

SUBJECT: Adoption of the Uniform Principal and Income Act

COMMITTEE: Financial Institutions — committee substitute recommended

VOTE: 7 ayes — Solomons, Christian, Flynn, Gutierrez, Hopson, Paxton, Wise
0 nays

WITNESSES: For — Dave Folz, Texas Capital Bank; Dian G. Kauth, Belmont Trust Co.; William R. Mureiko; Jim O’Connell, Texas Banker’s Association, Trust Division; (*Registered, but did not testify*): Melody Bohlmann, The Trust Company; Mark Morris, JP Morgan Chase; Robert H. Richardson, JP Morgan Chase

Against — Alvin J. Golden, Real Estate, Probate and Trust Law Division, State Bar of Texas; Sam K. Hildebrand, Real Estate, Probate and Trust Law Division, State Bar of Texas; Glenn M. Karisch, Real Estate, Probate and Trust Law Division, State Bar of Texas

BACKGROUND: Property Code Title 9, also known as the Texas Trust Code (TTC), governs trusts. A trust is created when a settlor places property in the control of a trustee for the benefit of one or more beneficiaries. The TTC contains default rules for trusts, meaning that a settlor may overcome these rules by explicitly dictating otherwise in the documents creating the trust. The trustee has certain fiduciary duties to the beneficiaries of the trust, including the duty of impartiality, and can be liable for the breach of those duties both personally and as the trustee. An trustee may be an entity, but the vast majority of trusts in Texas are administered by individuals.

TTC, Chapter 113, Subchapter D sets the default rules by which a trustee must adjust the principal and income of a trust between beneficiaries. Money coming into a trust has to be allocated either to principal or income. An income beneficiary benefits from investments that generate income, while a remainder beneficiary benefits from investments that grow the principal that he or she will receive at some future date. Current law does not allow a trustee to shift income and/or principal from one beneficiary to the other, unless the settlor provides otherwise. For example, if there are two beneficiaries to a

trust — an income beneficiary and a remainder beneficiary — the trustee cannot shift income to the remainder beneficiary or principal to the income beneficiary.

A trustee has a fiduciary duty to beneficiaries. This duty is the highest duty of care in the law. A trustee who is accused of violating a fiduciary duty must show by a preponderance of the evidence that his or her actions were justifiable. A preponderance means that it is more likely than not that the actions were justifiable.

The Uniform Principal and Income Act, promulgated by the Uniform Law Commissioners (a group of law professors and lawyers from around the country) has been adopted in 41 states. It is designed to provide trustees with procedures for separating principal and income and ensuring that the intention of settlors will be carried out. The act was amended in 1997 and 2000.

DIGEST:

CSHB 2241 would replace TTC Subchapter D with a new Chapter 116 called the “Uniform Principal and Income Act, which would be based closely upon the national act.

It would establish a trustee’s duties in allocating receipts and disbursements to or between principal and income of the trust, allowing a trustee to adjust between principal and income as the trustee considered necessary and fair to all beneficiaries. It would specify circumstances under which adjustments could be made and establish the factors a trustee would have to consider before making an adjustment.

In the event that a court found that a trustee had abused his or her discretion, CSHB 2241 would allow the court to order the trustee to remedy the harm caused. It would authorize a trustee to seek court approval of a decision relating to income and principal allocation prior to the trustee making that allocation.

CSHB 2241 would grandfather certain clauses, such as those relating to allocation of oil, gas, mineral, and timber income for currently existing trusts. It also would make conforming changes to sections of the TTC and Probate Code and repeal portions of these codes that would be inconsistent with the bill’s provisions.

CSHB 2241 would take effect January 1, 2004.

**SUPPORTERS
SAY:**

General arguments. CSHB 2241 would apply the national Uniform Principal and Income Act to Texas, which would clarify and modernize Texas trust law.

Allowing adjustment of income and principal between beneficiaries is an important aspect of modern investment theory. Although a trustee may follow the rules as to how to invest trust assets, following the allocation procedures established by the trust does not always yield a fair result. Permitting the trustee to adjust principal and income between beneficiaries would help ensure that all beneficiaries were treated equitably.

The bill would apply to existing trusts as well as newly created ones. Every state that has adopted the national act has done so as a full package, and not in a piecemeal fashion. It would not make sense to create one set of laws for existing trusts and another for newly created ones.

While HB 2240 by Paxton, which would give trustees freedom to invest in a wide variety of investments granted by the prudent investor rule, is a necessary adjunct to this bill, CSHB 2241 by itself still would be beneficial by modernizing Texas trust law and facilitating principal and income decisions.

Prior court approval of allocation decisions. By allowing a trustee to seek prior court approval of decisions on allocating income and principal, the bill would protect a trustee administering a trust involving several beneficiaries with competing interests. Normally, a trustee impartially proposes a plan of income and principal distribution in the belief that it will benefit all beneficiaries. However, objection to the plan by one or more beneficiaries often places the trustee in a no-win situation — whatever action the trustee takes is likely to make one of the beneficiaries unhappy, resulting in a lawsuit against the trustee. CSHB 2241 would help prevent such a situation by allowing the trustee to seek prior court approval of the plan, thus heading off lawsuits from aggrieved beneficiaries.

This provision also could help beneficiaries financially. While current law allows the assessment of damage to a trust and possible restitution after the fact, this bill would allow the court to advise the trustee on allocations, thus decreasing the likelihood that the trustee would make investment decisions

that would damage the trust. The court's decision would give the trustee and the beneficiaries confidence that the allocations would serve the best interests of the beneficiaries, as intended by the settlor.

Trustees would not use this provision as a measure to escape all possible liability, but only as a last resort. The bill would decrease litigation by preventing a beneficiary from arguing that a trustee had breached his or her fiduciary duty each time they were upset about the outcome of an investment.

Courts already issue decisions similar to the one provided for in this provision. For example, when a party knows that he owes another a sum of money, but there is no agreement as to which of two parties is owed money, all three may ask a court to dictate which party is owed. If the paying party follows the court order, the losing party cannot seek retribution from the paying party. Courts make such decisions without juries. By allowing the trustee to seek a decision from the court about allocations to beneficiaries, CSHB 2241 would be consistent with actions currently allowed in the courts.

This bill would have no effect on the ability of beneficiaries to hire attorneys to protect their interests. A beneficiary who wished to sue the trustee after an allocation decision had been made often would have no money to pay for an attorney up front, but the beneficiary could hire an attorney on a contingency fee, in hopes that attorney's fees would be paid through the recovery of damages. This would be true whether or not the allocation decision was made with prior court approval.

Requiring that trustees' decisions be upheld unless it was shown that they abused their discretion would be an appropriate standard because trustees are entrusted with the discretion to use their power as they see fit. The decisions of trustees should not be overturned absent an abuse of that power.

The prior court approval provision was added in the 2000 revision to the national act, thus demonstrating broad support for the idea that the protection and certainty offered by this provision is necessary for beneficiaries and trustees.

OPPONENTS
SAY:

General arguments. CSHB 2241 could cause problems with existing trusts because they were designed to comply with current law. Although some settlors might be able to amend the terms of their trusts, most would not. These default rules could cause an effect that was wholly different than that intended by the settlor.

If HB 2240 by Paxton were enacted and this bill were not, Texas will be a great disadvantage under the Uniform Prudent Investors Act because it would lack the necessary accounting rules to assure that the relative rights of beneficiaries were protected.

Prior court approval of allocation decisions. This bill improperly would absolve the trustee of any liability for making an allocation if he or she received prior court approval, which would involve the courts in a decision they would not normally consider and strip the beneficiary of the right to plead a case in front of a jury.

It has not been Texas law or policy to approve of a fiduciary decision prior to the making of that decision, as this bill would allow. Precedents in current law point to a court relieving a fiduciary of liability after a decision has been made, not before. For example, a court may relieve a fiduciary of liability for decisions in certain circumstances, such as under Sec. 149E of the Probate Code, where an independent executor can receive a judicial discharge of liability after an estate has been administered.

By allowing courts to grant prior approval to allocation decisions, this bill would shift the burden of proof to the beneficiary to show that the trustee abused his or her discretion. To protect beneficiaries from the bad actions of fiduciaries, the law historically has placed the burden of proof upon fiduciaries because they are in a better position to shoulder it. Shifting the burden would be unfair.

By seeking prior court approval of allocation decisions, trustees would be abdicating their responsibility to protect and manage the property of beneficiaries, power that settlors granted to trustees and paid them to use. This bill would negate the point of a trustee having such power.

Rather than decreasing the amount of litigation, this bill would increase it. The prior court approval provision would allow a trustee to seek an advisory opinion on any discretionary power in this entire chapter, not simply the power to allocate. Many trustees would want this protection for every decision they made, so they would go to court more often, forcing the beneficiaries also to attend. Under these circumstances, a beneficiary would be more likely to file counter suits against the trustee for every action he or she believed was a breach of the trustee's duties.

The court approval provision would benefit only trustees. If a beneficiary had issue with a trustee's allocation plan and could not convince the trustee to change it, the only available remedy would be for the beneficiary to wait for the plan's implementation and then sue the trustee for damages. This would be financially difficult for many beneficiaries because trustees would be unlikely to allow them to access their money to pay for legal fees, even though trustees have the advantage of being empowered to use trust resources to enforce their fiduciary interests. While a legally incapacitated beneficiary could get an attorney appointed *ad litem*, many beneficiaries are not legally incapacitated, but simply bad with money, which is why their assets are in the trust in the first place.

This bill would not require a trustee to follow a judge's recommendation for the allocation of funds. The court process could be wasted time and money if the trustee did not follow the decision, which later could be subject to suit.

Fewer than half the states have adopted the Uniform Principal and Income Act, which hardly demonstrates broad support for the prior court approval provision.

NOTES:

The committee substitute differs from the bill as introduced by adding provisions requiring a court to determine, on request by the trustee and prior to the allocation occurring, whether or not a trustee's decision relating to the allocation of principal and income would be an abuse of discretion. It added the requirement that after a beneficiary had been harmed by a trustee's adjustment decision, a court could reverse that decision only if it found that the trustee abused his or her discretion in making the decision. CSHB 2241 would specify to which trusts and/or estates the effective date of the bill would apply.

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The companion bill, SB 573 by Harris, has been referred to the Senate Jurisprudence Committee.

CSHB 2240 by Paxton, also on today's General State Calendar, addresses the Uniform Prudent Investors Act and is closely related to CSHB 2241.