the requirements of prudence and loyalty. A fiduciary cannot be prudent in the conduct of investment functions if the fiduciary is sacrificing the interests of the beneficiaries.

The duty of loyalty is not limited to settings entailing self-dealing or conflict of interest in which the trustee would benefit personally from the trust. "The trustee is under a duty to the beneficiary in administering the trust not to be guided by the interest of any third person. Thus, it is improper for the trustee to sell trust property to a third person for the purpose of benefitting the third person rather than the trust." Restatement of Trusts 2d § 170, comment *q*, at 371 (1959).

No form of so-called "social investing" is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries – for example, by accepting below-market returns – in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause. See, e.g., John H. Langbein & Richard Posner, Social Investing and the Law of Trusts, 79 Michigan L. Rev. 72, 96-97 (1980) (collecting authority). For pension trust assets, see generally Ian D. Lanoff, The Social Investment of Private Pension Plan Assets: May it Be Done Lawfully under ERISA?, 31 Labor L.J. 387 (1980). Commentators supporting social investing tend to concede the overriding force of the duty of loyalty. They argue instead that particular schemes of social investing may not result in below-market returns. See, e.g., Marcia O'Brien Hylton, "Socially Responsible" Investing: Doing Good Versus Doing Well in an Inefficient Market, 42 American U.L. Rev. 1 (1992). In 1994 the Department of Labor issued an Interpretive Bulletin reviewing its prior analysis of social investing questions and reiterating that pension trust fiduciaries may invest only in conformity with the prudence and

loyalty standards of ERISA §§ 403-404. Interpretive Bulletin 94-1, 59 Fed. Regis. 32606 (Jun. 22, 1994), to be codified as 29 CFR § 2509.94-1. The Bulletin reminds fiduciary investors that they are prohibited from "subordinat[ing] the interests of participants and beneficiaries in their retirement income to unrelated objectives."

SECTION 6. IMPARTIALITY. If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.

Comment

The duty of impartiality derives from the duty of loyalty. When the trustee owes duties to more than one beneficiary, loyalty requires the trustee to respect the interests of all the beneficiaries. Prudence in investing and administration requires the trustee to take account of the interests of all the beneficiaries for whom the trustee is acting, especially the conflicts between the interests of beneficiaries interested in income and those interested in principal.

The language of Section 6 derives from Restatement of Trusts 2d § 183 (1959); see also id., § 232. Multiple beneficiaries may be beneficiaries in succession (such as life and remainder interests) or beneficiaries with simultaneous interests (as when the income interest in a trust is being divided among several beneficiaries).

The trustee's duty of impartiality commonly affects the conduct of investment and management functions in the sphere of principal and income allocations. This Act prescribes no regime for allocating receipts and expenses. The details of such allocations are commonly handled under specialized legislation, such as the Revised Uniform Principal and Income Act (1962) (which is presently under study by the Uniform Law Commission with a view toward further revision).

SECTION 7. INVESTMENT COSTS. In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.

Comment

Wasting beneficiaries' money is imprudent. In devising and implementing strategies for the investment and management of trust assets, trustees are obliged to minimize costs.

The language of Section 7 derives from Restatement of Trusts 2d § 188 (1959). The Restatement of Trusts 3d says: "Concerns over compensation and other charges are not an obstacle to a reasonable course of action using mutual funds and other pooling arrangements, but they do require special attention by a trustee. . . . [I]t is important for trustees to make careful cost comparisons, particularly among similar products of a specific type being considered for a trust portfolio." Restatement of Trusts 3d: Prudent Investor Rule § 227, comment *m*, at 58 (1992).

SECTION 8. REVIEWING COMPLIANCE. Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight.

Comment

This section derives from the 1991 Illinois act, 760 ILCS 5/5(a)(2) (1992), which draws upon Restatement of Trusts 3d: Prudent Investor Rule § 227, comment *b*, at 11 (1992). Trustees are not insurers. Not every investment or management decision will turn out in the light of hindsight to have been successful. Hindsight is not the relevant standard. In the language of law and economics, the standard is ex ante, not ex post.

SECTION 9. DELEGATION OF INVESTMENT AND MANAGEMENT FUNCTIONS.

(a) A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:

(1) selecting an agent;

(2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and

(3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

(b) In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.

(c) A trustee who complies with the requirements of subsection (a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.

(d) By accepting the delegation of a trust function from the trustee of a trust that is subject to the law of this State, an agent submits to the jurisdiction of the courts of this State.

Comment

This section of the Act reverses the much-criticized rule that forbad trustees to delegate investment and management functions. The language of this section is derived from Restatement of Trusts 3d: Prudent Investor Rule § 171 (1992), discussed infra, and from the 1991 Illinois act, 760 ILCS § 5/5.1(b), (c) (1992).

Former law. The former nondelegation rule survived into the 1959 Restatement: "The trustee is under a duty to the beneficiary not to delegate to others the doing of acts which the trustee can reasonably be required personally to perform." The rule put a premium on the frequently arbitrary task of distinguishing discretionary functions that were thought to be nondelegable from supposedly ministerial functions that the trustee was allowed to delegate. Restatement of Trusts 2d § 171 (1959).

The Restatement of Trusts 2d admitted in a comment that "There is not a clear-cut line dividing the acts which a trustee can properly delegate from those which he cannot properly delegate." Instead, the comment directed attention to a list of factors that "may be of importance: (1) the amount of discretion involved; (2) the value and character of the property involved; (3) whether the property is principal or income; (4) the proximity or remoteness of the subject matter of the trust; (5) the character of the act as one involving professional skill or facilities possessed or not possessed by the trustee himself." Restatement of Trusts 2d § 171, comment *d* (1959). The 1959 Restatement further said: "A trustee cannot properly delegate to another power to select investments." Restatement of Trusts 2d § 171, comment *h* (1959).

For discussion and criticism of the former rule see William L. Cary & Craig B. Bright, The Delegation of Investment Responsibility for Endowment Funds, 74 Columbia L. Rev. 207 (1974); John H. Langbein & Richard A. Posner, Market Funds and Trust-Investment Law, 1976 American Bar Foundation Research J. 1, 18-24.

The modern trend to favor delegation. The trend of subsequent legislation, culminating in the Restatement of Trusts 3d: Prudent Investor Rule, has been strongly hostile to the nondelegation rule. See John H. Langbein, Reversing the Nondelegation Rule of Trust-Investment Law, 59 Missouri L. Rev. 105 (1994).

The delegation rule of the Uniform Trustee Powers Act. The Uniform Trustee Powers Act (1964) effectively abrogates the nondelegation rule. It authorizes trustees "to employ persons, including attorneys, auditors, investment advisors, or agents, even if they are associated with the trustee, to advise or assist the trustee in the performance of his administrative duties; to act without independent investigation upon their recommendations; and instead of acting personally, to employ one or more agents to perform any act of administration, whether or not discretionary . . . ." Uniform Trustee Powers Act § 3(24), 7B Uniform Laws Ann. 743 (1985). The Act has been enacted in 16 states, see "Record of Passage of Uniform and Model Acts as of September 30, 1993," 1993-94 Reference Book of Uniform Law Commissioners (unpaginated, following page 111) (1993).

UMIFA's delegation rule. The Uniform Management of Institutional Funds Act (1972) (UMIFA), authorizes the governing boards of eleemosynary institutions, who are trustee-like fiduciaries, to delegate investment matters either to a committee of the board or to outside investment advisors, investment counsel, managers, banks, or trust companies. UMIFA § 5, 7A Uniform Laws Ann. 705 (1985). UMIFA has been enacted in 38 states, see "Record of Passage of Uniform and Model Acts as of September 30, 1993," 1993-94 Reference Book of Uniform Law Commissioners (unpaginated, following page 111) (1993).

ERISA's delegation rule. The Employee Retirement Income Security Act of 1974, the federal statute that prescribes fiduciary standards for investing the assets of pension and employee benefit plans, allows a pension or employee benefit plan to provide that "authority to manage, acquire or dispose of assets of the plan is delegated to one or more investment managers . . . ." ERISA § 403(a)(2), 29 U.S.C. § 1103(a)(2). Commentators have explained the rationale for ERISA's encouragement of delegation:

> ERISA . . . invites the dissolution of unitary trusteeship. . . . ERISA's fractionation of traditional trusteeship reflects the complexity of the modern pension trust. Because millions, even billions of dollars can be involved, great care is required in investing and safekeeping plan assets. Administering such plans – computing and honoring benefit entitlements across decades of employment and retirement – is also a complex business . . . . Since, however, neither the sponsor nor any other single entity has a comparative advantage in performing all these functions, the tendency has been for pension plans to use a variety of specialized providers. A consulting actuary, a plan administration firm, or an insurance company may oversee the design of a plan and arrange for processing benefit claims. Investment industry professionals manage the portfolio (the largest plans spread their pension investments among dozens of money management firms).

John H. Langbein & Bruce A. Wolk, Pension and Employee Benefit Law 496 (1990).

The delegation rule of the 1992 Restatement. The Restatement of Trusts 3d: Prudent Investor Rule (1992) repeals the nondelegation rule of Restatement of Trusts 2d § 171 (1959), extracted supra, and replaces it with substitute text that reads:

> § 171. Duty with Respect to Delegation. A trustee has a duty personally to perform the responsibilities of trusteeship except as a prudent person might delegate those responsibilities to others. In deciding whether, to whom, and in what manner to delegate fiduciary authority in the administration of a trust, and thereafter in supervising agents, the trustee is under a duty to the beneficiaries to exercise fiduciary discretion and to act as a prudent person would act in similar circumstances.

Restatement of Trusts 3d: Prudent Investor Rule § 171 (1992). The 1992 Restatement integrates this delegation standard into the prudent investor rule of section 227, providing that "the trustee must . . . act with prudence in deciding whether and how to delegate to others . . . ." Restatement of Trusts 3d: Prudent Investor Rule § 227(c) (1992).

Protecting the beneficiary against unreasonable delegation. There is an intrinsic tension in trust law between granting trustees broad powers that facilitate flexible and efficient trust administration, on the one hand, and protecting trust beneficiaries from the misuse of such powers on the other hand. A broad set of trustees' powers, such as those found in most lawyer-drafted instruments and exemplified in the Uniform Trustees' Powers Act, permits the trustee to act vigorously and expeditiously to maximize the interests of the beneficiaries in a variety of transactions and administrative settings. Trust law relies upon the duties of loyalty and prudent administration, and upon procedural safeguards such as periodic accounting and the availability of judicial oversight, to prevent the misuse of these powers. Delegation, which is a species of trustee power, raises the same tension. If the trustee delegates effectively, the beneficiaries obtain the advantage of the agent's specialized investment skills or whatever other attributes induced the trustee to delegate. But if the trustee delegates to a knave or an incompetent, the delegation can work harm upon the beneficiaries.

Section 9 of the Uniform Prudent Investor Act is designed to strike the appropriate balance between the advantages and the hazards of delegation. Section 9 authorizes delegation under the limitations of subsections (a) and (b). Section 9(a) imposes duties of care, skill, and caution on the trustee in selecting the agent, in establishing the terms of the delegation, and in reviewing the agent's compliance.

The trustee's duties of care, skill, and caution in framing the terms of the delegation should protect the beneficiary against overbroad delegation. For example, a trustee could not prudently agree to an investment management agreement containing an exculpation clause that leaves the trust without recourse against reckless mismanagement. Leaving one's beneficiaries remediless against willful wrongdoing is inconsistent with the duty to use care and caution in formulating the terms of the delegation. This sense that it is imprudent to expose beneficiaries to broad exculpation clauses underlies both federal and state legislation restricting exculpation clauses, e.g., ERISA §§ 404(a)(1)(D), 410(a), 29 U.S.C. §§ 1104(a)(1)(D), 1110(a); New York Est. Powers Trusts Law § 11-1.7 (McKinney 1967).

Although subsection (c) of the Act exonerates the trustee from personal responsibility for the agent's conduct when the delegation satisfies the standards of subsection 9(a), subsection 9(b) makes the agent responsible to the trust. The beneficiaries of the trust can, therefore, rely upon the trustee to enforce the terms of the delegation.

Costs. The duty to minimize costs that is articulated in Section 7 of this Act applies to delegation as well as to other aspects of fiduciary investing.

In deciding whether to delegate, the trustee must balance the projected benefits against the likely costs. Similarly, in deciding how to delegate, the trustee must take costs into account. The trustee must be alert to protect the beneficiary from "double dipping." If, for example, the trustee's regular compensation schedule presupposes that the trustee will conduct the investment management function, it should ordinarily follow that the trustee will lower its fee when delegating the investment function to an outside manager.

SECTION 10. LANGUAGE INVOKING STANDARD OF [ACT]. 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 [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."

Comment

This provision is taken from the Illinois act, 760 ILCS § 5/5(d) (1992), and is meant to facilitate incorporation of the Act by means of the formulaic language commonly used in trust instruments.

SECTION 11. APPLICATION TO EXISTING TRUSTS. This [Act] applies to trusts existing on and created after its effective date. As applied to trusts existing on its effective date, this [Act] governs only decisions or actions occurring after that date.

SECTION 12. UNIFORMITY OF APPLICATION AND CONSTRUCTION. This [Act] shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this [Act] among the States enacting it.

SECTION 13. SHORT TITLE. This [Act] may be cited as the "[Name of Enacting State] Uniform Prudent Investor Act."

SECTION 14. SEVERABILITY. If any provision of this [Act] or its application to any person or circumstance is held invalid, the invalidity does not affect other provisions or applications of this [Act] which can be given effect without the invalid provision or application, and to this end the provisions of this [Act] are severable.

SECTION 15. EFFECTIVE DATE. This [Act] takes effect

. . . .

SECTION 16. REPEALS. The following acts and parts of acts are repealed:

(1)

(2)

(3)