

Drafting Issues

1. Opting In and Out of the Prudent Investor Act

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

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

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

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

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

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

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

Sec. 117.012. LANGUAGE INVOKING STANDARD OF CHAPTER.
The following terms or comparable language in the provisions of a trust, *unless otherwise limited or modified*, authorizes *any investment or strategy* permitted under this chapter: "investments permissible by law for investment of trust funds," "legal investments," "authorized investments," "using the judgment and care under the circumstances then prevailing that persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital," "prudent man rule," "prudent trustee rule," "prudent person rule," and "prudent investor rule."
[emphasis added]

The official comment of the National Conference of Commissioners on Uniform State

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

exercise the judgment and care under the circumstances then prevailing that persons of ordinary prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income from as well as the probable increase in value and the safety of their capital.

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

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

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

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

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

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

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

ii. Authorization to Hold Investments Without Diversification. Perhaps the most common provision which will opt out of part, but not all, of the Prudent Investor Act, is

a provision specifically authorizing the trustee to hold assets comprising a part of the trust estate without being required to diversify and without risk of loss or liability. For example, this type of provision is fairly common in trusts containing detailed trustee powers:

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

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

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

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

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

d. Other Drafting Suggestions. For more drafting suggestions, see “Drafting Under the New Prudent Investor Standard” by C. Boone Schwartzel, 14th Annual Advanced Drafting: Estate Planning and Probate Course (2003).

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

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

The trustee may allocate receipts and disbursements to income and principal as the trustee in its discretion determines is appropriate.

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

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

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

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

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

Consider using this as a form for notice to beneficiaries when the trustee wishes to make an adjustment between principal and income under Texas Trust Code §116.005:

Dear _____:

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

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

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

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

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

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

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

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

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

Sincerely,

Trustee

I object to the proposed adjustment.

Signature: _____

Printed Name: _____

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

Signature: _____

Printed Name: _____

5. Exculpation Clause

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

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

(1) a breach of trust committed:

(A) in bad faith;

(B) intentionally; or

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

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