

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

## Appendix C

- A. Index of Laws & Regulations Found in FDIC Loose-leaf Rules & Regulations Service
- B. "Prudent Man" Rule
- C. Uniform Prudent Investor Act
- D. List of States
- E. Uniform Principal and Income Act 1962
- F. Uniform Principal and Income Act 1997 (Act)
- G. List of States Adopting the Uniform Principal and Income Act
- H. FDIC Memorandums Regarding Consent to Exercise Trust Powers
- I. FDIC Legal Opinion on FRB Section 23B Fees and Affiliated Employee Benefit Plans
- J. FDIC Financial Institution Letter 76-93: Problems from Customer "Free-Riding" in Custody Accounts
- K. FRB Memorandum on "Free Riding"
- L. FFIEC Examination Council Supervisory Policy on Repurchase Agreements Of Depository Institutions With Securities Dealers And Others
- M. FFIEC Examination Council Supervisory Policy on Securities Lending
- N. State Statutes Authorizing Fiduciary Investments in Proprietary Mutual Funds
- O. Supervisory Guidance Regarding the Investment of Fiduciary Assets in Mutual Funds and Potential Conflicts of Interest
- P. FDIC General Counsel's Opinion No. 12: "Engaged in the Business of Receiving Deposits Other Than Trust Funds"
- Q. FDIC Financial Institution Letter 38-2002: Credit Risks Arising From Bank Investment Securities and Custodial Accounts Held at Securities Broker-Dealers

## A. INDEX OF LAWS & REGULATIONS FOUND IN FDIC LOOSE-LEAF RULES & REGULATIONS SERVICE

### FDIC Regulations Topic

Section 303.6 Application to Extend Corporate Powers (Trust)

Part 333 Extension of Corporate Powers (Trust)

←

## B. "PRUDENT MAN" RULE

Source: Restatement (Second) of Trusts: Prudent Man Rule (1959), issued by the American Law Institute, Philadelphia. This is commonly referred to as the Restatement of Trusts 2d: Prudent Man Rule.

### Investment Of Trust Funds - Section 227

#### Investments Which a Trustee Can Properly Make

In making investments of trust funds the trustee is under a duty to the beneficiary -

(a). In the absence of provisions in the terms of the trust or of a statute otherwise providing, 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;

(b). in the absence of provisions in the terms of the trust, to conform to the statutes, if any, governing investments by trustees;

(c). to conform to the terms of the trust, except as stated in § 165-168.

#### 1. Comment:

- Scope of the rule. Except as otherwise provided by the terms of the trust the trustee is under a duty to the beneficiary to use reasonable care and skill to preserve the trust property and to make it productive. This topic deals with the manner in which the trustee should perform these duties in making investments.

The rule stated in this Section is the so-called "prudent-man rule" first laid down by the Massachusetts court and followed in a number of States, even in the absence of a statute. In many States this rule has now been adopted by statute. In a few States, by statute or otherwise, the scope of trust investments is more limited.

#### 2. Comment on Clause (a):

- Requirement of care. The trustee does not use due care in making an investment unless he makes an investigation as to the safety of the investment and the probable income to be derived therefrom. Ordinarily this involves securing information from sources on which prudent men in the community customarily rely. He may take into consideration advice given to him by attorneys, bankers, brokers and others whom prudent men in the community regard as qualified to give advice, but he is not ordinarily justified in relying solely on such advice, but must exercise his own judgment.
- Requirement of care Requirement of skill. The trustee is liable for a loss resulting from his failure to use the skill of a man of ordinary intelligence, although he may have exercised all the skill of which he was capable. On the other hand, if the trustee has a greater degree of skill than that of a man of ordinary intelligence, he is liable for a loss resulting from the failure to use such skill as he has.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

So also, if a trustee, for example a corporate or professional trustee, procured his appointment as trustee by representing that he has greater skill than that of a man of ordinary knowledge, he is liable for a loss resulting from the failure to use such skill.

Corporate trustees. If the trustee is a bank or trust company, it must use in selecting investments the facilities which it has or should have, and it may properly be required to show that it has made a more thorough and complete investigation than would ordinarily be expected from an individual trustee.

- Requirement of caution. In making investments not only is the trustee under a duty to use due care and skill, but he must use the caution of a prudent man. In the absence of provisions in the terms of the trust or statutory provisions, the investments which a trustee can properly make are those which a prudent man would make in investing property with a view to the safety of the principal and to the securing of an income reasonable in amount and payable with regularity.

In making investments, however, a loss is always possible, since in any investment there is always some risk. The question of the amount of risk, however, is a question of degree. No man of intelligence would make a disposition of property where in view of the price the risk of loss is out of proportion to the opportunity for gain. Where, however, the risk is not out of proportion, a man of intelligence may make a disposition which is speculative in character with a view to increasing his property instead of merely preserving it. Such a disposition is not a proper trust investment, because it is not a disposition which makes the preservation of the fund a primary consideration.

It is not ordinarily the duty of a trustee to invest only in the very safest and most conservative securities available. Thus, assuming that United States government bonds are the safest and most conservative securities available but that the income yield thereon is lower than on other securities, it is not necessarily the duty of the trustee to invest the whole trust property, or even any part of it, in such bonds, even when no question of favoring one beneficiary over another is involved. The reason for this is that by the use of care, skill and caution, an investment can ordinarily be made which will yield a higher income and as to which there is no reason to anticipate a loss of principal.

The trustee, in considering the scope of investments that he should make, should take into consideration many circumstances, such as:

- the amount of the trust estate,
- the situation of the beneficiaries,
- the trend of prices and of the cost of living,
- the prospect of inflation and of deflation.

In some circumstances the amount and regularity of the income may be more important than the preservation of the principal; under other circumstances the preservation of the principal may be of primary importance. It is impossible to lay down a hard-and-fast rule as to what is a prudent investment, since much may depend upon the time and place of the administration of the trust and much may depend upon the character of the particular trust.

- Kinds of investments. Ordinarily it is proper for a trustee to invest in government securities, such as bonds of the United States or of the State or of municipalities, in first mortgages on land, or in corporate bonds. In any case, however, whether the investment is proper depends upon the circumstances. Such investments are not proper if under all the circumstances they are not prudent investments. See Comment o.
- Acquiring property for resale. Although a trustee cannot properly purchase property for resale, yet if he holds a mortgage in trust and the mortgage is foreclosed he can properly purchase the property on the foreclosure sale, if it is prudent to do so. Also, the trustee may be justified in taking real or personal property in payment of a debt that is not otherwise collectible.
- Junior mortgages. Ordinarily second or other junior mortgages are not proper trust investments. It may be proper for the trustee, however, to take a second mortgage where this is a reasonable method of settling a claim, or where the trustee is authorized or directed to sell land and it is reasonably necessary to take a second mortgage in order to enable him to make the sale.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

- **Unsecured Loan.** An unsecured loan of trust funds may be improper because imprudent. Such a loan, however, is not necessarily imprudent. Thus, a trustee can properly make a general deposit of trust money in a bank, as a method of safekeeping.

A deposit in a bank at interest, as, for example, a deposit in a savings account, may be proper as a method of investing trust funds. Such a deposit was generally held to be prudent as an investment even before such deposits were at least partially insured by the Federal Deposit Insurance Corporation. In some States statutes have permitted such deposits to the extent to which they are insured.

- **Combining trust funds in making investments.** The fact that in making investments trust funds of one trust are combined with funds of other trusts administered by the trustee does not make the investment improper, provided that it is in other respects proper. Thus, an investment of trust funds in a participating interest in one or more mortgages on land held by the trustee is a proper trust investment if the mortgage or mortgages were a proper trust investment.

If the investment is otherwise proper, the mere fact that a corporate trustee advanced its own money in the first place and acquired the mortgage or mortgages for the purpose of distributing them among the trust estates administered by it, where only a short interval elapses between the purchase and the distribution, does not constitute such self-dealing as to make the transaction improper.

- **Common trust funds.** By statute in almost all of the States, corporate trustees are permitted to invest trust funds in a common trust fund maintained by the trustee, subject to the restrictions specified in the statute.

By the federal Revenue Act of 1936, common trust funds were exempted from taxation as corporations or associations, provided that the fund was maintained by a bank "(1) exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian; and (2) in conformity with the rules and regulations, prevailing from time to time, of the Board of Governors of the Federal Reserve System pertaining to the collective investment of trust funds by national banks." See Internal Revenue Code of 1954, § 584.

By § 17 of Regulation F, issued by the Board of Governors of the Federal Reserve System, provision is made for the establishment and maintenance by banks of common trust funds. [FDIC Note: this is now OCC Regulation 9.18] Investments outside the State.

- **Investments outside the State** in which the trust is administered are not ordinarily improper, although the fact that they are outside the State may be one element in considering whether the trustee is acting prudently. In earlier decisions, the courts were inclined to look with disfavor on investments outside the United States or even outside the State in which the trust was administered. It is quite otherwise today. Information with respect to such investments is today very often as easy to acquire and as full as information with respect to local securities; and, if such information would lead a reasonable man to think that the investment is a prudent one, it is proper for a trustee to make it. Thus, investments in mortgages on land outside the State or in securities of a corporation incorporated and carrying on business in another State, or in bonds of another State or of a foreign government, are not ordinarily improper.
- **Shares of stock.** The purchase of shares of preferred or common stock of a company with regular earnings and paying regular dividends which may reasonably be expected to continue is a proper trust investment if prudent men in the community are accustomed to invest in such shares when making an investment of their savings with a view to their safety.

The fact that shares of stock are non-voting in character, does not of itself make the investment in such shares by a trustee improper.

In many States in which it was previously improper for a trustee to invest in shares of stock, statutes have permitted such investments. In several of the States such an investment is permitted only as to a specified proportion of the trust estate.

- **Investment trusts (Mutual Funds).** In several States trustees are permitted, subject to certain restrictions, to invest in stocks or other securities of management type investment companies. In many of the statutes the company, whether a trustee or corporation, must be qualified under the Investment Company Act of 1940. Apart from statute, it would seem to be not

improper for a trustee to make such an investment, provided that it is a prudent one, and that such an investment does not involve any delegation by the trustee of his powers.

- Matters to be considered in the selection among authorized investments. Although trustees may properly invest in a particular type of security, a trustee must use care and skill and caution in selecting an investment within the type. Among the matters which the trustee should consider in selecting a given investment, in addition to those relating to the safety of the fund invested and the amount and regularity of the income, are:
  - the marketability of the particular investment;
  - the length of the term of the investment, for example, the maturity date, if any, the callability or redeemability, if any;
  - the probable duration of the trust;
  - the probable condition of the market with respect to the value of the particular investment at the termination of the trust especially if at the termination of the trust the investment must be converted into money for the purpose of distribution;
  - the probable condition of the market with respect to reinvestment at the time when the particular investment matures;
  - the aggregate value of the trust estate and the nature of the other investments;
  - the requirements of the beneficiary or beneficiaries, particularly with respect to the amount of the income;
  - the other assets of the beneficiary or beneficiaries including earning capacity;
  - the effect of the investment in increasing or diminishing liability for taxes;
  - the likelihood of inflation.

Whether the trustee has acted properly in making an investment depends upon the circumstances at the time when the investment is made and not upon subsequent events. If at the time when the trustee makes an investment it is an investment that a prudent man would make at that time, he incurs no liability although subsequently the investment depreciates in value.

Ordinarily, if the trust is to terminate at a fixed time, as after the lapse of a certain period or when a designated person reaches a certain age, the trustee should not make an investment which cannot readily be disposed of and converted into cash at the time of the termination of the trust. Thus, if the trust is to terminate within a year or two, the trustee should not invest in a mortgage which will not mature until a considerable time after the creation of the trust, if it is probable that such a mortgage cannot readily be sold. On the other hand, the trustee need not necessarily invest in short term obligations, but can properly invest in bonds which are proper trust investments, even though they may not mature until a long time after the termination of the trust, provided that they are of such a character that it is probable that they can readily be sold and converted into cash.

### 3. Comment on Clause (b):

- Statutes. In many States there are statutes governing investments by trustees. In many States the prudent-man rule, stated in this Section, has been adopted by statute. In some States statutes are more restricted, allowing only such investments as government securities, first mortgages on land, and certain types of bonds. The modern [in 1959] trend of legislation is toward the adoption of the prudent-man rule. In some States statutes are merely permissive, designating the kind of securities in which it is proper for a trustee to invest, but without confining the trustee to such investments. In other States, no investments except those designated by statute are proper investments for a trustee, unless it is otherwise provided by the terms of the trust.

Statutes confining trustees to certain types of investments are not construed as preventing the settlor from empowering the trustee to make investments not designated by the statute.

When discretion as to investments is conferred upon the trustee by the terms of the trust, it is a question of interpretation whether the settlor intends to enlarge the scope of investments permissible under the statutes, and if so to what extent. Where by statute trustees are confined to certain types of investments, but by the terms of the trust it is provided that the trustee may invest in securities "other than legal trust investments," the scope of the proper investments is enlarged and the trustee can properly invest in such securities as are permitted under the rule stated in Clause (a). The result is ordinarily the same if the trustee is authorized to make investments "in his discretion," or such investments as may to him appear to be expedient or advisable. By the terms of the trust the trustee may be permitted to invest in securities which are speculative or otherwise improper under the rule stated in Clause (a). The provisions of the trust instrument, however, are ordinarily strictly construed against an enlargement of the scope of permissible investments beyond those allowed under the rule stated in Clause (a).

An authorization by statute to invest in a particular type of security does not mean that any investment in securities of that type is proper. The trustee must use care and skill and caution in making the selection. Thus, if by statute trustees are authorized to invest in bonds of foreign governments, a trustee must use care and skill and caution in selecting the particular bonds.

Whether an investment is proper is determined by the terms of the statute in force at the time when the investment is made, and not by the statutory or other rules in force at the time of the creation of the trust unless it is otherwise provided by the terms of the trust.

#### 4. Comment on Clause (c):

- Terms of the trust. As a general rule a trustee can properly make such investments as are authorized by the terms of the trust and cannot properly make investments which are forbidden by the terms of the trust. In making investments, however, the trustee is not under a duty to the beneficiary to comply with a term of the trust with which it is impossible for him to comply, or to comply with a term of the trust which is illegal. The trustee is not under a duty to the beneficiary to comply with a term of the trust if he is directed or permitted by a proper court not to comply where owing to circumstances not known to the settlor and not anticipated by him compliance would defeat or substantially impair the accomplishment of the purposes of the trust; and under such circumstances the trustee may be subject to liability if he fails to apply to the court for permission to deviate from the terms of the trust.
- Terms restricting investments. By the terms of the trust the scope of the investments which the trustee could otherwise properly make can be restricted both with respect to investments permitted by statute under Clause (b) and those which in the absence of statutory regulation would be permitted under the rules stated in Clause (a). Thus, although by a statute trustees are permitted to invest in railroad bonds or public utility bonds, by the terms of the trust the trustee may be forbidden to invest in public utility bonds. Similarly, although in the absence of a statute an investment in a certain type of bonds would be proper, by the terms of the trust the trustee can be forbidden to invest in bonds of that type.
- Terms enlarging permissible investments. On the other hand, by the terms of the trust the scope of investments which the trustee could otherwise properly make can be enlarged. Thus, although by statute trustees are permitted to invest only in government securities or first mortgages on land, by the terms of the trust the trustee can be permitted to invest in bonds or in shares of private corporations or to make other investments not permitted by the statute. See Comment p. Similarly, although in the absence of a statute an investment in a certain type of bond would be improper, by the terms of the trust the trustee can be permitted to invest in bonds of that type, although there is an element of risk which would make the investment otherwise improper.
- Permissive or mandatory terms of the trust. The terms of the trust as to investments may be either permissive or mandatory; that is, the trustee may be merely authorized or he may be directed to invest in certain securities or kinds of securities. If he is merely authorized to make certain investments, he has a privilege but not a duty to make such investments; if he is directed to make such investments, he has not merely a privilege but a duty to do so.
- Interpretation of the terms of the trust. When discretion as to investments is conferred upon the trustee by the terms of the trust, it is a question of interpretation whether and to what extent the settlor intends to enlarge the scope of permissible

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

investments. If by the terms of the trust the trustee is authorized to make investments "in his discretion," such an authorization does not ordinarily permit the trustee to make investments other than those which a prudent man would make under the rule stated in Clause (a). By the terms of the trust, however, the trustee may be permitted to invest in securities which are speculative or otherwise improper under the rule stated in Clause (a). The provisions of the trust instrument are ordinarily strictly construed against an enlargement of the scope of permissible investments beyond those allowed under the rule stated in Clause (a). Even though by the terms of the trust the trustee is authorized to invest according to his absolute and uncontrolled discretion, he cannot properly lend trust money to himself individually or purchase securities from himself individually.

A provision in the terms of the trust authorizing the trustee to invest in "securities" is ordinarily interpreted as broad enough to include not merely secured obligations but also other investments such as shares of stock or debentures. An authorization to invest in securities, however, does not of itself empower the trustee to make an investment which would not be made by a prudent man dealing with his own property and having primarily in view the preservation of the trust estate and the amount and regularity of the income to be derived.

- An authorization by the terms of the trust to invest in a particular type of security does not mean that any investment in securities of that type is proper. The trustee must use care and skill and caution in making the selection. Thus, if the trustee is authorized by the terms of the trust to invest in railroad bonds, he is guilty of a breach of trust if he invests in bonds of a railroad company in which a prudent man would not invest because of the financial condition of the company.

Where by the terms of the trust discretion is conferred upon the trustee to make certain investments, he is subject to liability if he abuses the discretion. Thus, if the trustee is permitted to invest in a particular security or type of security in his discretion and the circumstances are such that it would be beyond the bounds of a reasonable judgment to make the investment, the trustee is subject to liability if he makes it.

- If by the terms of the trust the trustee is authorized or directed to invest in a particular security or a particular type of security, he may nevertheless be liable for making such an investment, where owing to circumstances not known to the settlor and not anticipated by him the making of such investment would defeat or substantially impair the accomplishment of the purposes of the trust. Thus, whereby the terms of the trust the trustee was authorized to invest in shares of a particular company which at the time of the creation of the trust was in sound financial condition, but which has since fallen into such financial difficulties that the shares have become highly speculative, the trustee is subject to liability if he invests in these shares.
- Informal trusts. In the case of an informal trust, as where one hands over money to another to invest for him, the duty to invest and the propriety of investments are governed by the intention of the parties as shown by their words or other conduct as interpreted in the light of all the circumstances. Whether the trust is created by a formal instrument such as a will or deed, or is not so created, the duty of the trustee in making investments is to conform to the rules stated in this Section. The circumstances, however, surrounding informal trusts may more freely lend themselves to an interpretation of the terms of the trust as permitting a wider latitude in making investments, or may show an intention that the trustee should not make any investments. If the trust is one created by will or deed of trust, the trust instrument must itself express a latitude to invest in securities that would not otherwise be proper trust investments.
- Successive beneficiaries. An investment which would not otherwise be improper as a trust investment is improper where the trust is created for successive beneficiaries, if the investment would be unduly favorable to one beneficiary at the expense of the other.
- General duties of trustee. In making investments, as in other matters relating to the administration of the trust, the trustee is under a duty to act solely in the interest of the beneficiary. It is a breach of trust for the trustee in making an investment to purchase property owned by him individually.

Delegation of Duties - In making investments, as in other matters relating to the administration of the trust, the trustee is under a duty not to delegate to others the doing of acts which the trustee can reasonably be required personally to perform. He cannot properly delegate to another power to select investments.

←

## C. 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) 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:

Richard V. Wellman, University of Georgia, School of Law, Athens, GA 30602,

*Chair*

Clark A. Gravel, P.O. Box 369, 76 St. Paul Street, Burlington, VT 05402

John H. Langbein, Yale Law School, P.O. Box 208215, New Haven, CT 06520,

*National Conference Reporter*

Robert A. Stein, American Bar Association, 750 North Lake Shore Drive, Chicago, IL 60611,

*Ex Officio*

Richard C. Hite, 200 West Douglas Avenue, Suite 630, Wichita, KS 67202,

*President*

John H. Langbein, Yale Law School, P.O. Box 208215, New Haven, CT 06520, Chair, Division D

*Executive Director*

Fred H. Miller, University of Oklahoma, College of Law, 300 Timberdell Road, Norman, OK 73019, Executive Director

William J. Pierce, 1505 Roxbury Road, Ann Arbor, MI 48104,

*Executive Director Emeritus*

*Review Committee*

Edward F. Lowry, Jr., Suite 1040, 6900 East Camelback Road, Scottsdale, AZ 85251, Chair

H. Reese Hansen, Brigham Young University, J. Reuben Clark Law School, 348-A JRCB, Provo, UT 84602

Mildred W. Robinson, University of Virginia, School of Law, 580 Massie Road, Charlottesville, VA 22903

Advisor to drafting committee

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, Chicago, Illinois 60611. 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

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

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 § 26-45.1 (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].

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

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

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

"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.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

## *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).

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

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.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

## *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 under diversified 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 Law Excerpts or Digest of Applicable Laws, Regulations and Principles

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

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

(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*

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

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 forbade 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).

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

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.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

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."

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

## 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:

←

## D. LIST OF STATES

List of States Adopting the Uniform Prudent Investor Act

*(As of August 2004)*

Alaska AS §§ 13.36.200 to 13.36.275.  
Arizona West's Ariz. Rev. Stat. Ann. §§ 14-7601 to 14-7611.  
Arkansas A.C.A §§ 24-3-417 to 24-3-426.  
California West's Ann. Cal. Probate Code, §§ 16045 to 16054.  
Colorado West's C.S.R.A. §§ 15-1.1-101 to 15-1.1-115.  
Connecticut C.G.S.A. §§ 45a-541 to 45a-541/.  
District of Columbia D.C. Code 1981, §§ 28-4701 to 28-4712.  
Hawaii H.R.S §§ 554C-1 to 554C-12.  
Idaho I.C. §§ 68-501 to 68-514.  
Illinois West's 760 ILL Comp. Stat. §§ 5/5 and 5/5.1.  
Indiana West's A.I.C. §§ 30-4-3.5-1 to 30-4-3.5-13.  
Iowa West's Iowa Code Ann. § 633.4301 to 633.4310.  
Kansas (a) West's Kan. Stat. Ann. § 17-5004.  
Maine West's Me. Rev. Stat. Ann. tit. 18-A, § 7-302, 7-302 note.  
Maryland West's Md. Code Ann., Est. & Trusts § 15-114. (substantially similar)  
Massachusetts M.G.L.A c 203C, §§ 1 to 11.  
Michigan M.C.L.A. §§ 700.1501 to 700.1512.  
Minnesota West's Minn. Stat. Ann. § 501B.151, 501B.152.  
Missouri West's Mo. Ann. Stat. §§ 456.900 to 456.913.  
Montana West's Mont. Code Ann. § 72-34-114  
Nebraska R.R.S. 1943, §§ 8-2201 to 8-2213.  
Nevada West's Nev. Rev. Stat. § 164.050.  
New Hampshire RSA 564 A:3:B  
New Jersey West's N.J. Stat. Ann. § 3B:20-11.1 to 3B:20-11.12.  
New Mexico West's N.M. Stat. Ann. §§ 45-7-601 to 45-7-612.  
North Carolina G.S. §§ 36A-161 to 36A-173.  
North Dakota West's N.D. Cent. Code § 59-02-08.1 to 59-02-08.11.  
Ohio R.C. §§ 1339.52 to 1339.61.  
Oklahoma West's 60 Okla. Stat. Ann. tit. 60 §§ 175.60 to 175.72.  
Oregon West's Or. Rev. Stat. § 128.192 to 128.218.  
Pennsylvania 20 Pa. C.S.A. §§ 7201 to 7214.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Rhode Island Gen. Laws 1956, §§ 18-15-1 to 18-15-13.  
South Carolina West's S.C. Code Ann. § 62-7-302.  
Tennessee  
Texas West's Tex Prop. Code Ann. § 113.056.  
Utah West's Utah Code Ann. § 75-7-302.  
Vermont 9 V.S.A §§ 4651 to 4662.  
Virginia West's Va. Code Ann. § 26-45.3 to 26-45.14.  
Washington West's Wash. Rev. Code Ann. § 11.100.010 et. seq.  
West Virginia Code, 44-6C-1 to 44-6C-15.  
Wisconsin  
Wyoming Wyo. Stat. Ann. §§ 4-9-101 to 4-9-113.

## List of States Adopting a Quasi form of the Uniform Prudent Investor Act

Alabama West's Ala. Code § 19-3-120.2.  
Delaware West's Del. Code Ann. tit. 12 § 3302.  
Florida West's F.S.A. §§ 518.11 and 518.11  
Georgia West's Ga. Code Ann. § 53-12-280.  
Kentucky Revised Statutes 287.277  
New York West's N.Y. Est. Powers and Trusts Law § 11-2.3  
South Dakota West's S.D. Codified Laws Ann. § 55-5-6.

The remaining states to adopt some form of the Uniform Prudent Investor Act are Mississippi and Louisiana.

←

## E. UNIFORM PRINCIPAL AND INCOME ACT 1962

### Introduction

The 1962 version of the Act replaces the previous version, which had been approved in 1931. The revised Act provides, as did the original Act, that the settlor's intent is the guiding principle which should control the disposition of all receipts. But settlors have not always foreseen the multitude of problems that may have to be faced and even draftsmen have found it difficult to foresee all the possible kinds of receipts and disbursements. It is important, therefore, to set forth some clear and uniform standards to assist those to whom the power of decision has been committed, that is, the trustees, and this Act attempts to provide these standards.

The aim of the revised Act is simplicity and convenience of administration of the estate. Of course, fairness to all beneficiaries both present and future has also been considered. As a result, the revised Act is made applicable to all trusts and estates whether in existence at the time the revised Act becomes law or not. A trustee who administers several trusts, it was thought, would have difficulty attempting to administer the various trusts under different rules for distribution of receipts and allocation of disbursements and it was thought better, therefore, to make the Act applicable to all trusts.

The original Act followed the so-called "Massachusetts Rule" of awarding cash dividends on corporate stock to income and stock dividends to principal, thereby rejecting the Pennsylvania Rule or some variation of it requiring apportionment between the two funds. The revised Act continues to follow the Massachusetts Rule but provides for some newer problems that have arisen since the original Act was promulgated.

Provision is now made for corporate distributions pursuant to a court decree such as a divestiture order in an anti-trust suit. Provision is also made for treatment of the distributions of a regulated investment company or estate investment trust. Since the original Act was promulgated development has occurred in methods of issuing bonds, notably the discount type of bond such as the Series E bond of the United States government and provision had been made for allocating the increment in value between principal and income.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

The revised Act provides for an allocation of natural resources substantially different from that provided in the original Act but not substantially different from the rules adopted in many of the states producing natural resources. Because of the difficulty of apportioning receipts from extraction of natural resources among the income and principal beneficiaries it is provided in the revised Act that an arbitrary allocation should occur, that is, 27½% of the gross receipts shall be added to principal as a "depletion reserve," and the balance should be payable to the income beneficiary. Attempts to apportion the receipts on the relation of the amount of minerals extracted to the amount of minerals remaining in the ground have proved difficult of calculation and this method of allocation was accordingly rejected in favor of simplicity.

While the revised Act continues to deal specifically with a number of subjects, it also contains a "catchall" providing for disposition of receipts where there is no specific section in the Act dealing with the allocation. A form of "prudent man" rule has been adopted to handle this situation.

The Act, therefore, sets forth simple and workable rules of administration which are believed to be consistent with the wishes of settlors upon the subject treated unless the settlor specifically provides for a different treatment in his own trust instrument.

## Sections

1. Definitions
2. Duty of Trustee as to Receipts and Expenditure
3. Income; Principal; Charges
4. When Right to Income Arises; Apportionment of Income
5. Income Earned During Administration of a Decedent's Estate
6. Corporate Distributions
7. Bond Premium and Discount
8. Business and Farming Operations
9. Disposition of Natural Resources
10. Timber
11. Other Property Subject to Depletion
12. Underproductive Property
13. Charges Against Income and Principal
14. Application of Act
15. Uniformity of Interpretation
16. Short Title
17. Severability
18. Repeal
19. Time of Taking Effect of This Act

### *Section 1 - Definitions*

As used in this Act:

1. "income beneficiary" means the person to whom income is presently payable or for whom it is accumulated for distribution as income;
2. "inventory value" means the cost of property purchased by the trustee and the market value of other property at the time it became subject to the trust, but in the case of a testamentary trust the trustee may use any value finally determined for the purposes of an estate or inheritance tax;
3. "remainderman" means the person entitled to principal, including income which has been accumulated and added to principal;
4. "trustee" means an original trustee and any successor or added trustee.

### *Section 2 - Duty of Trustee as to Receipts and Expenditure*

1. A trust shall be administered with due regard to the respective interests of income beneficiaries and remaindermen. A trust is so administered with respect to the allocation of receipts and expenditures if a receipt is credited or an expenditure is charged to income or principal or partly to each -

- in accordance with the terms of the trust instrument, notwithstanding contrary provisions of this Act;
  - in the absence of any contrary terms of the trust instrument, in accordance with the provisions of this Act; or
  - if neither of the preceding rules of administration is applicable, in accordance with what is reasonable and equitable in view of the interests of those entitled to income as well as of those entitled to principal, and in view of the manner in which men of ordinary prudence, discretion and judgment would act in the management of their own affairs.
2. If the trust instrument gives the trustee discretion in crediting a receipt or charging an expenditure to income or principal or partly to each, no inference of imprudence or partiality arises from the fact that the trustee has made an allocation contrary to a provision of this Act.

## ***Section 3 - Income; Principal; Charges***

1. Income is the return in money or property derived from the use of principal, including return received as -
- rent of real or personal property, including sums received for cancellation or renewal of a lease;
  - interest on money lent, including sums received as consideration for the privilege of prepayment of principal except as provided in section 7 on bond premium and bond discount;
  - income earned during administration of a decedent's estate as provided in section 5;
  - corporate distributions as provided in section 6;
  - accrued increment on bonds or other obligations issued at discount as provided in section 7;
  - receipts from business and farming operations as provided in section 8;
  - receipts from disposition of natural resources as provided in sections 9 and 10;
  - receipts from other principal subject to depletion as provided in section 11;
  - receipts from disposition of underproductive property as provided in section 12.
2. Principal is the property which has been set aside by the owner or the person legally empowered so that it is held in trust eventually to be delivered to a remainderman while the return or use of the principal is in the meantime taken or received by or held for accumulation for an income beneficiary. Principal includes -
- consideration received by the trustee on the sale or other transfer of principal or on repayment of a loan or as a refund or replacement or change in the form of principal;
  - proceeds of property taken on eminent domain proceedings;
  - proceeds of insurance upon property forming part of the principal except proceeds of insurance upon a separate interest of an income beneficiary;
  - stock dividends, receipts on liquidation of a corporation, and other corporate distributions as provided in section 6;
  - receipts from the disposition of corporate securities as provided in section 7;
  - royalties and other receipts from disposition of natural resources as provided in sections 9 and 10;
  - receipts from other principal subject to depletion as provided in section 11;
  - any profit resulting from any change in the form of principal except as provided in section 12 on underproductive property;
  - receipts from disposition of underproductive property as provided in section 12;
  - any allowances for depreciation established under sections 8 and 13(a)(2).
3. After determining income and principal in accordance with the terms of the trust instrument or of this Act, the trustee shall charge to income or principal expenses and other charges as provided in section 13.

## ***Section 4 - When Right to Income Arises; Apportionment of Income***

1. An income beneficiary is entitled to income from the date specified in the trust instrument, or, if none is specified, from the date an asset becomes subject to the trust. In the case of an asset becoming subject to a trust by reason of a will, it becomes subject to the trust as of the date of the death of the testator even though there is an intervening period of administration of the testator's estate.
2. In the administration of a decedent's estate or an asset becoming subject to a trust by reason of a will -

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

- receipts due but not paid at the date of death of the testator are principal;
  - receipts in the form of periodic payments (other than corporate distributions to stockholders), including rent, interest, or annuities, not due at the date of the death of the testator shall be treated as accruing from day to day. That portion of the receipt accruing before the date of death is principal, and the balance is income.
3. In all other cases, any receipt from an income-producing asset is income even though the receipt was earned or accrued in whole or in part before the date when the asset became subject to the trust.
  4. On termination of an income interest, the income beneficiary whose interest is terminated, or his estate, is entitled to:
    - income undistributed on the date of termination;
    - income due but not paid to the trustee on the date of termination;
    - income in the form of periodic payments (other than corporate distributions to stockholders), including rent, interest, or annuities, not due on the date of termination, accrued from day to day.
  5. Corporate distributions to stockholders shall be treated as due on the day fixed by the corporation for determination of stockholders of record entitled to distribution or, if no date is fixed, on the date of declaration of the distribution by the corporation.

## ***Section 5 - Income Earned During Administration of a Decedent's Estate***

1. Unless the will otherwise provides and subject to subsection (b), all expenses incurred in connection with the settlement of a decedent's estate, including debts, funeral expenses, estate taxes, interest and penalties concerning taxes, family allowances, fees of attorneys and personal representatives, and court costs shall be charged against the principal of the estate.
2. Unless the will otherwise provides, income from the assets of a decedent's estate after the death of the testator and before distribution, including income from property used to discharge liabilities, shall be determined in accordance with the rules applicable to a trustee under this Act and distributed as follows:
  - to specific legatees and devisees, the income from the property bequeathed or devised to them respectively, less taxes, ordinary repairs, and other expenses of management and operation of the property, and an appropriate portion of interest accrued since the death of the testator and of taxes imposed on income (excluding taxes on capital gains) which accrue during the period of administration;
  - to all other legatees and devisees, except legatees of pecuniary bequests not in trust, the balance of the income, less the balance of taxes, ordinary repairs, and other expenses of management and operation of all property from which the estate is entitled to income, interest accrued since the death of the testator, and taxes imposed on income (excluding taxes on capital gains) which accrue during the period of administration, in proportion to their respective interests in the undistributed assets of the estate computed at times of distribution on the basis of inventory value.
3. Income received by a trustee under subsection (b) shall be treated as income of the trust.

## ***Section 6 - Corporate Distributions***

1. Corporate distributions of shares of the distributing corporation, including distributions in the form of a stock split or stock dividend, are principal. A right to subscribe to shares or other securities issued by the distributing corporation accruing to stockholders on account of their stock ownership and the proceeds of any sale of the right are principal.
2. Except to the extent that the corporation indicates that some part of a corporate distribution is a settlement of preferred or guaranteed dividends accrued since the trustee became a stockholder or is in lieu of an ordinary cash dividend, a corporate distribution is principal if the distribution is pursuant to –
  - a call of shares;
  - a merger, consolidation, reorganization, or other plan by which assets of the corporation are acquired by another corporation; or

- a total or partial liquidation of the corporation, including any distribution which the corporation indicates is a distribution in total or partial liquidation or any distribution of assets, other than cash, pursuant to a court decree or final administrative order by a government agency ordering distribution of the particular assets.
- 3. Distributions made from ordinary income by a regulated investment company or by a trust qualifying and electing to be taxed under federal law as a real estate investment trust are income. All other distributions made by the company or trust, including distributions from capital gains, depreciation, or depletion, whether in the form of cash or an option to take new stock or cash or an option to purchase additional shares, are principal.
- 4. Except as provided in subsections (a), (b), and (c), all corporate distributions are income, including cash dividends, distributions of or rights to subscribe to shares or securities or obligations of corporations other than the distributing corporation, and the proceeds of the rights or property distributions. Except as provided in subsections (b) and (c), if the distributing corporation gives a stockholder an option to receive a distribution either in cash or in its own shares, the distribution chosen is income.
- 5. The trustee may rely upon any statement of the distributing corporation as to any fact relevant under any provision of this Act concerning the source or character of dividends or distributions of corporate assets.

## ***Section 7 - Bond Premium and Discount***

1. Bonds or other obligations for the payment of money are principal at their inventory value, except as provided in subsection (b) for discount bonds. No provision shall be made for amortization of bond premiums or for accumulation for discount. The proceeds of sale, redemption, or other disposition of the bonds or obligations are principal.
2. The increment in value of a bond or other obligation for the payment of money payable at a future time in accordance with a fixed schedule of appreciation in excess of the price at which it was issued is distributable as income. The increment in value is distributable to the beneficiary who was the income beneficiary at the time of increment from the first principal cash available or, if none is available, when realized by sale, redemption, or other disposition. Whenever unrealized increment is distributed as income but out of principal, the principal shall be reimbursed for the increment when realized.

## ***Section 8 - Business and Farming Operations***

1. If a trustee uses any part of the principal in the continuance of a business of which the settlor was a sole proprietor or a partner, the net profits of the business, computed in accordance with generally accepted accounting principles for a comparable business, are income. If a loss results in any fiscal or calendar year, the loss falls on principal and shall not be carried into any other fiscal or calendar year for purposes of calculating net income.
2. Generally accepted accounting principles shall be used to determine income from an agricultural or farming operation, including the raising of animals or the operation of a nursery.

## ***Section 9 - Disposition Of Natural Resources***

1. If any part of the principal consists of a right to receive royalties, overriding or limited royalties, working interests, production payments, net profit interests, or other interests in minerals or other natural resources in, on or under land, the receipts from taking the natural resources from the land shall be allocated as follows:
  - If received as rent on a lease or extension payments on a lease, the receipts are income.
  - If received from a production payment, the receipts are income to the extent of any factor for interest or its equivalent provided in the governing instrument. There shall be allocated to principal the fraction of the balance of the receipts which the unrecovered cost of the production payment bears to the balance owed on the production payment, exclusive of any factor for interest or its equivalent. The receipts not allocated to principal are income.
  - If received as a royalty, overriding or limited royalty, or bonus, or from a working, net profit, or any other interest in minerals or other natural resources, receipts not provided for in the preceding paragraphs of this section shall be apportioned on a yearly basis in accordance with this paragraph whether or not any natural resource was being taken from the land at the time the trust was established. Twenty-seven and one-half per cent of the gross receipts (but not to exceed 50% of the net receipts remaining after payment of all expenses, direct and indirect, computed without allowance for depletion) shall be added to principal as an allowance for depletion. The balance of the gross receipts, after payment therefrom of all expenses, direct and indirect, is income.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

2. If a trustee, on the effective date of this Act, held an item of depletable property of a type specified in this section he shall allocate receipts from the property in the manner used before the effective date of this Act, but as to all depletable property acquired after the effective date of this Act by an existing or new trust, the method of allocation provided herein shall be used.
3. This section does not apply to timber, water, soil, sod, dirt, turf, or mosses.

## ***Section 10 – Timber***

If any part of the principal consists of land from which merchantable timber may be removed, the receipts from taking the timber from the land shall be allocated in accordance with section 2(a)(3).

## ***Section 11 - Other Property Subject to Depletion***

Except as provided in sections 9 and 10, if the principal consists of property subject to depletion, including leaseholds, patents, copyrights, royalty rights, and rights to receive payments on a contract for deferred compensation, receipts from the property, not in excess of 5% per year of its inventory value, are income, and the balance is principal.

## ***Section 12 - Underproductive Property***

1. Except as otherwise provided in this section, a portion of the net proceeds of sale of any part of principal which has not produced an average net income of at least 1% per year of its inventory value for more than a year (including as income the value of any beneficial use of the property by the income beneficiary) shall be treated as delayed income to which the income beneficiary is entitled as provided in this section. The net proceeds of sale are the gross proceeds received, including the value of any property, received in substitution for the property disposed of less the expenses, including capital gains tax, if any, incurred in disposition and less any carrying charges paid while the property was underproductive.
2. The sum allocated as delayed income is the difference between the net proceeds and the amount which, had it been invested at simple interest at [4%] per year while the property was underproductive, would have produced the net proceeds. This sum, plus any carrying charges and expenses previously charged against income while the property was underproductive, less any income received by the income beneficiary from the property and less the value of any beneficial use of the property by the income beneficiary, is income, and the balance is principal.
3. An income beneficiary or his estate is entitled to delayed income under this section as if it accrued from day to day during the time he was a beneficiary.
4. If principal subject to this section is disposed of by conversion into property which cannot be apportioned easily, including land or mortgages (for example, realty acquired by or in lieu of foreclosure), the income beneficiary is entitled to the net income from any property or obligation into which the original principal is converted while the substituted property or obligation is held. If within 5 years after the conversion the substituted property has not been further converted into easily apportionable property, no allocation as provided in this section shall be made.

## ***Section 13 - Charges Against Income and Principal***

1. The following charges shall be made against income:
  - ordinary expenses incurred in connection with the administration, management, or preservation of the trust property, including regularly recurring taxes assessed against any portion of the principal, water rates, premiums on insurance taken upon the interests of the income beneficiary, remainderman, or trustee, interest paid by the trustee, and ordinary repairs;
  - a reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting principles, but no allowance shall be made for depreciation of that portion of any real property used by a beneficiary as a residence or for depreciation of any property held by the trustee on the effective date of this Act for which the trustee is not then making an allowance for depreciation;
  - one-half of court costs, attorney's fees, and other fees on periodic judicial accounting, unless the court directs otherwise;
  - court costs, attorney's fees, and other fees on other accountings or judicial proceedings if the matter primarily concerns the income interest, unless the court directs otherwise;

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

- one-half of the trustee's regular compensation, whether based on a percentage of principal or income, and all expenses reasonably incurred for current management of principal and application of income;
  - any tax levied upon receipts defined as income under this Act or the trust instrument and payable by the trustee.
2. If charges against income are of unusual amount, the trustee may by means of reserves or other reasonable means Charge them over a reasonable period of time and withhold from distribution sufficient sums to regularize distributions.
3. The following charges shall be made against principal:
- trustee's compensation not chargeable to income under subsections (a)(4) and (a)(5), special compensation of trustees, expenses reasonably incurred in connection with principal, court costs and attorney's fees primarily concerning matters of principal, and trustee's compensation computed on principal as an acceptance, distribution, or termination fee;
  - charges not provided for in subsection (a), including the cost of investing and reinvesting principal, the payments on principal of an indebtedness (including a mortgage amortized by periodic payments of principal), expenses for preparation of property for rental or sale, and, unless the court directs otherwise, expenses incurred in maintaining or defending any action to construe the trust or protect it or the property or assure the title of any trust property;
  - extraordinary repairs or expenses incurred in making a capital improvement to principal, including special assessments, but, a trustee may establish an allowance for depreciation out of income to the extent permitted by subsection (a)(2) and by section 8;
  - any tax levied upon profit, gain, or other receipts allocated to principal notwithstanding denomination of the tax as an income tax by the taxing authority;
  - if an estate or inheritance tax is levied in respect of a trust in which both an income beneficiary and a remainderman have an interest, any amount apportioned to the trust including interest and penalties, even though the income beneficiary also has rights in the principal.
4. Regularly recurring charges payable from income shall be apportioned to the same extent and in the same manner that income is apportioned under section 4.

## ***Section 14 - Application of Act***

Except as specifically provided in the trust instrument or the will or in this Act, this Act shall apply to any receipt or expense received or incurred after the effective date of this Act by any trust or decedent's estate whether established before or after the effective date of this Act and whether the asset involved was acquired by the trustee before or after the effective date of this Act.

## ***Section 15 - Uniformity of Interpretation***

This Act shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it.

## ***Section 16 - Short Title***

This Act may be cited as the Revised Uniform Principal and Income Act.

## ***Section 17 – Severability***

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

## ***Section 18 – Repeal***

The following acts and parts of acts are repealed:

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

## *Section 19 - Time of Taking Effect of This Act*

This Act shall take effect on .....

←

## **F. UNIFORM PRINCIPAL AND INCOME ACT 1997 (ACT)**

### Introduction

(Last Amended or Revised in 2000)

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-sixth year in Sacramento, California (July 25 - August 1, 1997) with prefatory note and comments by National Conference of Commissioners on Uniform State Laws - August 21, 2003.

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

Matthew S. Rae, Jr., 37th Floor, 777 S. Figueroa Street, Los Angeles, CA 90017, Chair  
Frank W. Daykin, 4745 Giles Way, Carson City, NV 89704  
Joanne B. Huelsman, Room 510, 119 Martin Luther King, Madison, WI 53703  
L. S. Jerry Kurtz, Jr., 1050 Beech Lane, Anchorage, AK 99501  
Edward F. Lowry, Jr., Suite 1120, 2901 N. Central Avenue, Phoenix, AZ 85012  
Robert A. Stein, American Bar Association, 750 N. Lake Shore Drive, Chicago, IL 60611  
Harry M. Walsh, Office of Revisor of Statutes, 700 State Office Building, St. Paul, MN 55155  
Joel C. Dobris, University of California at Davis, School of Law, King Hall, Davis, CA 95616, Co-Reporter  
E. James Gamble, Suite 1300, 525 N. Woodward Avenue, Bloomfield Hills, MI 48304, Co-Reporter

### *Ex Officio*

Bion M. Gregory, Office of Legislative Counsel, State Capitol, Suite 3021, Sacramento, CA 95814-4996, President  
John H. Langbein, Yale Law School, P.O. Box 208215, New Haven, CT 06520, Chair, Division D

### *Executive Director*

Fred H. Miller, University of Oklahoma, College of Law, 300 Timberdell Road, Norman, OK 73019, Executive Director  
William J. Pierce, 1505 Roxbury Road, Ann Arbor, MI 48104, Executive Director Emeritus

### *Copies of this Act may be obtained from:*

National Conference of Commissioners on Uniform State Laws  
211 E. Ontario Street, Suite 1300  
Chicago, Illinois 60611  
312/915-0195

## Uniform Principal and Income Act

### ***Prefatory Note***

This revision of the 1931 Uniform Principal and Income Act and the 1962 Revised Uniform Principal and Income Act has two purposes.

One purpose is to revise the 1931 and the 1962 Acts. Revision is needed to support the now widespread use of the revocable living trust as a will substitute, to change the rules in those Acts that experience has shown need to be changed, and to establish

new rules to cover situations not provided for in the old Acts, including rules that apply to financial instruments invented since 1962.

The other purpose is to provide a means for implementing the transition to an investment regime based on principles embodied in the Uniform Prudent Investor Act, especially the principle of investing for total return rather than a certain level of "income" as traditionally perceived in terms of interest, dividends, and rents.

## *Revision of the 1931 and 1962 Acts*

The prior Acts and this revision of those Acts deal with four questions affecting the rights of beneficiaries:

- (1) How is income earned during the probate of an estate to be distributed to trusts and to persons who receive outright bequests of specific property, pecuniary gifts, and the residue?
- (2) When an income interest in a trust begins (i.e., when a person who creates the trust dies or when she transfers property to a trust during life), what property is principal that will eventually go to the remainder beneficiaries and what is income?
- (3) When an income interest ends, who gets the income that has been received but not distributed, or that is due but not yet collected, or that has accrued but is not yet due?
- (4) After an income interest begins and before it ends, how should its receipts and disbursements be allocated to or between principal and income?

Changes in the traditional sections are of three types: new rules that deal with situations not covered by the prior Acts, clarification of provisions in the 1962 Act, and changes to rules in the prior Acts.

New rules. Issues addressed by some of the more significant new rules include:

- (1) The application of the probate administration rules to revocable living trusts after the settlor's death and to other terminating trusts. Articles 2 and 3.
- (2) The payment of interest or some other amount on the delayed payment of an outright pecuniary gift that is made pursuant to a trust agreement instead of a will when the agreement or state law does not provide for such a payment. Section 201(3).
- (3) The allocation of net income from partnership interests acquired by the trustee other than from a decedent (the old Acts deal only with partnership interests acquired from a decedent). Section 401.
- (4) An "unincorporated entity" concept has been introduced to deal with businesses operated by a trustee, including farming and livestock operations, and investment activities in rental real estate, natural resources, timber, and derivatives. Section 403.
- (5) The allocation of receipts from discount obligations such as zero-coupon bonds. Section 406(b).
- (6) The allocation of net income from harvesting and selling timber between principal and income. Section 412.
- (7) The allocation between principal and income of receipts from derivatives, options, and asset-backed securities. Sections 414 and 415.
- (8) Disbursements made because of environmental laws. Section 502(a)(7).
- (9) Income tax obligations resulting from the ownership of S corporation stock and interests in partnerships. Section 505.
- (10) The power to make adjustments between principal and income to correct inequities caused by tax elections or peculiarities in the way the fiduciary income tax rules apply. Section 506.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Clarifications and changes in existing rules. A number of matters provided for in the prior Acts have been changed or clarified in this revision, including the following:

- (1) An income beneficiary's estate will be entitled to receive only net income actually received by a trust before the beneficiary's death and not items of accrued income. Section 303.
- (2) Income from a partnership is based on actual distributions from the partnership, in the same manner as corporate distributions. Section 401.
- (3) Distributions from corporations and partnerships that exceed 20% of the entity's gross assets will be principal whether or not intended by the entity to be a partial liquidation. Section 401(d)(2).
- (4) Deferred compensation is dealt with in greater detail in a separate section. Section 409.
- (5) The 1962 Act rule for "property subject to depletion," (patents, copyrights, royalties, and the like), which provides that a trustee may allocate up to 5% of the asset's inventory value to income and the balance to principal, has been replaced by a rule that allocates 90% of the amounts received to principal and the balance to income. Section 410.
- (6) The percentage used to allocate amounts received from oil and gas has been changed - 90% of those receipts are allocated to principal and the balance to income. Section 411.
- (7) The unproductive property rule has been eliminated for trusts other than marital deduction trusts. Section 413.
- (8) Charging depreciation against income is no longer mandatory, and is left to the discretion of the trustee. Section 503.

## *Coordination with the Uniform Prudent Investor Act*

The law of trust investment has been modernized. See Uniform Prudent Investor Act (1994); Restatement (Third) of Trusts: Prudent Investor Rule (1992) (hereinafter Restatement of Trusts 3d: Prudent Investor Rule). Now it is time to update the principal and income allocation rules so the two bodies of doctrine can work well together. This revision deals conservatively with the tension between modern investment theory and traditional income allocation. The starting point is to use the traditional system. If prudent investing of all the assets in a trust viewed as a portfolio and traditional allocation effectuate the intent of the settlor, then nothing need be done. The Act, however, helps the trustee who has made a prudent, modern portfolio-based investment decision that has the initial effect of skewing return from all the assets under management, viewed as a portfolio, as between income and principal beneficiaries. The Act gives that trustee a power to reallocate the portfolio return suitably. To leave a trustee constrained by the traditional system would inhibit the trustee's ability to fully implement modern portfolio theory.

As to modern investing see, e.g., the Preface to, terms of, and Comments to the Uniform Prudent Investor Act (1994); the discussion and reporter's note by Edward C. Halbach, Jr. in Restatement of Trusts 3d: Prudent Investor Rule; John H. Langbein, The Uniform Prudent Investor Act and the Future of Trust Investing, 81 Iowa L. Rev. 641 (1996); Bevis Longstreth, Modern Investment Management and the Prudent Man Rule (1986); John H. Langbein & Richard A. Posner, The Revolution in Trust Investment Law, 62 A.B.A.J. 887 (1976); and Jeffrey N. Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U. L. Rev. 52 (1987). See also R.A. Brearly, An Introduction to Risk and Return from Common Stocks (2d ed. 1983); Jonathan R. Macey, An Introduction to Modern Financial Theory (2d ed. 1998). As to the need for principal and income reform see, e.g., Joel C. Dobris, Real Return, Modern Portfolio Theory and College, University and Foundation Decisions on Annual Spending From Endowments: A Visit to the World of Spending Rules, 28 Real Prop., Prob., & Tr. J. 49 (1993); Joel C. Dobris, The Probate World at the End of the Century: Is a New Principal and Income Act in Your Future?, 28 Real Prop., Prob., & Tr. J. 393 (1993); and Kenneth L. Hirsch, Inflation and the Law of Trusts, 18 Real Prop., Prob., & Tr. J. 601 (1983). See also, Jerold I. Horn, The Prudent Investor Rule - Impact on Drafting and Administration of Trusts, 20 ACTEC Notes 26 (Summer 1994).

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

## [Article] 1 – Definitions and Fiduciary Duties

**Section 101. Short Title.** *This [Act] may be cited as the Uniform Principal and Income Act.*

**Section 102. Definitions.** *In this [Act]:*

- (1) "Accounting period" means a calendar year unless another 12-month period is selected by a fiduciary. The term includes a portion of a calendar year or other 12-month period that begins when an income interest begins or ends when an income interest ends.
- (2) "Beneficiary" includes, in the case of a decedent's estate, an heir [, legatee,] and devisee and, in the case of a trust, an income beneficiary and a remainder beneficiary.
- (3) "Fiduciary" means a personal representative or a trustee. The term includes an executor, administrator, successor personal representative, special administrator, and a person performing substantially the same function.
- (4) "Income" means money or property that a fiduciary receives as current return from a principal asset. The term includes a portion of receipts from a sale, exchange, or liquidation of a principal asset, to the extent provided in [Article] 4.
- (5) "Income beneficiary" means a person to whom net income of a trust is or may be payable.
- (6) "Income interest" means the right of an income beneficiary to receive all or part of net income, whether the terms of the trust require it to be distributed or authorize it to be distributed in the trustee's discretion.
- (7) "Mandatory income interest" means the right of an income beneficiary to receive net income that the terms of the trust require the fiduciary to distribute.
- (8) "Net income" means the total receipts allocated to income during an accounting period minus the disbursements made from income during the period, plus or minus transfers under this [Act] to or from income during the period.
- (9) "Person" means an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, government; governmental subdivision, agency, or instrumentality; public corporation, or any other legal or commercial entity.
- (10) "Principal" means property held in trust for distribution to a remainder beneficiary when the trust terminates.
- (11) "Remainder beneficiary" means a person entitled to receive principal when an income interest ends.
- (12) "Terms of a trust" means the manifestation of the intent of a settlor or decedent with respect to the trust, expressed in a manner that admits of its proof in a judicial proceeding, whether by written or spoken words or by conduct.
- (13) "Trustee" includes an original, additional, or successor trustee, whether or not appointed or confirmed by a court.

### *Comment*

*"Income beneficiary."* The definitions of income beneficiary (Section 102(5)) and income interest (Section 102(6)) cover both mandatory and discretionary beneficiaries and interests. There are no definitions for "discretionary income beneficiary" or "discretionary income interest" because those terms are not used in the Act.

*Inventory value.* There is no definition for inventory value in this Act because the provisions in which that term was used in the 1962 Act have either been eliminated (in the case of the underproductive property provision) or changed in a way that eliminates the need for the term (in the case of bonds and other money obligations, property subject to depletion, and the method for determining entitlement to income distributed from a probate estate).

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

"*Net income*." The reference to "transfers under this Act to or from income" means transfers made under Sections 104(a), 412(b), 502(b), 503(b), 504(a), and 506.

"*Terms of a trust*." This term was chosen in preference to "terms of the trust instrument" (the phrase used in the 1962 Act) to make it clear that the Act applies to oral trusts as well as those whose terms are expressed in written documents. The definition is based on the Restatement (Second) of Trusts § 4 (1959) and the Restatement (Third) of Trusts § 4 (Tent. Draft No. 1, 1996). Constructional preferences or rules would also apply, if necessary, to determine the terms of the trust.

## ***Section 103. Fiduciary Duties; General Principles.***

(a) In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:

- (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];
- (2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];
- (3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and
- (4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

(b) In exercising the power to adjust under Section 104(a) or a discretionary power of administration regarding a matter within the scope of this [Act], whether granted by the terms of a trust, a will, or this [Act], a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries. A determination in accordance with this [Act] is presumed to be fair and reasonable to all of the beneficiaries.

## **Comment**

*Prior Act.* The rule in Section 2(a) of the 1962 Act is restated in Section 103(a), without changing its substance, to emphasize that the Act contains only default rules and that provisions in the terms of the trust are paramount. However, Section 2(a) of the 1962 Act applies only to the allocation of receipts and disbursements to or between principal and income. In this Act, the first sentence of Section 103(a) states that it also applies to matters within the scope of Articles 2 and 3. Section 103(a)(2) incorporates the rule in Section 2(b) of the 1962 Act that a discretionary allocation made by the trustee that is contrary to a rule in the Act should not give rise to an inference of imprudence or partiality by the trustee.

The Act deletes the language that appears at the end of 1962 Act Section 2(a)(3) - "and in view of the manner in which men of ordinary prudence, discretion and judgment would act in the management of their affairs" - because persons of ordinary prudence, discretion and judgment, acting in the management of their own affairs do not normally think in terms of the interests of successive beneficiaries. If there is an analogy to an individual's decision-making process, it is probably the individual's decision to spend or to save, but this is not a useful guideline for trust administration. No case has been found in which a court has relied on the "prudent man" rule of the 1962 Act.

*Fiduciary discretion.* The general rule is that if a discretionary power is conferred upon a trustee, the exercise of that power is not subject to control by a court except to prevent an abuse of discretion. Restatement (Second) of Trusts § 187. The situations in which a court will control the exercise of a trustee's discretion are discussed in the comments to § 187. See also *id.* § 233 Comment p.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Questions for which there is no provision. Section 103(a)(4) allocates receipts and disbursements to principal when there is no provision for a different allocation in the terms of the trust, the will, or the Act. This may occur because money is received from a financial instrument not available at the present time (inflation-indexed bonds might have fallen into this category had they been announced after this Act was approved by the Commissioners on Uniform State Laws) or because a transaction is of a type or occurs in a manner not anticipated by the Drafting Committee for this Act or the drafter of the trust instrument.

Allocating to principal a disbursement for which there is no provision in the Act or the terms of the trust preserves the income beneficiary's level of income in the year it is allocated to principal, but thereafter will reduce the amount of income produced by the principal. Allocating to principal a receipt for which there is no provision will increase the income received by the income beneficiary in subsequent years, and will eventually, upon termination of the trust, also favor the remainder beneficiary. Allocating these items to principal implements the rule that requires a trustee to administer the trust impartially, based on what is fair and reasonable to both income and remainder beneficiaries. However, if the trustee decides that an adjustment between principal and income is needed to enable the trustee to comply with Section 103(b), after considering the return from the portfolio as a whole, the trustee may make an appropriate adjustment under Section 104(a).

*Duty of impartiality.* Whenever there are two or more beneficiaries, a trustee is under a duty to deal impartially with them. Restatement of Trusts 3d: Prudent Investor Rule § 183 (1992). This rule applies whether the beneficiaries' interests in the trust are concurrent or successive. If the terms of the trust give the trustee discretion to favor one beneficiary over another, a court will not control the exercise of such discretion except to prevent the trustee from abusing it. Id. § 183, Comment a. "The precise meaning of the trustee's duty of impartiality and the balancing of competing interests and objectives inevitably are matters of judgment and interpretation. Thus, the duty and balancing are affected by the purposes, terms, distribution requirements, and other circumstances of the trust, not only at the outset but as they may change from time to time." Id. § 232, Comment c.

The terms of a trust may provide that the trustee, or an accountant engaged by the trustee, or a committee of persons who may be family members or business associates, shall have the power to determine what is income and what is principal. If the terms of a trust provide that this Act specifically or principal and income legislation in general does not apply to the trust but fail to provide a rule to deal with a matter provided for in this Act, the trustee has an implied grant of discretion to decide the question. Section 103(b) provides that the rule of impartiality applies in the exercise of such a discretionary power to the extent that the terms of the trust do not provide that one or more of the beneficiaries are to be favored. The fact that a person is named an income beneficiary or a remainder beneficiary is not by itself an indication of partiality for that beneficiary.

## ***Section 104. Trustee's Power to Adjust***

(a) A trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines, after applying the rules in Section 103(a), that the trustee is unable to comply with Section 103(b).

(b) In deciding whether and to what extent to exercise the power conferred by subsection (a), a trustee shall consider all factors relevant to the trust and its beneficiaries, including the following factors to the extent they are relevant:

- (1) the nature, purpose, and expected duration of the trust;
- (2) the intent of the settlor;
- (3) the identity and circumstances of the beneficiaries;
- (4) the needs for liquidity, regularity of income, and preservation and appreciation of capital;
- (5) the assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor;

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

(6) the net amount allocated to income under the other sections of this [Act] and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available;

(7) whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income;

(8) the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and

(9) the anticipated tax consequences of an adjustment.

(c) A trustee may not make an adjustment:

(1) that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction would be allowed, in whole or in part, if the trustee did not have the power to make the adjustment;

(2) that reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion;

(3) that changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets;

(4) from any amount that is permanently set aside for charitable purposes under a will or the terms of a trust unless both income and principal are so set aside;

(5) if possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust for income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to make an adjustment;

(6) if possessing or exercising the power to make an adjustment causes all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the individual if the trustee did not possess the power to make an adjustment;

(7) if the trustee is a beneficiary of the trust; or

(8) if the trustee is not a beneficiary, but the adjustment would benefit the trustee directly or indirectly.

(d) If subsection (c)(5), (6), (7), or (8) applies to a trustee and there is more than one trustee, a cotrustee to whom the provision does not apply may make the adjustment unless the exercise of the power by the remaining trustee or trustees is not permitted by the terms of the trust.

(e) A trustee may release the entire power conferred by subsection (a) or may release only the power to adjust from income to principal or the power to adjust from principal to income if the trustee is uncertain about whether possessing or exercising the power will cause a result described in subsection (c)(1) through (6) or (c)(8) or if 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 subsection (c). The release may be permanent or for a specified period, including a period measured by the life of an individual.

(f) Terms of a trust that limit the power of a trustee to make an adjustment between principal and income do not affect the application of this section unless it is clear from the terms of the trust that the terms are intended to deny the trustee the power of adjustment conferred by subsection (a).

## Comment

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

*Purpose and Scope of Provision.* The purpose of Section 104 is to enable a trustee to select investments using the standards of a prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional trust accounting income such as interest, dividends, and rents. Section 104(a) authorizes a trustee to make adjustments between principal and income if three conditions are met: (1) the trustee must be managing the trust assets under the prudent investor rule; (2) the terms of the trust must express the income beneficiary's distribution rights in terms of the right to receive "income" in the sense of traditional trust accounting income; and (3) the trustee must determine, after applying the rules in Section 103(a), that he is unable to comply with Section 103(b). In deciding whether and to what extent to exercise the power to adjust, the trustee is required to consider the factors described in Section 104(b), but the trustee may not make an adjustment in circumstances described in Section 104(c).

Section 104 does not empower a trustee to increase or decrease the degree of beneficial enjoyment to which a beneficiary is entitled under the terms of the trust; rather, it authorizes the trustee to make adjustments between principal and income that may be necessary if the income component of a portfolio's total return is too small or too large because of investment decisions made by the trustee under the prudent investor rule. The paramount consideration in applying Section 104(a) is the requirement in Section 103(b) that "a fiduciary must administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries." The power to adjust is subject to control by the court to prevent an abuse of discretion. Restatement (Second) of Trusts § 187 (1959). See also *id.* §§ 183, 232, 233, Comment p (1959).

Section 104 will be important for trusts that are irrevocable when a State adopts the prudent investor rule by statute or judicial approval of the rule in Restatement of Trusts 3d: Prudent Investor Rule. Wills and trust instruments executed after the rule is adopted can be drafted to describe a beneficiary's distribution rights in terms that do not depend upon the amount of trust accounting income, but to the extent that drafters of trust documents continue to describe an income beneficiary's distribution rights by referring to trust accounting income, Section 104 will be an important tool in trust administration.

Three conditions to the exercise of the power to adjust. The first of the three conditions that must be met before a trustee can exercise the power to adjust - that the trustee invest and manage trust assets as a prudent investor - is expressed in this Act by language derived from the Uniform Prudent Investor Act, but the condition will be met whether the prudent investor rule applies because the Uniform Act or other prudent investor legislation has been enacted, the prudent investor rule has been approved by the courts, or the terms of the trust require it. Even if a State's legislature or courts have not formally adopted the rule, the Restatement establishes the prudent investor rule as an authoritative interpretation of the common law prudent man rule, referring to the prudent investor rule as a "modest reformulation of the Harvard College dictum and the basic rule of prior Restatements." Restatement of Trusts 3d: Prudent Investor Rule, Introduction, at 5. As a result, there is a basis for concluding that the first condition is satisfied in virtually all States except those in which a trustee is permitted to invest only in assets set forth in a statutory "legal list."

The second condition will be met when the terms of the trust require all of the "income" to be distributed at regular intervals; or when the terms of the trust require a trustee to distribute all of the income, but permit the trustee to decide how much to distribute to each member of a class of beneficiaries; or when the terms of a trust provide that the beneficiary shall receive the greater of the trust accounting income and a fixed dollar amount (an annuity), or of trust accounting income and a fractional share of the value of the trust assets (a unitrust amount). If the trust authorizes the trustee in its discretion to distribute the trust's income to the beneficiary or to accumulate some or all of the income, the condition will be met because the terms of the trust do not permit the trustee to distribute more than the trust accounting income.

To meet the third condition, the trustee must first meet the requirements of Section 103(a), i.e., she must apply the terms of the trust, decide whether to exercise the discretionary powers given to the trustee under the terms of the trust, and must apply the provisions of the Act if the terms of the trust do not contain a different provision or give the trustee discretion. Second, the trustee must determine the extent to which the terms of the trust clearly manifest an intention by the settlor that the trustee may or must favor one or more of the beneficiaries. To the extent that the terms of the trust do not require partiality, the trustee must conclude that she is unable to comply with the duty to administer the trust impartially. To the extent that the terms of the trust do require or permit the trustee to favor the income beneficiary or the remainder beneficiary, the trustee must conclude that she is unable to achieve the degree of partiality required or permitted. If the trustee comes to either conclusion - that she is unable to administer the trust impartially or that she is unable to achieve the degree of partiality required or permitted - she may exercise the power to adjust under Section 104(a).

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

*Impartiality and productivity of income.* The duty of impartiality between income and remainder beneficiaries is linked to the trustee's duty to make the portfolio productive of trust accounting income whenever the distribution requirements are expressed in terms of distributing the trust's "income." The 1962 Act implies that the duty to produce income applies on an asset by asset basis because the right of an income beneficiary to receive "delayed income" from the sale proceeds of underproductive property under Section 12 of that Act arises if "any part of principal ... has not produced an average net income of at least 1% per year of its inventory value for more than a year ... ." Under the prudent investor rule, "[t]o whatever extent a requirement of income productivity exists, ... the requirement applies not investment by investment but to the portfolio as a whole." Restatement of Trusts 3d: Prudent Investor Rule § 227, Comment i, at 34. The power to adjust under Section 104(a) is also to be exercised by considering net income from the portfolio as a whole and not investment by investment. Section 413(b) of this Act eliminates the underproductive property rule in all cases other than trusts for which a marital deduction is allowed; the rule applies to a marital deduction trust if the trust's assets "consist substantially of property that does not provide the spouse with sufficient income from or use of the trust assets ..." - in other words, the section applies by reference to the portfolio as a whole.

While the purpose of the power to adjust in Section 104(a) is to eliminate the need for a trustee who operates under the prudent investor rule to be concerned about the income component of the portfolio's total return, the trustee must still determine the extent to which a distribution must be made to an income beneficiary and the adequacy of the portfolio's liquidity as a whole to make that distribution.

For a discussion of investment considerations involving specific investments and techniques under the prudent investor rule, see Restatement of Trusts 3d: Prudent Investor Rule § 227, Comments k-p.

*Factors to consider in exercising the power to adjust.* Section 104(b) requires a trustee to consider factors relevant to the trust and its beneficiaries in deciding whether and to what extent the power to adjust should be exercised. Section 2(c) of the Uniform Prudent Investor Act sets forth circumstances that a trustee is to consider in investing and managing trust assets. The circumstances in Section 2(c) of the Uniform Prudent Investor Act are the source of the factors in paragraphs (3) through (6) and (8) of Section 104(b) (modified where necessary to adapt them to the purposes of this Act) so that, to the extent possible, comparable factors will apply to investment decisions and decisions involving the power to adjust. If a trustee who is operating under the prudent investor rule decides that the portfolio should be composed of financial assets whose total return will result primarily from capital appreciation rather than dividends, interest, and rents, the trustee can decide at the same time the extent to which an adjustment from principal to income may be necessary under Section 104. On the other hand, if a trustee decides that the risk and return objectives for the trust are best achieved by a portfolio whose total return includes interest and dividend income that is sufficient to provide the income beneficiary with the beneficial interest to which the beneficiary is entitled under the terms of the trust, the trustee can decide that it is unnecessary to exercise the power to adjust.

*Assets received from the settlor.* Section 3 of the Uniform Prudent Investor Act provides that "[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." The special circumstances may include the wish to retain a family business, the benefit derived from deferring liquidation of the asset in order to defer payment of income taxes, or the anticipated capital appreciation from retaining an asset such as undeveloped real estate for a long period. To the extent the trustee retains assets received from the settlor because of special circumstances that overcome the duty to diversify, the trustee may take these circumstances into account in determining whether and to what extent the power to adjust should be exercised to change the results produced by other provisions of this Act that apply to the retained assets. See Section 104(b)(5); Uniform Prudent Investor Act § 3, Comment, 7B U.L.A. 18, at 25-26 (Supp. 1997); Restatement of Trusts 3d: Prudent Investor Rule § 229 and Comments a-e.

*Limitations on the power to adjust.* The purpose of subsections (c)(1) through (4) is to preserve tax benefits that may have been an important purpose for creating the trust. Subsections (c)(5), (6), and (8) deny the power to adjust in the circumstances described in those subsections in order to prevent adverse tax consequences, and subsection (c)(7) denies the power to adjust to any beneficiary, whether or not possession of the power may have adverse tax consequences.

Under subsection (c)(1), a trustee cannot make an adjustment that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction is allowed; but this subsection does not prevent the trustee from making an adjustment that increases the amount of income paid from a marital deduction trust to the spouse. Subsection (c)(1) applies to a trust that qualifies for the marital deduction because the spouse has a general power of appointment over the trust, but it applies to a qualified terminable interest property (QTIP) trust only if and to

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

the extent that the fiduciary makes the election required to obtain the tax deduction. Subsection (c)(1) does not apply to a so-called "estate" trust. This type of trust qualifies for the marital deduction because the terms of the trust require the principal and undistributed income to be paid to the surviving spouse's estate when the spouse dies; it is not necessary for the terms of an estate trust to require the income to be distributed annually. Reg. § 20.2056(c)-2(b)(1)(iii).

Subsection (c)(3) applies to annuity trusts and unitrusts with no charitable beneficiaries as well as to trusts with charitable income or remainder beneficiaries; its purpose is to make it clear that a beneficiary's right to receive a fixed annuity or a fixed fraction of the value of a trust's assets is not subject to adjustment under Section 104(a). Subsection (c)(3) does not apply to any additional amount to which the beneficiary may be entitled that is expressed in terms of a right to receive income from the trust. For example, if a beneficiary is to receive a fixed annuity or the trust's income, whichever is greater, subsection (c)(3) does not prevent a trustee from making an adjustment under Section 104(a) in determining the amount of the trust's income.

If subsection (c)(5), (6), (7), or (8), prevents a trustee from exercising the power to adjust, subsection (d) permits a cotrustee who is not subject to the provision to exercise the power unless the terms of the trust do not permit the cotrustee to do so.

*Release of the power to adjust.* Section 104(e) permits a trustee to release all or part of the power to adjust in circumstances in which the possession or exercise of the power might deprive the trust of a tax benefit or impose a tax burden. For example, if possessing the power would diminish the actuarial value of the income interest in a trust for which the income beneficiary's estate may be eligible to claim a credit for property previously taxed if the beneficiary dies within ten years after the death of the person creating the trust, the trustee is permitted under subsection (e) to release just the power to adjust from income to principal.

Trust terms that limit a power to adjust. Section 104(f) applies to trust provisions that limit a trustee's power to adjust. Since the power is intended to enable trustees to employ the prudent investor rule without being constrained by traditional principal and income rules, an instrument executed before the adoption of this Act whose terms describe the amount that may or must be distributed to a beneficiary by referring to the trust's income or that prohibit the invasion of principal or that prohibit equitable adjustments in general should not be construed as forbidding the use of the power to adjust under Section 104(a) if the need for adjustment arises because the trustee is operating under the prudent investor rule. Instruments containing such provisions that are executed after the adoption of this Act should specifically refer to the power to adjust if the settlor intends to forbid its use. See generally, Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

## Examples

The following examples illustrate the application of Section 104:

*Example (1)* - T is the successor trustee of a trust that provides income to A for life, remainder to B. T has received from the prior trustee a portfolio of financial assets invested 20% in stocks and 80% in bonds. Following the prudent investor rule, T determines that a strategy of investing the portfolio 50% in stocks and 50% in bonds has risk and return objectives that are reasonably suited to the trust, but T also determines that adopting this approach will cause the trust to receive a smaller amount of dividend and interest income. After considering the factors in Section 104(b), T may transfer cash from principal to income to the extent T considers it necessary to increase the amount distributed to the income beneficiary.

*Example (2)* - T is the trustee of a trust that requires the income to be paid to the settlor's son C for life, remainder to C's daughter D. In a period of very high inflation, T purchases bonds that pay double-digit interest and determines that a portion of the interest, which is allocated to income under Section 406 of this Act, is a return of capital. In consideration of the loss of value of principal due to inflation and other factors that T considers relevant, T may transfer part of the interest to principal.

*Example (3)* - T is the trustee of a trust that requires the income to be paid to the settlor's sister E for life, remainder to charity F. E is a retired schoolteacher who is single and has no children. E's income from her social security, pension, and savings exceeds the amount required to provide for her accustomed standard of living. The terms of the trust permit T to invade principal to provide for E's health and to support her in her accustomed manner of living, but do not otherwise indicate that T should favor E or F. Applying the prudent investor rule, T determines that the trust assets should be invested entirely in growth stocks that produce very little dividend income. Even though it is not necessary to invade principal to maintain E's accustomed standard of

living, she is entitled to receive from the trust the degree of beneficial enjoyment normally accorded a person who is the sole income beneficiary of a trust, and T may transfer cash from principal to income to provide her with that degree of enjoyment.

*Example (4)* - T is the trustee of a trust that is governed by the law of State X. The trust became irrevocable before State X adopted the prudent investor rule. The terms of the trust require all of the income to be paid to G for life, remainder to H, and also give T the power to invade principal for the benefit of G for "dire emergencies only." The terms of the trust limit the aggregate amount that T can distribute to G from principal during G's life to 6% of the trust's value at its inception. The trust's portfolio is invested initially 50% in stocks and 50% in bonds, but after State X adopts the prudent investor rule T determines that, to achieve suitable risk and return objectives for the trust, the assets should be invested 90% in stocks and 10% in bonds. This change increases the total return from the portfolio and decreases the dividend and interest income. Thereafter, even though G does not experience a dire emergency, T may exercise the power to adjust under Section 104(a) to the extent that T determines that the adjustment is from only the capital appreciation resulting from the change in the portfolio's asset allocation. If T is unable to determine the extent to which capital appreciation resulted from the change in asset allocation or is unable to maintain adequate records to determine the extent to which principal distributions to G for dire emergencies do not exceed the 6% limitation, T may not exercise the power to adjust. See Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

*Example (5)* - T is the trustee of a trust for the settlor's child. The trust owns a diversified portfolio of marketable financial assets with a value of \$600,000, and is also the sole beneficiary of the settlor's IRA, which holds a diversified portfolio of marketable financial assets with a value of \$900,000. The trust receives a distribution from the IRA that is the minimum amount required to be distributed under the Internal Revenue Code, and T allocates 10% of the distribution to income under Section 409(c) of this Act. The total return on the IRA's assets exceeds the amount distributed to the trust, and the value of the IRA at the end of the year is more than its value at the beginning of the year. Relevant factors that T may consider in determining whether to exercise the power to adjust and the extent to which an adjustment should be made to comply with Section 103(b) include the total return from all of the trust's assets, those owned directly as well as its interest in the IRA, the extent to which the trust will be subject to income tax on the portion of the IRA distribution that is allocated to principal, and the extent to which the income beneficiary will be subject to income tax on the amount that T distributes to the income beneficiary.

*Example (6)* - T is the trustee of a trust whose portfolio includes a large parcel of undeveloped real estate. T pays real property taxes on the undeveloped parcel from income each year pursuant to Section 501(3). After considering the return from the trust's portfolio as a whole and other relevant factors described in Section 104(b), T may exercise the power to adjust under Section 104(a) to transfer cash from principal to income in order to distribute to the income beneficiary an amount that T considers necessary to comply with Section 103(b).

*Example (7)* - T is the trustee of a trust whose portfolio includes an interest in a mutual fund that is sponsored by T. As the manager of the mutual fund, T charges the fund a management fee that reduces the amount available to distribute to the trust by \$2,000. If the fee had been paid directly by the trust, one-half of the fee would have been paid from income under Section 501(1) and the other one-half would have been paid from principal under Section 502(a)(1). After considering the total return from the portfolio as a whole and other relevant factors described in Section 104(b), T may exercise its power to adjust under Section 104(a) by transferring \$1,000, or half of the trust's proportionate share of the fee, from principal to income.

## **Section 105. Judicial Control Of Discretionary Power.**

(a) The court may not order a fiduciary to change a decision to exercise or not to exercise a discretionary power conferred by this [Act] unless it determines that the decision was an abuse of the fiduciary's discretion. A fiduciary's decision is not an abuse of discretion merely because the court would have exercised the power in a different manner or would not have exercised the power.

(b) The decisions to which subsection (a) applies include:

- (1) a decision under Section 104(a) as to whether and to what extent an amount should be transferred from principal to income or from income to principal.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

(2) a decision regarding the factors that are relevant to the trust and its beneficiaries, the extent to which the factors are relevant, and the weight, if any, to be given to those factors, in deciding whether and to what extent to exercise the discretionary power conferred by Section 104(a).

(c) If the court determines that a fiduciary has abused the fiduciary's discretion, the court may place the income and remainder beneficiaries in the positions they would have occupied if the discretion had not been abused, according to the following rules:

(1) To the extent that the abuse of discretion has resulted in no distribution to a beneficiary or in a distribution that is too small, the court shall order the fiduciary to distribute from the trust to the beneficiary an amount that the court determines will restore the beneficiary, in whole or in part, to the beneficiary's appropriate position.

(2) To the extent that the abuse of discretion has resulted in a distribution to a beneficiary which is too large, the court shall place the beneficiaries, the trust, or both, in whole or in part, in their appropriate positions by ordering the fiduciary to withhold an amount from one or more future distributions to the beneficiary who received the distribution that was too large or ordering that beneficiary to return some or all of the distribution to the trust. (3) To the extent that the court is unable, after applying paragraphs (1) and (2), to place the beneficiaries, the trust, or both, in the positions they would have occupied if the discretion had not been abused, the court may order the fiduciary to pay an appropriate amount from its own funds to one or more of the beneficiaries or the trust or both.

(d) Upon [petition] by the fiduciary, the court having jurisdiction over a trust or estate shall determine whether a proposed exercise or nonexercise by the fiduciary of a discretionary power conferred by this [Act] will result in an abuse of the fiduciary's discretion. If the petition describes the proposed exercise or nonexercise of the power and contains sufficient information to inform the beneficiaries of the reasons for the proposal, the facts upon which the fiduciary relies, and an explanation of how the income and remainder beneficiaries will be affected by the proposed exercise or nonexercise of the power, a beneficiary who challenges the proposed exercise or nonexercise has the burden of establishing that it will result in an abuse of discretion.

## Comment

*General.* All of the discretionary powers in the 1997 Act are subject to the normal rules that govern a fiduciary's exercise of discretion. Section 105 codifies those rules for purposes of the Act so that they will be readily apparent and accessible to fiduciaries, beneficiaries, their counsel and the courts if and when questions concerning such powers arise.

Section 105 also makes clear that the normal rules governing the exercise of a fiduciary's powers apply to the discretionary power to adjust conferred upon a trustee by Section 104(a). Discretionary provisions authorizing trustees to determine what is income and what is principal have been used in governing instruments for years; Section 2 of the 1931 Uniform Principal and Income Act recognized that practice by providing that "the person establishing the principal may himself direct the manner of ascertainment of income and principal...or grant discretion to the trustee or other person to do so...." Section 103(a)(2) also recognizes the power of a settlor to grant such discretion to the trustee. Section 105 applies to a discretionary power granted by the terms of a trust or a will as well as the power to adjust in Section 104(a).

*Power to Adjust.* The exercise of the power to adjust is governed by a trustee's duty of impartiality, which requires the trustee to strike an appropriate balance between the interests of the income and remainder beneficiaries. Section 103(b) expresses this duty by requiring the trustee to "administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries." Because this involves the exercise of judgment in circumstances rarely capable of perfect resolution, trustees are not expected to achieve perfection; they are, however, required to make conscious decisions in good faith and with proper motives.

In seeking the proper balance between the interests of the beneficiaries in matters involving principal and income, a trustee's traditional approach has been to determine the settlor's objectives from the terms of the trust, gather the information needed to ascertain the financial circumstances of the beneficiaries, determine the extent to which the settlor's objectives can be achieved with the resources available in the trust, and then allocate the trust's assets between stocks and fixed-income securities in a way that will produce a particular level or range of income for the income beneficiary. The key element in this process has been to determine the appropriate level or range of income for the income beneficiary, and that will continue to be the key element in

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

deciding whether and to what extent to exercise the discretionary power conferred by Section 104(a). If it becomes necessary for a court to determine whether an abuse of the discretionary power to adjust between principal and income has occurred, the criteria should be the same as those that courts have used in the past to determine whether a trustee has abused its discretion in allocating the trust's assets between stocks and fixed-income securities.

A fiduciary has broad latitude in choosing the methods and criteria to use in deciding whether and to what extent to exercise the power to adjust in order to achieve impartiality between income beneficiaries and remainder beneficiaries or the degree of partiality for one or the other that is provided for by the terms of the trust or the will. For example, in deciding what the appropriate level or range of income should be for the income beneficiary and whether to exercise the power, a trustee may use the methods employed prior to the adoption of the 1997 Act in deciding how to allocate trust assets between stocks and fixed-income securities; or may consider the amount that would be distributed each year based on a percentage of the portfolio's value at the beginning or end of an accounting period, or the average portfolio value for several accounting periods, in a manner similar to a unitrust, and may select a percentage that the trustee believes is appropriate for this purpose and use the same percentage or different percentages in subsequent years. The trustee may also use hypothetical portfolios of marketable securities to determine an appropriate level or range of income within which a distribution might fall.

An adjustment may be made prospectively at the beginning of an accounting period, based on a projected return or range of returns for a trust's portfolio, or retrospectively after the fiduciary knows the total realized or unrealized return for the period; and instead of an annual adjustment, the trustee may distribute a fixed dollar amount for several years, in a manner similar to an annuity, and may change the fixed dollar amount periodically. No inference of abuse is to be drawn if a fiduciary uses different methods or criteria for the same trust from time to time, or uses different methods or criteria for different trusts for the same accounting period.

While a trustee must consider the portfolio as a whole in deciding whether and to what extent to exercise the power to adjust, a trustee may apply different criteria in considering the portion of the portfolio that is composed of marketable securities and the portion whose market value cannot be determined readily, and may take into account a beneficiary's use or possession of a trust asset.

Under the prudent investor rule, a trustee is to incur costs that are appropriate and reasonable in relation to the assets and the purposes of the trust, and the same consideration applies in determining whether and to what extent to exercise the power to adjust. In making investment decisions under the prudent investor rule, the trustee will have considered the purposes, terms, distribution requirements, and other circumstances of the trust for the purpose of adopting an overall investment strategy having risk and return objectives reasonably suited to the trust. A trustee is not required to duplicate that work for principal and income purposes, and in many cases the decision about whether and to what extent to exercise the power to adjust may be made at the same time as the investment decisions. To help achieve the objective of reasonable investment costs, a trustee may also adopt policies that apply to all trusts or to individual trusts or classes of trusts, based on their size or other criteria, stating whether and under what circumstances the power to adjust will be exercised and the method of making adjustments; no inference of abuse is to be drawn if a trustee adopts such policies.

*General rule.* The first sentence of Section 105(a) is from Restatement (Second) of Trusts § 187 and Restatement (Third) of Trusts (Tentative Draft No. 2, 1999) § 50(1). The second sentence of Section 105(a) derives from Comment e to § 187 of the Second Restatement and Comment b to § 50 of the Third Restatement.

The reference in Section 105(a) to a fiduciary's decision to exercise or not to exercise a discretionary power underscores a fundamental precept, which is that a fiduciary has a duty to make a conscious decision about exercising or not exercising a discretionary power. Comment b to § 50 of the Third Restatement states:

[A] court will intervene where the exercise of a power is left to the judgment of a trustee who improperly fails to exercise that judgment. Thus, even where a trustee has discretion whether or not to make any payments to a particular beneficiary, the court will interpose if the trustee, arbitrarily or without knowledge of or inquiry into relevant circumstances, fails to exercise the discretion.

Section 105(b) makes clear that the rule of subsection (a) applies not only to the power conferred by Section 104(a) but also to the evaluation process required by Section 104(b) in deciding whether and to what extent to exercise the power to adjust. Under

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Section 104(b), a trustee is to consider all of the factors that are relevant to the trust and its beneficiaries, including, to the extent the trustee determines they are relevant, the nine factors enumerated in Section 104(b). Section 104(b) derives from Section 2(c) of the Uniform Prudent Investor Act, which lists eight circumstances that a trustee shall consider, to the extent they are relevant, in investing and managing assets. The trustee's decisions about what factors are relevant for purposes of Section 104(b) and the weight to be accorded each of the relevant factors are part of the discretionary decision-making process. As such, these decisions are not subject to change for the purpose of changing the trustee's ultimate decision unless the court determines that there has been an abuse of discretion in determining the relevancy and weight of these factors.

*Remedy.* The exercise or nonexercise of a discretionary power under the Act normally affects the amount or timing of a distribution to the income or remainder beneficiaries. The primary remedy under Section 105(c) for abuse of discretion is the restoration of the beneficiaries and the trust to the positions they would have occupied if the abuse had not occurred. It draws on a basic principle of restitution that if a person pays money to someone who is not intended to receive it (and in a case to which this Act applies, not intended by the settlor to receive it in the absence of an abuse of discretion by the trustee), that person is entitled to restitution on the ground that the payee would be unjustly enriched if he were permitted to retain the payment. See Restatement of Restitution § 22 (1937). The objective is to accomplish the restoration initially by making adjustments between the beneficiaries and the trust to the extent possible; to the extent that restoration is not possible by such adjustments, a court may order the trustee to pay an amount to one or more of the beneficiaries, the trust, or both the beneficiaries and the trust. If the court determines that it is not possible in the circumstances to restore them to their appropriate positions, the court may provide other remedies appropriate to the circumstances. The approach of Section 105(c) is supported by Comment b to § 50 of the Third Restatement of Trusts:

When judicial intervention is required, a court may direct the trustee to make or refrain from making certain payments; issue instructions to clarify the standards or guidelines applicable to the exercise of the power; or rescind the trustee's payment decisions, usually directing the trustee to recover amounts improperly distributed and holding the trustee liable for failure or inability to do so....

*Advance determinations.* Section 105(d) employs the familiar remedy of the trustee's petition to the court for instructions. It requires the court to determine, upon a petition by the fiduciary, whether a proposed exercise or nonexercise of a discretionary power by the fiduciary of a power conferred by the Act would be an abuse of discretion under the general rule of Section 105(a). If the petition contains the information prescribed in the second sentence of subsection (d), the proposed action or inaction is presumed not to result in an abuse, and a beneficiary who challenges the proposal must establish that it will.

Subsection (d) is intended to provide a fiduciary the opportunity to obtain an assurance of finality in a judicial proceeding before proceeding with a proposed exercise or nonexercise of a discretionary power. Its purpose is not, however, to have the court instruct the fiduciary how to exercise the discretion.

A fiduciary may also obtain the consent of the beneficiaries to a proposed act or an omission to act, and a beneficiary cannot hold the fiduciary liable for that act or omission unless:

- (a) the beneficiary was under an incapacity at the time of such consent or of such act or omission; or
- (b) the beneficiary, when he gave his consent, did not know of his rights and of the material facts which the trustee knew or should have known and which the trustee did not reasonably believe that the beneficiary knew; or
- (c) the consent of the beneficiary was induced by improper conduct of the trustee.

## **Restatement (Second) of Trusts § 216.**

If there are many beneficiaries, including some who are incapacitated or unascertained, the fiduciary may prefer the greater assurance of finality provided by a judicial proceeding that will bind all persons who have an interest in the trust.

## [Article] 2 - Descendant's estate or terminating income interest

**Section 201. Determination and Distribution of Net Income.** *After a decedent dies, in the case of an estate, or after an income interest in a trust ends, the following rules apply:*

(1) A fiduciary of an estate or of a terminating income interest shall determine the amount of net income and net principal receipts received from property specifically given to a beneficiary under the rules in [Articles] 3 through 5 which apply to trustees and the rules in paragraph (5). The fiduciary shall distribute the net income and net principal receipts to the beneficiary who is to receive the specific property.

(2) A fiduciary shall determine the remaining net income of a decedent's estate or a terminating income interest under the rules in [Articles] 3 through 5 which apply to trustees and by:

(A) including in net income all income from property used to discharge liabilities;

(B) paying from income or principal, in the fiduciary's discretion, fees of attorneys, accountants, and fiduciaries; court costs and other expenses of administration; and interest on death taxes, but the fiduciary may pay those expenses from income of property passing to a trust for which the fiduciary claims an estate tax marital or charitable deduction only to the extent that the payment of those expenses from income will not cause the reduction or loss of the deduction; and (C) paying from principal all other disbursements made or incurred in connection with the settlement of a decedent's estate or the winding up of a terminating income interest, including debts, funeral expenses, disposition of remains, family allowances, and death taxes and related penalties that are apportioned to the estate or terminating income interest by the will, the terms of the trust, or applicable law.

(3) A fiduciary shall distribute to a beneficiary who receives a pecuniary amount outright the interest or any other amount provided by the will, the terms of the trust, or applicable law from net income determined under paragraph (2) or from principal to the extent that net income is insufficient. If a beneficiary is to receive a pecuniary amount outright from a trust after an income interest ends and no interest or other amount is provided for by the terms of the trust or applicable law, the fiduciary shall distribute the interest or other amount to which the beneficiary would be entitled under applicable law if the pecuniary amount were required to be paid under a will.

(4) A fiduciary shall distribute the net income remaining after distributions required by paragraph (3) in the manner described in Section 202 to all other beneficiaries, including a beneficiary who receives a pecuniary amount in trust, even if the beneficiary holds an unqualified power to withdraw assets from the trust or other presently exercisable general power of appointment over the trust.

(5) A fiduciary may not reduce principal or income receipts from property described in paragraph (1) because of a payment described in Section 501 or 502 to the extent that the will, the terms of the trust, or applicable law requires the fiduciary to make the payment from assets other than the property or to the extent that the fiduciary recovers or expects to recover the payment from a third party. The net income and principal receipts from the property are determined by including all of the amounts the fiduciary receives or pays with respect to the property, whether those amounts accrued or became due before, on, or after the date of a decedent's death or an income interest's terminating event, and by making a reasonable provision for amounts that the fiduciary believes the estate or terminating income interest may become obligated to pay after the property is distributed.

### Comment

Terminating income interests and successive income interests. A trust that provides for a single income beneficiary and an outright distribution of the remainder ends when the income interest ends. A more complex trust may have a number of income interests, either concurrent or successive, and the trust will not necessarily end when one of the income interests ends. For that reason, the Act speaks in terms of income interests ending and beginning rather than trusts ending and beginning. When an income interest in a trust ends, the trustee's powers continue during the winding up period required to complete its administration. A terminating income interest is one that has ended but whose administration is not complete.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

If two or more people are given the right to receive specified percentages or fractions of the income from a trust concurrently and one of the concurrent interests ends, e.g., when a beneficiary dies, the beneficiary's income interest ends but the trust does not. Similarly, when a trust with only one income beneficiary ends upon the beneficiary's death, the trust instrument may provide that part or all of the trust assets shall continue in trust for another income beneficiary. While it is common to think and speak of this (and even to characterize it in a trust instrument) as a "new" trust, it is a continuation of the original trust for a remainder beneficiary who has an income interest in the trust assets instead of the right to receive them outright. For purposes of this Act, this is a successive income interest in the same trust. The fact that a trust may or may not end when an income interest ends is not significant for purposes of this Act.

If the assets that are subject to a terminating income interest pass to another trust because the income beneficiary exercises a general power of appointment over the trust assets, the recipient trust would be a new trust; and if they pass to another trust because the beneficiary exercises a nongeneral power of appointment over the trust assets, the recipient trust might be a new trust in some States (see 5A Austin W. Scott & William F. Fratcher, *The Law of Trusts* § 640, at 483 (4th ed. 1989)); but for purposes of this Act a new trust created in these circumstances is also a successive income interest.

Gift of a pecuniary amount. Section 201(3) and (4) provide different rules for an outright gift of a pecuniary amount and a gift in trust of a pecuniary amount; this is the same approach used in Section 5(b)(2) of the 1962 Act.

Interest on pecuniary amounts. Section 201(3) provides that the beneficiary of an outright pecuniary amount is to receive the interest or other amount provided by applicable law if there is no provision in the will or the terms of the trust. Many States have no applicable law that provides for interest or some other amount to be paid on an outright pecuniary gift under an inter vivos trust; this section provides that in such a case the interest or other amount to be paid shall be the same as the interest or other amount required to be paid on testamentary pecuniary gifts. This provision is intended to accord gifts under inter vivos instruments the same treatment as testamentary gifts. The various state authorities that provide for the amount that a beneficiary of an outright pecuniary amount is entitled to receive are collected in Richard B. Covey, *Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions*, App. B (4th ed. 1997).

Administration expenses and interest on death taxes. Under Section 201(2)(B) a fiduciary may pay administration expenses and interest on death taxes from either income or principal. An advantage of permitting the fiduciary to choose the source of the payment is that, if the fiduciary's decision is consistent with the decision to deduct these expenses for income tax purposes or estate tax purposes, it eliminates the need to adjust between principal and income that may arise when, for example, an expense that is paid from principal is deducted for income tax purposes or an expense that is paid from income is deducted for estate tax purposes.

The United States Supreme Court has considered the question of whether an estate tax marital deduction or charitable deduction should be reduced when administration expenses are paid from income produced by property passing in trust for a surviving spouse or for charity and deducted for income tax purposes. The Court rejected the IRS position that administration expenses properly paid from income under the terms of the trust or state law must reduce the amount of a marital or charitable transfer, and held that the value of the transferred property is not reduced for estate tax purposes unless the administration expenses are material in light of the income the trust corpus could have been expected to generate. *Commissioner v. Estate of Otis C. Hubert*, 117 S. Ct. 1124 (1997). The provision in Section 201(2)(B) permits a fiduciary to pay and deduct administration expenses from income only to the extent that it will not cause the reduction or loss of an estate tax marital or charitable contributions deduction, which means that the limit on the amount payable from income will be established eventually by Treasury Regulations.

Interest on estate taxes. The IRS agrees that interest on estate and inheritance taxes may be deducted for income tax purposes without having to reduce the estate tax deduction for amounts passing to a charity or surviving spouse, whether the interest is paid from principal or income. Rev. Rul. 93-48, 93-2 C.B. 270. For estates of persons who died before 1998, a fiduciary may not want to deduct for income tax purposes interest on estate tax that is deferred under Section 6166 or 6163 because deducting that interest for estate tax purposes may produce more beneficial results, especially if the estate has little or no income or the income tax bracket is significantly lower than the estate tax bracket. For estates of persons who die after 1997, no estate tax or income tax deduction will be allowed for interest paid on estate tax that is deferred under Section 6166. However, interest on estate tax deferred under Section 6163 will continue to be deductible for both purposes, and interest on estate tax deficiencies will continue to be deductible for estate tax purposes if an election under Section 6166 is not in effect.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Under the 1962 Act, Section 13(c)(5) charges interest on estate and inheritance taxes to principal. The 1931 Act has no provision. Section 501(3) of this Act provides that, except to the extent provided in Section 201(2)(B) or (C), all interest must be paid from income.

## ***Section 202. Distribution to Residuary and Remainder Beneficiaries.***

(a) Each beneficiary described in Section 201(4) is entitled to receive a portion of the net income equal to the beneficiary's fractional interest in undistributed principal assets, using values as of the distribution date. If a fiduciary makes more than one distribution of assets to beneficiaries to whom this section applies, each beneficiary, including one who does not receive part of the distribution, is entitled, as of each distribution date, to the net income the fiduciary has received after the date of death or terminating event or earlier distribution date but has not distributed as of the current distribution date.

(b) In determining a beneficiary's share of net income, the following rules apply:

(1) The beneficiary is entitled to receive a portion of the net income equal to the beneficiary's fractional interest in the undistributed principal assets immediately before the distribution date, including assets that later may be sold to meet principal obligations. (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 in trust.

(3) The beneficiary's fractional interest in the undistributed principal assets must be calculated on the basis of the aggregate value of those assets as of the distribution date without reducing the value by any unpaid principal obligation.

(4) The distribution date for purposes of this section may be the date as of which the fiduciary calculates the value of the assets if that date is reasonably near the date on which assets are actually distributed.

(c) If a fiduciary does not distribute all of the collected but undistributed net income to each person as of a distribution date, the fiduciary shall maintain appropriate records showing the interest of each beneficiary in that net income.

(d) A fiduciary may apply the rules in this section, to the extent that the fiduciary considers it appropriate, to net gain or loss realized after the date of death or terminating event or earlier distribution date from the disposition of a principal asset if this section applies to the income from the asset.

### **Comment**

*Relationship to prior Acts.* Section 202 retains the concept in Section 5(b)(2) of the 1962 Act that the residuary legatees of estates are to receive net income earned during the period of administration on the basis of their proportionate interests in the undistributed assets when distributions are made. It changes the basis for determining their proportionate interests by using asset values as of a date reasonably near the time of distribution instead of inventory values; it extends the application of these rules to distributions from terminating trusts; and it extends these rules to gain or loss realized from the disposition of assets during administration, an omission in the 1962 Act that has been noted by several commentators. See, e.g., Richard B. Covey, *Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions* 91 (4th ed. 1998); Thomas H. Cantrill, *Fractional or Percentage Residuary Bequests: Allocation of Postmortem Income, Gain and Unrealized Appreciation*, 10 Prob. Notes 322, 327 (1985).

[Article] 3 - Apportionment at beginning and end of income interest

## ***Section 301. When Right to Income Begins and Ends.***

(a) An income beneficiary is entitled to net income from the date on which the income interest begins. An income interest begins on the date specified in the terms of the trust or, if no date is specified, on the date an asset becomes subject to a trust or successive income interest.

(b) An asset becomes subject to a trust:

- (1) on the date it is transferred to the trust in the case of an asset that is transferred to a trust during the transferor's life;
  - (2) on the date of a testator's death in the case of an asset that becomes subject to a trust by reason of a will, even if there is an intervening period of administration of the testator's estate; or
  - (3) on the date of an individual's death in the case of an asset that is transferred to a fiduciary by a third party because of the individual's death.
- (c) An asset becomes subject to a successive income interest on the day after the preceding income interest ends, as determined under subsection (d), even if there is an intervening period of administration to wind up the preceding income interest.
- (d) An income interest ends on the day before an income beneficiary dies or another terminating event occurs, or on the last day of a period during which there is no beneficiary to whom a trustee may distribute income.

## Comment

*Period during which there is no beneficiary.* The purpose of the second part of subsection (d) is to provide that, at the end of a period during which there is no beneficiary to whom a trustee may distribute income, the trustee must apply the same apportionment rules that apply when a mandatory income interest ends. This provision would apply, for example, if a settlor creates a trust for grandchildren before any grandchildren are born. When the first grandchild is born, the period preceding the date of birth is treated as having ended, followed by a successive income interest, and the apportionment rules in Sections 302 and 303 apply accordingly if the terms of the trust do not contain different provisions.

## ***Section 302. Apportionment of Receipts and Disbursements When Decedent Dies or Income Interest Begins.***

- (a) A trustee shall allocate an income receipt or disbursement other than one to which Section 201(1) applies to principal if its due date occurs before a decedent dies in the case of an estate or before an income interest begins in the case of a trust or successive income interest.
- (b) A trustee shall allocate an income receipt or disbursement to income if its due date occurs on or after the date on which a decedent dies or an income interest begins and it is a periodic due date. An income receipt or disbursement must be treated as accruing from day to day if its due date is not periodic or it has no due date. The portion of the receipt or disbursement accruing before the date on which a decedent dies or an income interest begins must be allocated to principal and the balance must be allocated to income.
- (c) An item of income or an obligation is due on the date the payer is required to make a payment. If a payment date is not stated, there is no due date for the purposes of this [Act]. Distributions to shareholders or other owners from an entity to which Section 401 applies are deemed to be due on the date fixed by the entity for determining who is entitled to receive the distribution or, if no date is fixed, on the declaration date for the distribution. A due date is periodic for receipts or disbursements that must be paid at regular intervals under a lease or an obligation to pay interest or if an entity customarily makes distributions at regular intervals.

## Comment

*Prior Acts.* Professor Bogert stated that "Section 4 of the [1962] Act makes a change with respect to the apportionment of the income of trust property not due until after the trust began but which accrued in part before the commencement of the trust. It treats such income as to be credited entirely to the income account in the case of a living trust, but to be apportioned between capital and income in the case of a testamentary trust. The [1931] Act apportions such income in the case of both types of trusts, except in the case of corporate dividends." George G. Bogert, *The Revised Uniform Principal and Income Act*, 38 Notre Dame Law. 50, 52 (1962). The 1962 Act also provides that an asset passing to an inter vivos trust by a bequest in the settlor's will is governed by the rule that applies to a testamentary trust, so that different rules apply to assets passing to an inter vivos trust depending upon whether they were transferred to the trust during the settlor's life or by his will.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Having several different rules that apply to similar transactions is confusing. In order to simplify administration, Section 302 applies the same rule to inter vivos trusts (revocable and irrevocable), testamentary trusts, and assets that become subject to an inter vivos trust by a testamentary bequest.

*Periodic payments.* Under Section 302, a periodic payment is principal if it is due but unpaid before a decedent dies or before an asset becomes subject to a trust, but the next payment is allocated entirely to income and is not apportioned. Thus, periodic receipts such as rents, dividends, interest, and annuities, and disbursements such as the interest portion of a mortgage payment, are not apportioned. This is the original common law rule. Edwin A. Howes, Jr., *The American Law Relating to Income and Principal* 70 (1905). In trusts in which a surviving spouse is dependent upon a regular flow of cash from the decedent's securities portfolio, this rule will help to maintain payments to the spouse at the same level as before the settlor's death. Under the 1962 Act, the pre-death portion of the first periodic payment due after death is apportioned to principal in the case of a testamentary trust or securities bequeathed by will to an inter vivos trust.

*Nonperiodic payments.* Under the second sentence of Section 302(b), interest on an obligation that does not provide a due date for the interest payment, such as interest on an income tax refund, would be apportioned to principal to the extent it accrues before a person dies or an income interest begins unless the obligation is specifically given to a devisee or remainder beneficiary, in which case all of the accrued interest passes under Section 201(1) to the person who receives the obligation. The same rule applies to interest on an obligation that has a due date but does not provide for periodic payments. If there is no stated interest on the obligation, such as a zero coupon bond, and the proceeds from the obligation are received more than one year after it is purchased or acquired by the trustee, the entire amount received is principal under Section 406.

## ***Section 303. Apportionment When Income Interest Ends.***

(a) In this section, "undistributed income" means net income received before the date on which an income interest ends. The term does not include an item of income or expense that is due or accrued or net income that has been added or is required to be added to principal under the terms of the trust.

(b) When a mandatory income interest ends, the trustee shall pay to a mandatory income beneficiary who survives that date, or the estate of a deceased mandatory income beneficiary whose death causes the interest to end, the beneficiary's share of the undistributed income that is not disposed of under the terms of the trust unless the beneficiary has an unqualified power to revoke more than five percent of the trust immediately before the income interest ends. In the latter case, the undistributed income from the portion of the trust that may be revoked must be added to principal.

(c) When a trustee's obligation to pay a fixed annuity or a fixed fraction of the value of the trust's assets ends, the trustee shall prorate the final payment if and to the extent required by applicable law to accomplish a purpose of the trust or its settlor relating to income, gift, estate, or other tax requirements.

## **Comment**

Prior Acts. Both the 1931 Act (Section 4) and the 1962 Act (Section 4(d)) provide that a deceased income beneficiary's estate is entitled to the undistributed income. The Drafting Committee concluded that this is probably not what most settlors would want, and that, with respect to undistributed income, most settlors would favor the income beneficiary first, the remainder beneficiaries second, and the income beneficiary's heirs last, if at all. However, it decided not to eliminate this provision to avoid causing disputes about whether the trustee should have distributed collected cash before the income beneficiary died.

Accrued periodic payments. Under the prior Acts, an income beneficiary or his estate is entitled to receive a portion of any payments, other than dividends, that are due or that have accrued when the income interest terminates. The last sentence of subsection (a) changes that rule by providing that such items are not included in undistributed income. The items affected include periodic payments of interest, rent, and dividends, as well as items of income that accrue over a longer period of time; the rule also applies to expenses that are due or accrued.

## **Example**

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

*Accrued periodic payments.* The rules in Section 302 and Section 303 work in the following manner: Assume that a periodic payment of rent that is due on July 20 has not been paid when an income interest ends on July 30; the successive income interest begins on July 31, and the rent payment that was due on July 20 is paid on August 3. Under Section 302(a), the July 20 payment is added to the principal of the successive income interest when received. Under Section 302(b), the entire periodic payment of rent that is due on August 20 is income when received by the successive income interest. Under Section 303, neither the income beneficiary of the terminated income interest nor the beneficiary's estate is entitled to any part of either the July 20 or the August 20 payments because neither one was received before the income interest ended on July 30. The same principles apply to expenses of the trust.

Beneficiary with an unqualified power to revoke. The requirement in subsection (b) to pay undistributed income to a mandatory income beneficiary or her estate does not apply to the extent the beneficiary has an unqualified power to revoke more than five percent of the trust immediately before the income interest ends. Without this exception, subsection (b) would apply to a revocable living trust whose settlor is the mandatory income beneficiary during her lifetime, even if her will provides that all of the assets in the probate estate are to be distributed to the trust.

If a trust permits the beneficiary to withdraw all or a part of the trust principal after attaining a specified age and the beneficiary attains that age but fails to withdraw all of the principal that she is permitted to withdraw, a trustee is not required to pay her or her estate the undistributed income attributable to the portion of the principal that she left in the trust. The assumption underlying this rule is that the beneficiary has either provided for the disposition of the trust assets (including the undistributed income) by exercising a power of appointment that she has been given or has not withdrawn the assets because she is willing to have the principal and undistributed income be distributed under the terms of the trust. If the beneficiary has the power to withdraw 25% of the trust principal, the trustee must pay to her or her estate the undistributed income from the 75% that she cannot withdraw.

## [Article] 4 - Allocation of receipts during administration of trust

### A. [Part 1 - Receipts from Entities]

#### Section 401. Character of Receipts.

(a) In this section, "entity" means a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or any other organization in which a trustee has an interest other than a trust or estate to which Section 402 applies, a business or activity to which Section 403 applies, or an asset-backed security to which Section 415 applies.

(b) Except as otherwise provided in this section, a trustee shall allocate to income money received from an entity.

(c) A trustee shall allocate the following receipts from an entity to principal:

- (1) property other than money;
- (2) money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;
- (3) money received in total or partial liquidation of the entity; and

(4) money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes. (d) Money is received in partial liquidation:

- (1) to the extent that the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation; or
- (2) if the total amount of money and property received in a distribution or series of related distributions is greater than 20 percent of the entity's gross assets, as shown by the entity's year-end financial statements immediately preceding the initial receipt.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

(e) Money is not received in partial liquidation, nor may it be taken into account under subsection (d)(2), to the extent that it does not exceed the amount of income tax that a trustee or beneficiary must pay on taxable income of the entity that distributes the money.

(f) A trustee may rely upon a statement made by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the entity's board of directors or other person or group of persons authorized to exercise powers to pay money or transfer property comparable to those of a corporation's board of directors.

## Comment

*Entities to which Section 401 applies.* The reference to partnerships in Section 401(a) is intended to include all forms of partnerships, including limited partnerships, limited liability partnerships, and variants that have slightly different names and characteristics from State to State. The section does not apply, however, to receipts from an interest in property that a trust owns as a tenant in common with one or more co-owners, nor would it apply to an interest in a joint venture if, under applicable law, the trust's interest is regarded as that of a tenant in common.

*Capital gain dividends.* Under the Internal Revenue Code and the Income Tax Regulations, a "capital gain dividend" from a mutual fund or real estate investment trust is the excess of the fund's or trust's net long-term capital gain over its net short-term capital loss. As a result, a capital gain dividend does not include any net short-term capital gain, and cash received by a trust because of a net short-term capital gain is income under this Act.

*Reinvested dividends.* If a trustee elects (or continues an election made by its predecessor) to reinvest dividends in shares of stock of a distributing corporation or fund, whether evidenced by new certificates or entries on the books of the distributing entity, the new shares would be principal. Making or continuing such an election would be equivalent to deciding under Section 104 to transfer income to principal in order to comply with Section 103(b). However, if the trustee makes or continues the election for a reason other than to comply with Section 103(b), e.g., to make an investment without incurring brokerage commissions, the trustee should transfer cash from principal to income in an amount equal to the reinvested dividends.

*Distribution of property.* The 1962 Act describes a number of types of property that would be principal if distributed by a corporation. This becomes unwieldy in a section that applies to both corporations and all other entities. By stating that principal includes the distribution of any property other than money, Section 401 embraces all of the items enumerated in Section 6 of the 1962 Act as well as any other form of nonmonetary distribution not specifically mentioned in that Act.

*Partial liquidations.* Under subsection (d)(1), any distribution designated by the entity as a partial liquidating distribution is principal regardless of the percentage of total assets that it represents. If a distribution exceeds 20% of the entity's gross assets, the entire distribution is a partial liquidation under subsection (d)(2) whether or not the entity describes it as a partial liquidation. In determining whether a distribution is greater than 20% of the gross assets, the portion of the distribution that does not exceed the amount of income tax that the trustee or a beneficiary must pay on the entity's taxable income is ignored.

*Other large distributions.* A cash distribution may be quite large (for example, more than 10% but not more than 20% of the entity's gross assets) and have characteristics that suggest it should be treated as principal rather than income. For example, an entity may have received cash from a source other than the conduct of its normal business operations because it sold an investment asset; or because it sold a business asset other than one held for sale to customers in the normal course of its business and did not replace it; or it borrowed a large sum of money and secured the repayment of the loan with a substantial asset; or a principal source of its cash was from assets such as mineral interests, 90% of which would have been allocated to principal if the trust had owned the assets directly. In such a case the trustee, after considering the total return from the portfolio as a whole and the income component of that return, may decide to exercise the power under Section 104(a) to make an adjustment between income and principal, subject to the limitations in Section 104(c).

## Section 402. Distribution From Trust or Estate.

A trustee shall allocate to income an amount received as a distribution of income from a trust or an estate in which the trust has an interest other than a purchased interest, and shall allocate to principal an amount received as a distribution of principal from

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

such a trust or estate. If a trustee purchases an interest in a trust that is an investment entity, or a decedent or donor transfers an interest in such a trust to a trustee, Section 401 or 415 applies to a receipt from the trust.

## Comment

*Terms of the distributing trust or estate.* Under Section 103(a), a trustee is to allocate receipts in accordance with the terms of the recipient trust or, if there is no provision, in accordance with this Act. However, in determining whether a distribution from another trust or an estate is income or principal, the trustee should also determine what the terms of the distributing trust or estate say about the distribution - for example, whether they direct that the distribution, even though made from the income of the distributing trust or estate, is to be added to principal of the recipient trust. Such a provision should override the terms of this Act, but if the terms of the recipient trust contain a provision requiring such a distribution to be allocated to income, the trustee may have to obtain a judicial resolution of the conflict between the terms of the two documents.

*Investment trusts.* An investment entity to which the second sentence of this section applies includes a mutual fund, a common trust fund, a business trust or other entity organized as a trust for the purpose of receiving capital contributed by investors, investing that capital, and managing investment assets, including asset-backed security arrangements to which Section 415 applies. See John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 Yale L.J. 165 (1997).

## Section 403. Business and Other Activities Conducted By Trustee.

(a) If a trustee who conducts a business or other activity determines that it is in the best interest of all the beneficiaries to account separately for the business or activity instead of accounting for it as part of the trust's general accounting records, the trustee may maintain separate accounting records for its transactions, whether or not its assets are segregated from other trust assets.

(b) A trustee who accounts separately for a business or other activity may determine the extent to which its net cash receipts must be retained for 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. If a trustee sells assets of the business or other activity, other than in the ordinary course of the business or activity, the trustee shall account for the net amount received as principal in the trust's general accounting records to the extent the trustee determines that the amount received is no longer required in the conduct of the business.

(c) Activities for which a trustee may maintain separate accounting records include:

- (1) retail, manufacturing, service, and other traditional business activities;
- (2) farming;
- (3) raising and selling livestock and other animals;
- (4) management of rental properties;
- (5) extraction of minerals and other natural resources;
- (6) timber operations; and
- (7) activities to which Section 414 applies.

## Comment

*Purpose and scope.* The provisions in Section 403 are intended to give greater flexibility to a trustee who operates a business or other activity in proprietorship form rather than in a wholly-owned corporation (or, where permitted by state law, a single-member limited liability company), and to facilitate the trustee's ability to decide the extent to which the net receipts from the activity should be allocated to income, just as the board of directors of a corporation owned entirely by the trust would decide the amount of the annual dividend to be paid to the trust. It permits a trustee to account for farming or livestock operations, rental properties,

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

oil and gas properties, timber operations, and activities in derivatives and options as though they were held by a separate entity. It is not intended, however, to permit a trustee to account separately for a traditional securities portfolio to avoid the provisions of this Act that apply to such securities.

Section 403 permits the trustee to account separately for each business or activity for which the trustee determines separate accounting is appropriate. A trustee with a computerized accounting system may account for these activities in a "subtrust"; an individual trustee may continue to use the business and record-keeping methods employed by the decedent or transferor who may have conducted the business under an assumed name. The intent of this section is to give the trustee broad authority to select business record-keeping methods that best suit the activity in which the trustee is engaged.

If a fiduciary liquidates a sole proprietorship or other activity to which Section 403 applies, the proceeds would be added to principal, even though derived from the liquidation of accounts receivable, because the proceeds would no longer be needed in the conduct of the business. If the liquidation occurs during probate or during an income interest's winding up period, none of the proceeds would be income for purposes of Section 201.

*Separate accounts.* A trustee may or may not maintain separate bank accounts for business activities that are accounted for under Section 403. A professional trustee may decide not to maintain separate bank accounts, but an individual trustee, especially one who has continued a decedent's business practices, may continue the same banking arrangements that were used during the decedent's lifetime. In either case, the trustee is authorized to decide to what extent cash is to be retained as part of the business assets and to what extent it is to be transferred to the trust's general accounts, either as income or principal.

## ***B. [Part 2 Receipts not normally apportioned]***

### **Section 404. Principal Receipts.** A trustee shall allocate to principal:

- (1) to the extent not allocated to income under this [Act], assets received from a transferor during the transferor's lifetime, a decedent's estate, a trust with a terminating income interest, or a payer under a contract naming the trust or its trustee as beneficiary;
- (2) money or other property received from the sale, exchange, liquidation, or change in form of a principal asset, including realized profit, subject to this [article];
- (3) amounts recovered from third parties to reimburse the trust because of disbursements described in Section 502(a)(7) or for other reasons to the extent not based on the loss of income;
- (4) proceeds of property taken by eminent domain, but a separate award made for the loss of income with respect to an accounting period during which a current income beneficiary had a mandatory income interest is income;
- (5) net income received in an accounting period during which there is no beneficiary to whom a trustee may or must distribute income; and
- (6) other receipts as provided in [Part 3].

### **Comment**

Eminent domain awards. Even though the award in an eminent domain proceeding may include an amount for the loss of future rent on a lease, if that amount is not separately stated the entire award is principal. The rule is the same in the 1931 and 1962 Acts.

### **Section 405. Rental Property.**

To the extent that a trustee accounts for receipts from rental property pursuant to this section, the trustee shall allocate to income an amount received as rent of real or personal property, including an amount received for cancellation or renewal of a lease. An amount received as a refundable deposit, including a security deposit or a deposit that is to be applied as rent for future periods,

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

must be added to principal and held subject to the terms of the lease and is not available for distribution to a beneficiary until the trustee's contractual obligations have been satisfied with respect to that amount.

## Comment

*Application of Section 403.* This section applies to the extent that the trustee does not account separately under Section 403 for the management of rental properties owned by the trust.

*Receipts that are capital in nature.* A portion of the payment under a lease may be a reimbursement of principal expenditures for improvements to the leased property that is characterized as rent for purposes of invoking contractual or statutory remedies for nonpayment. If the trustee is accounting for rental income under Section 405, a transfer from income to reimburse principal may be appropriate under Section 504 to the extent that some of the "rent" is really a reimbursement for improvements. This set of facts could also be a relevant factor for a trustee to consider under Section 104(b) in deciding whether and to what extent to make an adjustment between principal and income under Section 104(a) after considering the return from the portfolio as a whole.

## Section 406. Obligation to Pay Money.

(a) An amount received as interest, whether determined at a fixed, variable, or floating rate, on an obligation to pay money to the trustee, including an amount received as consideration for prepaying principal, must be allocated to income without any provision for amortization of premium.

(b) A trustee shall allocate to principal an amount received from the sale, redemption, or other disposition of an obligation to pay money to the trustee more than one year after it is purchased or acquired by the trustee, including an obligation whose purchase price or value when it is acquired is less than its value at maturity. If the obligation matures within one year after it is purchased or acquired by the trustee, an amount received in excess of its purchase price or its value when acquired by the trust must be allocated to income.

(c) This section does not apply to an obligation to which Section 409, 410, 411, 412, 414, or 415 applies.

## Comment

*Variable or floating interest rates.* The reference in subsection (a) to variable or floating interest rate obligations is intended to clarify that, even though an obligation's interest rate may change from time to time based upon changes in an index or other market indicator, an obligation to pay money containing a variable or floating rate provision is subject to this section and is not to be treated as a derivative financial instrument under Section 414.

*Discount obligations.* Subsection (b) applies to all obligations acquired at a discount, including short-term obligations such as U.S. Treasury Bills, long-term obligations such as U.S. Savings Bonds, zero-coupon bonds, and discount bonds that pay interest during part, but not all, of the period before maturity. Under subsection (b), the entire increase in value of these obligations is principal when the trustee receives the proceeds from the disposition unless the obligation, when acquired, has a maturity of less than one year. In order to have one rule that applies to all discount obligations, the Act eliminates the provision in the 1962 Act for the payment from principal of an amount equal to the increase in the value of U.S. Series E bonds. The provision for bonds that mature within one year after acquisition by the trustee is derived from the Illinois act. 760 ILCS 15/8 (1996).

Subsection (b) also applies to inflation-indexed bonds - any increase in principal due to inflation after issuance is principal upon redemption if the bond matures more than one year after the trustee acquires it; if it matures within one year, all of the increase, including any attributable to an inflation adjustment, is income.

*Effect of Section 104.* In deciding whether and to what extent to exercise the power to adjust between principal and income granted by Section 104(a), a relevant factor for the trustee to consider is the effect on the portfolio as a whole of having a portion of the assets invested in bonds that do not pay interest currently.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

## Section 407. Insurance Policies and Similar Contracts.

- (a) Except as otherwise provided in subsection (b), a trustee shall allocate to principal the proceeds of a life insurance policy or other contract in which the trust or its trustee is named as beneficiary, including a contract that insures the trust or its trustee against loss for damage to, destruction of, or loss of title to a trust asset. The trustee shall allocate dividends on an insurance policy to income if the premiums on the policy are paid from income, and to principal if the premiums are paid from principal.
- (b) A trustee shall allocate to income proceeds of a contract that insures the trustee against loss of occupancy or other use by an income beneficiary, loss of income, or, subject to Section 403, loss of profits from a business.
- (c) This section does not apply to a contract to which Section 409 applies.

## **C. [Part 3 - Receipts normally apportioned]**

## Section 408. Insubstantial Allocations Not Required.

If a trustee determines that an allocation between principal and income required by Section 409, 410, 411, 412, or 415 is insubstantial, the trustee may allocate the entire amount to principal unless one of the circumstances described in Section 104(c) applies to the allocation. This power may be exercised by a cotrustee in the circumstances described in Section 104(d) and may be released for the reasons and in the manner described in Section 104(e). An allocation is presumed to be insubstantial if:

- (1) the amount of the allocation would increase or decrease net income in an accounting period, as determined before the allocation, by less than 10 percent; or
- (2) the value of the asset producing the receipt for which the allocation would be made is less than 10 percent of the total value of the trust's assets at the beginning of the accounting period.

### **Comment**

This section is intended to relieve a trustee from making relatively small allocations while preserving the trustee's right to do so if an allocation is large in terms of absolute dollars.

For example, assume that a trust's assets, which include a working interest in an oil well, have a value of \$1,000,000; the net income from the assets other than the working interest is \$40,000; and the net receipts from the working interest are \$400. The trustee may allocate all of the net receipts from the working interest to principal instead of allocating 10%, or \$40, to income under Section 411. If the net receipts from the working interest are \$35,000, so that the amount allocated to income under Section 411 would be \$3,500, the trustee may decide that this amount is sufficiently significant to the income beneficiary that the allocation provided for by Section 411 should be made, even though the trustee is still permitted under Section 408 to allocate all of the net receipts to principal because the \$3,500 would increase the net income of \$40,000, as determined before making an allocation under Section 411, by less than 10%. Section 408 will also relieve a trustee from having to allocate net receipts from the sale of trees in a small woodlot between principal and income.

While the allocation to principal of small amounts under this section should not be a cause for concern for tax purposes, allocations are not permitted under this section in circumstances described in Section 104(c) to eliminate claims that the power in this section has adverse tax consequences.

## Section 409. Deferred Compensation, Annuities, and Similar Payments.

- (a) In this section, "payment" means a payment that a trustee may receive over a fixed number of years or during the life of one or more individuals because of services rendered or property transferred to the payer in exchange for future payments. The term includes a payment made in money or property from the payer's general assets or from a separate fund created by the payer, including a private or commercial annuity, an individual retirement account, and a pension, profit-sharing, stock-bonus, or stock-ownership plan.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

(b) To the extent that a payment is characterized as interest or a dividend or a payment made in lieu of interest or a dividend, a trustee shall allocate it to income. The trustee shall allocate to principal the balance of the payment and any other payment received in the same accounting period that is not characterized as interest, a dividend, or an equivalent payment.

(c) If no part of a payment is characterized as interest, a dividend, or an equivalent payment, and all or part of the payment is required to be made, a trustee shall allocate to income 10 percent of the part that is required to be made during the accounting period and the balance to principal. If no part of a payment is required to be made or the payment received is the entire amount to which the trustee is entitled, the trustee shall allocate the entire payment to principal. For purposes of this subsection, a payment is not "required to be made" to the extent that it is made because the trustee exercises a right of withdrawal.

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

(e) This section does not apply to payments to which Section 410 applies.

## Comment

*Scope.* Section 409 applies to amounts received under contractual arrangements that provide for payments to a third party beneficiary as a result of services rendered or property transferred to the payer. While the right to receive such payments is a liquidating asset of the kind described in Section 410 (i.e., "an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration"), these payment rights are covered separately in Section 409 because of their special characteristics.

Section 409 applies to receipts from all forms of annuities and deferred compensation arrangements, whether the payment will be received by the trust in a lump sum or in installments over a period of years. It applies to bonuses that may be received over two or three years and payments that may last for much longer periods, including payments from an individual retirement account (IRA), deferred compensation plan (whether qualified or not qualified for special federal income tax treatment), and insurance renewal commissions. It applies to a retirement plan to which the settlor has made contributions, just as it applies to an annuity policy that the settlor may have purchased individually, and it applies to variable annuities, deferred annuities, annuities issued by commercial insurance companies, and "private annuities" arising from the sale of property to another individual or entity in exchange for payments that are to be made for the life of one or more individuals. The section applies whether the payments begin when the payment right becomes subject to the trust or are deferred until a future date, and it applies whether payments are made in cash or in kind, such as employer stock (in-kind payments usually will be made in a single distribution that will be allocated to principal under the second sentence of subsection (c)).

*The 1962 Act.* Under Section 12 of the 1962 Act, receipts from "rights to receive payments on a contract for deferred compensation" are allocated to income each year in an amount "not in excess of 5% per year" of the property's inventory value. While "not in excess of 5%" suggests that the annual allocation may range from zero to 5% of the inventory value, in practice the rule is usually treated as prescribing a 5% allocation. The inventory value is usually the present value of all the future payments, and since the inventory value is determined as of the date on which the payment right becomes subject to the trust, the inventory value, and thus the amount of the annual income allocation, depends significantly on the applicable interest rate on the decedent's date of death. That rate may be much higher or lower than the average long-term interest rate. The amount determined under the 5% formula tends to become fixed and remain unchanged even though the amount received by the trust increases or decreases.

*Allocations Under Section 409(b).* Section 409(b) applies to plans whose terms characterize payments made under the plan as dividends, interest, or payments in lieu of dividends or interest. For example, some deferred compensation plans that hold debt obligations or stock of the plan's sponsor in an account for future delivery to the person rendering the services provide for the annual payment to that person of dividends received on the stock or interest received on the debt obligations. Other plans provide that the account of the person rendering the services shall be credited with "phantom" shares of stock and require an annual payment that is equivalent to the dividends that would be received on that number of shares if they were actually issued; or a plan may entitle the person rendering the services to receive a fixed dollar amount in the future and provide for the annual payment of interest on the deferred amount during the period prior to its payment. Under Section 409(b), payments of dividends, interest or payments in lieu of dividends or interest under plans of this type are allocated to income; all other payments received under these plans are allocated to principal.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Section 409(b) does not apply to an IRA or an arrangement with payment provisions similar to an IRA. IRAs and similar arrangements are subject to the provisions in Section 409(c).

*Allocations Under Section 409(c).* The focus of Section 409, for purposes of allocating payments received by a trust to or between principal and income, is on the payment right rather than on assets that may be held in a fund from which the payments are made. Thus, if an IRA holds a portfolio of marketable stocks and bonds, the amount received by the IRA as dividends and interest is not taken into account in determining the principal and income allocation except to the extent that the Internal Revenue Service may require them to be taken into account when the payment is received by a trust that qualifies for the estate tax marital deduction (a situation that is provided for in Section 409(d)). An IRA is subject to federal income tax rules that require payments to begin by a particular date and be made over a specific number of years or a period measured by the lives of one or more persons. The payment right of a trust that is named as a beneficiary of an IRA is not a right to receive particular items that are paid to the IRA, but is instead the right to receive an amount determined by dividing the value of the IRA by the remaining number of years in the payment period. This payment right is similar to the right to receive a unitrust amount, which is normally expressed as an amount equal to a percentage of the value of the unitrust assets without regard to dividends or interest that may be received by the unitrust.

An amount received from an IRA or a plan with a payment provision similar to that of an IRA is allocated under Section 409(c), which differentiates between payments that are required to be made and all other payments. To the extent that a payment is required to be made (either under federal income tax rules or, in the case of a plan that is not subject to those rules, under the terms of the plan), 10% of the amount received is allocated to income and the balance is allocated to principal. All other payments are allocated to principal because they represent a change in the form of a principal asset; Section 409 follows the rule in Section 404(2), which provides that money or property received from a change in the form of a principal asset be allocated to principal.

Section 409(c) produces an allocation to income that is similar to the allocation under the 1962 Act formula if the annual payments are the same throughout the payment period, and it is simpler to administer. The amount allocated to income under Section 409 is not dependent upon the interest rate that is used for valuation purposes when the decedent dies, and if the payments received by the trust increase or decrease from year to year because the fund from which the payment is made increases or decreases in value, the amount allocated to income will also increase or decrease.

Marital deduction requirements. When an IRA is payable to a QTIP marital deduction trust, the IRS treats the IRA as separate terminable interest property and requires that a QTIP election be made for it. In order to qualify for QTIP treatment, an IRS ruling states that all of the IRA's income must be distributed annually to the QTIP marital deduction trust and then must be allocated to trust income for distribution to the spouse. Rev. Rul. 89-89, 1989-2 C.B. 231. If an allocation to income under this Act of 10% of the required distribution from the IRA does not meet the requirement that all of the IRA's income be distributed from the trust to the spouse, the provision in subsection (d) requires the trustee to make a larger allocation to income to the extent necessary to qualify for the marital deduction. The requirement of Rev. Rul. 89-89 should also be satisfied if the IRA beneficiary designation permits the spouse to require the trustee to withdraw the necessary amount from the IRA and distribute it to her, even though the spouse never actually requires the trustee to do so. If such a provision is in the beneficiary designation, a distribution under subsection (d) should not be necessary.

*Application of Section 104.* Section 104(a) of this Act gives a trustee who is acting under the prudent investor rule the power to adjust from principal to income if, considering the portfolio as a whole and not just receipts from deferred compensation, the trustee determines that an adjustment is necessary. See Example (5) in the Comment following Section 104.

## **Section 410. Liquidating Asset.**

(a) In this section, "liquidating asset" means an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration. The term includes a leasehold, patent, copyright, royalty right, and right to receive payments during a period of more than one year under an arrangement that does not provide for the payment of interest on the unpaid balance. The term does not include a payment subject to Section 409, resources subject to Section 411, timber subject to Section 412, an activity subject to Section 414, an asset subject to Section 415, or any asset for which the trustee establishes a reserve for depreciation under Section 503.

(b) A trustee shall allocate to income 10 percent of the receipts from a liquidating asset and the balance to principal.

## Comment

*Prior Acts.* Section 11 of the 1962 Act allocates receipts from "property subject to depletion" to income in an amount "not in excess of 5%" of the asset's inventory value. The 1931 Act has a similar 5% rule that applies when the trustee is under a duty to change the form of the investment. The 5% rule imposes on a trust the obligation to pay a fixed annuity to the income beneficiary until the asset is exhausted. Under both the 1931 and 1962 Acts the balance of each year's receipts is added to principal. A fixed payment can produce unfair results. The remainder beneficiary receives all of the receipts from unexpected growth in the asset, e.g., if royalties on a patent or copyright increase significantly. Conversely, if the receipts diminish more rapidly than expected, most of the amount received by the trust will be allocated to income and little to principal. Moreover, if the annual payments remain the same for the life of the asset, the amount allocated to principal will usually be less than the original inventory value. For these reasons, Section 410 abandons the annuity approach under the 5% rule.

*Lottery payments.* The reference in subsection (a) to rights to receive payments under an arrangement that does not provide for the payment of interest includes state lottery prizes and similar fixed amounts payable over time that are not deferred compensation arrangements covered by Section 409.

### **Section 411. Minerals, Water, and Other Natural Resources.**

(a) To the extent that a trustee accounts for receipts from an interest in minerals or other natural resources pursuant to this section, the trustee shall allocate them as follows:

(1) If received as nominal delay rental or nominal annual rent on a lease, a receipt must be allocated to income.

(2) If received from a production payment, a receipt must be allocated to income if and to the extent that the agreement creating the production payment provides a factor for interest or its equivalent. The balance must be allocated to principal.

(3) If an amount received as a royalty, shut-in-well payment, take-or-pay payment, bonus, or delay rental is more than nominal, 90 percent must be allocated to principal and the balance to income.

(4) If an amount is received from a working interest or any other interest not provided for in paragraph (1), (2), or (3), 90 percent of the net amount received must be allocated to principal and the balance to income.

(b) An amount received on account of an interest in water that is renewable must be allocated to income. If the water is not renewable, 90 percent of the amount must be allocated to principal and the balance to income.

(c) This [Act] applies whether or not a decedent or donor was extracting minerals, water, or other natural resources before the interest became subject to the trust.

(d) If a trust owns an interest in minerals, water, or other natural resources on [the effective date of this [Act]], the trustee may allocate receipts from the interest as provided in this [Act] or in the manner used by the trustee before [the effective date of this [Act]]. If the trust acquires an interest in minerals, water, or other natural resources after [the effective date of this [Act]], the trustee shall allocate receipts from the interest as provided in this [Act].

## Comment

*Prior Acts.* The 1962 Act allocates to principal as a depletion allowance, 27-1/2% of the gross receipts, but not more than 50% of the net receipts after paying expenses. The Internal Revenue Code no longer provides for a 27-1/2% depletion allowance, although the major oil-producing States have retained the 27-1/2% provision in their principal and income acts (Texas amended its Act in 1993, but did not change the depletion provision). Section 9 of the 1931 Act allocates all of the net proceeds received as consideration for the "permanent severance of natural resources from the lands" to principal.

Section 411 allocates 90% of the net receipts to principal and 10% to income. A depletion provision that is tied to past or present Code provisions is undesirable because it causes a large portion of the oil and gas receipts to be paid out as income. As wells are

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

depleted, the amount received by the income beneficiary falls drastically. Allocating a larger portion of the receipts to principal enables the trustee to acquire other income producing assets that will continue to produce income when the mineral reserves are exhausted.

*Application of Sections 403 and 408.* This section applies to the extent that the trustee does not account separately for receipts from minerals and other natural resources under Section 403 or allocate all of the receipts to principal under Section 408.

*Open mine doctrine.* The purpose of Section 411(c) is to abolish the "open mine doctrine" as it may apply to the rights of an income beneficiary and a remainder beneficiary in receipts from the production of minerals from land owned or leased by a trust. Instead, such receipts are to be allocated to or between principal and income in accordance with the provisions of this Act. For a discussion of the open mine doctrine, see generally 3A Austin W. Scott & William F. Fratcher, *The Law of Trusts* § 239.3 (4th ed. 1988), and *Nutter v. Stockton*, 626 P.2d 861 (Okla. 1981).

*Effective date provision.* Section 9(b) of the 1962 Act provides that the natural resources provision does not apply to property interests held by the trust on the effective date of the Act, which reflects concerns about the constitutionality of applying a retroactive administrative provision to interests in real estate, based on the opinion in the Oklahoma case of *Franklin v. Margay Oil Corporation*, 153 P.2d 486, 501 (Okla. 1944). Section 411(d) permits a trustee to use either the method provided for in this Act or the method used before the Act takes effect. Lawyers in jurisdictions other than Oklahoma may conclude that retroactivity is not a problem as to property situated in their States, and this provision permits trustees to decide, based on advice from counsel in States whose law may be different from that of Oklahoma, whether they may apply this provision retroactively if they conclude that to do so is in the best interests of the beneficiaries.

If the property is in a State other than the State where the trust is administered, the trustee must be aware that the law of the property's situs may control this question. The outcome turns on a variety of questions: whether the terms of the trust specify that the law of a State other than the situs of the property shall govern the administration of the trust, and whether the courts will follow the terms of the trust; whether the trust's asset is the land itself or a leasehold interest in the land (as it frequently is with oil and gas property); whether a leasehold interest or its proceeds should be classified as real property or personal property, and if as personal property, whether applicable state law treats it as a movable or an immovable for conflict of laws purposes. See 5A Austin W. Scott & William F. Fratcher, *The Law of Trusts* §§ 648, at 531, 533-534; § 657, at 600 (4th ed. 1989).

## Section 412. Timber.

(a) To the extent that a trustee accounts for receipts from the sale of timber and related products pursuant to this section, the trustee shall allocate the net receipts:

- (1) to income to the extent that the amount of timber removed from the land does not exceed the rate of growth of the timber during the accounting periods in which a beneficiary has a mandatory income interest;
- (2) to principal to the extent that the amount of timber removed from the land exceeds the rate of growth of the timber or the net receipts are from the sale of standing timber;
- (3) to or between income and principal if the net receipts are from the lease of timberland or from a contract to cut timber from land owned by a trust, by determining the amount of timber removed from the land under the lease or contract and applying the rules in paragraphs (1) and (2); or
- (4) to principal to the extent that advance payments, bonuses, and other payments are not allocated pursuant to paragraph (1), (2), or (3).

(b) In determining net receipts to be allocated pursuant to subsection (a), a trustee shall deduct and transfer to principal a reasonable amount for depletion.

(c) This [Act] applies whether or not a decedent or transferor was harvesting timber from the property before it became subject to the trust.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

(d) If a trust owns an interest in timberland on [the effective date of this [Act]], the trustee may allocate net receipts from the sale of timber and related products as provided in this [Act] or in the manner used by the trustee before [the effective date of this [Act]]. If the trust acquires an interest in timberland after [the effective date of this [Act]], the trustee shall allocate net receipts from the sale of timber and related products as provided in this [Act].

## Comment

*Scope of section.* The rules in Section 412 are intended to apply to net receipts from the sale of trees and by-products from harvesting and processing trees without regard to the kind of trees that are cut or whether the trees are cut before or after a particular number of years of growth. The rules apply to the sale of trees that are expected to produce lumber for building purposes, trees sold as pulpwood, and Christmas and other ornamental trees. Subsection (a) applies to net receipts from property owned by the trustee and property leased by the trustee. The Act is not intended to prevent a tenant in possession of the property from using wood that he cuts on the property for personal, noncommercial purposes, such as a Christmas tree, firewood, mending old fences or building new fences, or making repairs to structures on the property.

Under subsection (a), the amount of net receipts allocated to income depends upon whether the amount of timber removed is more or less than the rate of growth. The method of determining the amount of timber removed and the rate of growth is up to the trustee, based on methods customarily used for the kind of timber involved.

*Application of Sections 403 and 408.* This section applies to the extent that the trustee does not account separately for net receipts from the sale of timber and related products under Section 403 or allocate all of the receipts to principal under Section 408. The option to account for net receipts separately under Section 403 takes into consideration the possibility that timber harvesting operations may have been conducted before the timber property became subject to the trust, and that it may make sense to continue using accounting methods previously established for the property. It also permits a trustee to use customary accounting practices for timber operations even if no harvesting occurred on the property before it became subject to the trust.

## Section 413. Property Not Productive of Income.

(a) If a marital deduction is allowed for all or part of a trust whose assets consist substantially of property that does not provide the spouse with sufficient income from or use of the trust assets, and if the amounts that the trustee transfers from principal to income under Section 104 and distributes to the spouse from principal pursuant to the terms of the trust are insufficient to provide the spouse with the beneficial enjoyment required to obtain the marital deduction, the spouse may require the trustee to make property productive of income, convert property within a reasonable time, or exercise the power conferred by Section 104(a). The trustee may decide which action or combination of actions to take.

(b) In cases not governed by subsection (a), proceeds from the sale or other disposition of an asset are principal without regard to the amount of income the asset produces during any accounting period.

## Comment

Prior Acts' Conflict with Uniform Prudent Investor Act. Section 2(b) of the Uniform Prudent Investor Act provides that "[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 ... ." The underproductive property provisions in Section 12 of the 1962 Act and Section 11 of the 1931 Act give the income beneficiary a right to receive a portion of the proceeds from the sale of underproductive property as "delayed income." In each Act the provision applies on an asset by asset basis and not by taking into consideration the trust portfolio as a whole, which conflicts with the basic precept in Section 2(b) of the Prudent Investor Act. Moreover, in determining the amount of delayed income, the prior Acts do not permit a trustee to take into account the extent to which the trustee may have distributed principal to the income beneficiary, under principal invasion provisions in the terms of the trust, to compensate for insufficient income from the unproductive asset. Under Section 104(b)(7) of this Act, a trustee must consider prior distributions of principal to the income beneficiary in deciding whether and to what extent to exercise the power to adjust conferred by Section 104(a).

Duty to make property productive of income. In order to implement the Uniform Prudent Investor Act, this Act abolishes the right to receive delayed income from the sale proceeds of an asset that produces little or no income, but it does not alter existing

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

state law regarding the income beneficiary's right to compel the trustee to make property productive of income. As the law continues to develop in this area, the duty to make property productive of current income in a particular situation should be determined by taking into consideration the performance of the portfolio as a whole and the extent to which a trustee makes principal distributions to the income beneficiary under the terms of the trust and adjustments between principal and income under Section 104 of this Act.

Trusts for which the value of the right to receive income is important for tax reasons may be affected by Reg. § 1.7520-3(b)(2)(v) *Example (1)*, § 20.7520-3(b)(2)(v) *Examples (1) and (2)*, and § 25.7520-3(b)(2)(v) *Examples (1) and (2)*, which provide that if the income beneficiary does not have the right to compel the trustee to make the property productive, the income interest is considered unproductive and may not be valued actuarially under those sections.

Marital deduction trusts. Subsection (a) draws on language in Reg. § 20.2056(b)-5(f)(4) and (5) to enable a trust for a spouse to qualify for a marital deduction if applicable state law is unclear about the spouse's right to compel the trustee to make property productive of income. The trustee should also consider the application of Section 104 of this Act and the provisions of Restatement of Trusts 3d: Prudent Investor Rule § 240, at 186, app. § 240, at 252 (1992). Example (6) in the Comment to Section 104 describes a situation involving the payment from income of carrying charges on unproductive real estate in which Section 104 may apply.

Once the two conditions have occurred - insufficient beneficial enjoyment from the property and the spouse's demand that the trustee take action under this section - the trustee must act; but instead of the formulaic approach of the 1962 Act, which is triggered only if the trustee sells the property, this Act permits the trustee to decide whether to make the property productive of income, convert it, transfer funds from principal to income, or to take some combination of those actions. The trustee may rely on the power conferred by Section 104(a) to adjust from principal to income if the trustee decides that it is not feasible or appropriate to make the property productive of income or to convert the property. Given the purpose of Section 413, the power under Section 104(a) would be exercised to transfer principal to income and not to transfer income to principal.

Section 413 does not apply to a so-called "estate" trust, which will qualify for the marital deduction, even though the income may be accumulated for a term of years or for the life of the surviving spouse, if the terms of the trust require the principal and undistributed income to be paid to the surviving spouse's estate when the spouse dies. Reg. § 20.2056(c)-2(b)(1)(iii).

## **Section 414. Derivatives and Options.**

(a) In this section, "derivative" means a contract or financial instrument or a combination of contracts and financial instruments which gives a trust the right or obligation to participate in some or all changes in the price of a tangible or intangible asset or group of assets, or changes in a rate, an index of prices or rates, or other market indicator for an asset or a group of assets.

(b) To the extent that a trustee does not account under Section 403 for transactions in derivatives, the trustee shall allocate to principal receipts from and disbursements made in connection with those transactions.

(c) If a trustee grants an option to buy property from the trust, whether or not the trust owns the property when the option is granted, grants an option that permits another person to sell property to the trust, or acquires an option to buy property for the trust or an option to sell an asset owned by the trust, and the trustee or other owner of the asset is required to deliver the asset if the option is exercised, an amount received for granting the option must be allocated to principal. An amount paid to acquire the option must be paid from principal. A gain or loss realized upon the exercise of an option, including an option granted to a settlor of the trust for services rendered, must be allocated to principal.

## **Comment**

*Scope and application.* It is difficult to predict how frequently and to what extent trustees will invest directly in derivative financial instruments rather than participating indirectly through investment entities that may utilize these instruments in varying degrees. If the trust participates in derivatives indirectly through an entity, an amount received from the entity will be allocated under Section 401 and not Section 414. If a trustee invests directly in derivatives to a significant extent, the expectation is that receipts and disbursements related to derivatives will be accounted for under Section 403; if a trustee chooses not to account under Section 403, Section 414(b) provides the default rule. Certain types of option transactions in which trustees may engage are dealt with in subsection (c) to distinguish those transactions from ones involving options that are embedded in derivative financial instruments.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

*Definition of "derivative."* "Derivative" is a difficult term to define because new derivatives are invented daily as dealers tailor their terms to achieve specific financial objectives for particular clients. Since derivatives are typically contract-based, a derivative can probably be devised for almost any set of objectives if another party can be found who is willing to assume the obligations required to meet those objectives.

The most comprehensive definition of derivative is in the Exposure Draft of a Proposed Statement of Financial Accounting Standards titled "Accounting for Derivative and Similar Financial Instruments and for Hedging Activities," which was released by the Financial Accounting Standards Board (FASB) on June 20, 1996 (No. 162-B). The definition in Section 414(a) is derived in part from the FASB definition. The purpose of the definition in subsection (a) is to implement the substantive rule in subsection (b) that provides for all receipts and disbursements to be allocated to principal to the extent the trustee elects not to account for transactions in derivatives under Section 403. As a result, it is much shorter than the FASB definition, which serves much more ambitious objectives.

A derivative is frequently described as including futures, forwards, swaps and options, terms that also require definition, and the definition in this Act avoids these terms. FASB used the same approach, explaining in paragraph 65 of the Exposure Draft: The definition of *derivative financial instrument* in this Statement includes those financial instruments generally considered to be derivatives, such as forwards, futures, swaps, options, and similar instruments. The Board considered defining a derivative financial instrument by merely referencing those commonly understood instruments, similar to paragraph 5 of Statement 119, which says that "... a derivative financial instrument is a futures, forward, swap, or option contract, or other financial instrument with similar characteristics." However, the continued development of financial markets and innovative financial instruments could ultimately render a definition based on examples inadequate and obsolete. The Board, therefore, decided to base the definition of a derivative financial instrument on a description of the common characteristics of those instruments in order to accommodate the accounting for newly developed derivatives. (Footnote omitted.)

*Marking to market.* A gain or loss that occurs because the trustee marks securities to market or to another value during an accounting period is not a transaction in a derivative financial instrument that is income or principal under the Act - only cash receipts and disbursements, and the receipt of property in exchange for a principal asset, affect a trust's principal and income accounts.

Receipt of property other than cash. If a trustee receives property other than cash upon the settlement of a derivatives transaction, that property would be principal under Section 404(2).

Options. Options to which subsection (c) applies include an option to purchase real estate owned by the trustee and a put option purchased by a trustee to guard against a drop in value of a large block of marketable stock that must be liquidated to pay estate taxes. Subsection (c) would also apply to a continuing and regular practice of selling call options on securities owned by the trust if the terms of the option require delivery of the securities. It does not apply if the consideration received or given for the option is something other than cash or property, such as cross-options granted in a buy-sell agreement between owners of an entity.

## **Section 415. Asset-Backed Securities.**

(a) In this section, "asset-backed security" means an asset whose value is based upon the right it gives the owner to receive distributions from the proceeds of financial assets that provide collateral for the security. The term includes an asset that gives the owner the right to receive from the collateral financial assets only the interest or other current return or only the proceeds other than interest or current return. The term does not include an asset to which Section 401 or 409 applies.

(b) If a trust receives a payment from interest or other current return and from other proceeds of the collateral financial assets, the trustee shall allocate to income the portion of the payment which the payer identifies as being from interest or other current return and shall allocate the balance of the payment to principal.

(c) If a trust receives one or more payments in exchange for the trust's entire interest in an asset-backed security in one accounting period, the trustee shall allocate the payments to principal. If a payment is one of a series of payments that will result in the liquidation of the trust's interest in the security over more than one accounting period, the trustee shall allocate 10 percent of the payment to income and the balance to principal.

## Comment

*Scope of section.* Typical asset-backed securities include arrangements in which debt obligations such as real estate mortgages, credit card receivables and auto loans are acquired by an investment trust and interests in the trust are sold to investors. The source for payments to an investor is the money received from principal and interest payments on the underlying debt. An asset-backed security includes an "interest only" or a "principal only" security that permits the investor to receive only the interest payments received from the bonds, mortgages or other assets that are the collateral for the asset-backed security, or only the principal payments made on those collateral assets. An asset-backed security also includes a security that permits the investor to participate in either the capital appreciation of an underlying security or in the interest or dividend return from such a security, such as the "Primes" and "Scores" issued by Americus Trust. An asset-backed security does not include an interest in a corporation, partnership, or an investment trust described in the Comment to Section 402, whose assets consist significantly or entirely of investment assets. Receipts from an instrument that do not come within the scope of this section or any other section of the Act would be allocated entirely to principal under the rule in Section 103(a)(4), and the trustee may then consider whether and to what extent to exercise the power to adjust in Section 104, taking into account the return from the portfolio as whole and other relevant factors.

*[Article] 5 - Allocation of disbursements during administration of trust*

### **Section 501. Disbursements From Income.**

A trustee shall make the following disbursements from income to the extent that they are not disbursements to which Section 201(2)(B) or (C) applies:

- (1) one-half of the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee;
- (2) one-half of all expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests;
- (3) all of the other ordinary expenses incurred in connection with the administration, management, or preservation of trust property and the distribution of income, including interest, ordinary repairs, regularly recurring taxes assessed against principal, and expenses of a proceeding or other matter that concerns primarily the income interest; and
- (4) recurring premiums on insurance covering the loss of a principal asset or the loss of income from or use of the asset.

## Comment

*Trustee fees.* The regular compensation of a trustee or the trustee's agent includes compensation based on a percentage of either principal or income or both.

*Insurance premiums.* The reference in paragraph (4) to "recurring" premiums is intended to distinguish premiums paid annually for fire insurance from premiums on title insurance, each of which covers the loss of a principal asset. Title insurance premiums would be a principal disbursement under Section 502(a)(5).

*Regularly recurring taxes.* The reference to "regularly recurring taxes assessed against principal" includes all taxes regularly imposed on real property and tangible and intangible personal property.

### **Section 502. Disbursements From Principal.**

(a) A trustee shall make the following disbursements from principal:

- (1) the remaining one-half of the disbursements described in Section 501(1) and (2);

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

- (2) all of the trustee's compensation calculated on principal as a fee for acceptance, distribution, or termination, and disbursements made to prepare property for sale;
- (3) payments on the principal of a trust debt;
- (4) expenses of a proceeding that concerns primarily principal, including a proceeding to construe the trust or to protect the trust or its property;
- (5) premiums paid on a policy of insurance not described in Section 501(4) of which the trust is the owner and beneficiary;
- (6) estate, inheritance, and other transfer taxes, including penalties, apportioned to the trust; and
- (7) disbursements related to environmental matters, including reclamation, assessing environmental conditions, remedying and removing environmental contamination, monitoring remedial activities and the release of substances, preventing future releases of substances, collecting amounts from persons liable or potentially liable for the costs of those activities, penalties imposed under environmental laws or regulations and other payments made to comply with those laws or regulations, statutory or common law claims by third parties, and defending claims based on environmental matters.

(b) If a principal asset is encumbered with an obligation that requires income from that asset to be paid directly to the creditor, the trustee shall transfer from principal to income an amount equal to the income paid to the creditor in reduction of the principal balance of the obligation.

## Comment

*Environmental expenses.* All environmental expenses are payable from principal, subject to the power of the trustee to transfer funds to principal from income under Section 504. However, the Drafting Committee decided that it was not necessary to broaden this provision to cover other expenditures made under compulsion of governmental authority. See generally the annotation at 43 A.L.R.4th 1012 (Duty as Between Life Tenant and Remainderman with Respect to Cost of Improvements or Repairs Made Under Compulsion of Governmental Authority).

Environmental expenses paid by a trust are to be paid from principal under Section 502(a)(7) on the assumption that they will usually be extraordinary in nature. Environmental expenses might be paid from income if the trustee is carrying on a business that uses or sells toxic substances, in which case environmental cleanup costs would be a normal cost of doing business and would be accounted for under Section 403. In accounting under that Section, environmental costs will be a factor in determining how much of the net receipts from the business is trust income. Paying all other environmental expenses from principal is consistent with this Act's approach regarding receipts - when a receipt is not clearly a current return on a principal asset, it should be added to principal because over time both the income and remainder beneficiaries benefit from this treatment. Here, allocating payments required by environmental laws to principal imposes the detriment of those payments over time on both the income and remainder beneficiaries.

Under Sections 504(a) and 504(b)(5), a trustee who makes or expects to make a principal disbursement for an environmental expense described in Section 502(a)(7) is authorized to transfer an appropriate amount from income to principal to reimburse principal for disbursements made or to provide a reserve for future principal disbursements.

The first part of Section 502(a)(7) is based upon the definition of an "environmental remediation trust" in Treas. Reg. § 301.7701-4(e) (as amended in 1996). This is not because the Act applies to an environmental remediation trust, but because the definition is a useful and thoroughly vetted description of the kinds of expenses that a trustee owning contaminated property might incur. Expenses incurred to comply with environmental laws include the cost of environmental consultants, administrative proceedings and burdens of every kind imposed as the result of an administrative or judicial proceeding, even though the burden is not formally characterized as a penalty.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

*Title proceedings.* Disbursements that are made to protect a trust's property, referred to in Section 502(a)(4), include an "action to assure title" that is mentioned in Section 13(c)(2) of the 1962 Act.

*Insurance premiums.* Insurance premiums referred to in Section 502(a)(5) include title insurance premiums. They also include premiums on life insurance policies owned by the trust, which represent the trust's periodic investment in the insurance policy. There is no provision in the 1962 Act for life insurance premiums.

*Taxes.* Generation-skipping transfer taxes are payable from principal under subsection (a)(6).

## **Section 503. Transfers From Income To Principal For Depreciation.**

(a) In this section, "depreciation" means a reduction in value due to wear, tear, decay, corrosion, or gradual obsolescence of a fixed asset having a useful life of more than one year.

(b) A trustee may transfer to principal a reasonable amount of the net cash receipts from a principal asset that is subject to depreciation, but may not transfer any amount for depreciation:

- (1) of that portion of real property used or available for use by a beneficiary as a residence or of tangible personal property held or made available for the personal use or enjoyment of a beneficiary;
- (2) during the administration of a decedent's estate; or
- (3) under this section if the trustee is accounting under Section 403 for the business or activity in which the asset is used.

(c) An amount transferred to principal need not be held as a separate fund.

## **Comment**

*Prior Acts.* The 1931 Act has no provision for depreciation. Section 13(a)(2) of the 1962 Act provides that a charge shall be made against income for "... a reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting principles ... ." That provision has been resisted by many trustees, who do not provide for any depreciation for a variety of reasons. One reason relied upon is that a charge for depreciation is not needed to protect the remainder beneficiaries if the value of the land is increasing; another is that generally accepted accounting principles may not require depreciation to be taken if the property is not part of a business. The Drafting Committee concluded that the decision to provide for depreciation should be discretionary with the trustee. The power to transfer funds from income to principal that is granted by this section is a discretionary power of administration referred to in Section 103(b), and in exercising the power a trustee must comply with Section 103(b).

One purpose served by transferring cash from income to principal for depreciation is to provide funds to pay the principal of an indebtedness secured by the depreciable property. Section 504(b)(4) permits the trustee to transfer additional cash from income to principal for this purpose to the extent that the amount transferred from income to principal for depreciation is less than the amount of the principal payments.

## **Section 504. Transfers From Income To Reimburse Principal.**

(a) If a trustee makes or expects to make a principal disbursement described in this section, the trustee may transfer an appropriate amount from income to principal in one or more accounting periods to reimburse principal or to provide a reserve for future principal disbursements.

(b) Principal disbursements to which subsection (a) applies include the following, but only to the extent that the trustee has not been and does not expect to be reimbursed by a third party:

- (1) an amount chargeable to income but paid from principal because it is unusually large, including extraordinary repairs;

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

- (2) a capital improvement to a principal asset, whether in the form of changes to an existing asset or the construction of a new asset, including special assessments;
- (3) disbursements made to prepare property for rental, including tenant allowances, leasehold improvements, and broker's commissions;
- (4) periodic payments on an obligation secured by a principal asset to the extent that the amount transferred from income to principal for depreciation is less than the periodic payments; and
- (5) disbursements described in Section 502(a)(7).

(c) If the asset whose ownership gives rise to the disbursements becomes subject to a successive income interest after an income interest ends, a trustee may continue to transfer amounts from income to principal as provided in subsection (a).

## Comment

*Prior Acts.* The sources of Section 504 are Section 13(b) of the 1962 Act, which permits a trustee to "regularize distributions," if charges against income are unusually large, by using "reserves or other reasonable means" to withhold sums from income distributions; Section 13(c)(3) of the 1962 Act, which authorizes a trustee to establish an allowance for depreciation out of income if principal is used for extraordinary repairs, capital improvements and special assessments; and Section 12(3) of the 1931 Act, which permits the trustee to spread income expenses of unusual amount "throughout a series of years." Section 504 contains a more detailed enumeration of the circumstances in which this authority may be used, and includes in subsection (b)(4) the express authority to use income to make principal payments on a mortgage if the depreciation charge against income is less than the principal payments on the mortgage.

## Section 505. Income Taxes.

- (a) A tax required to be paid by a trustee based on receipts allocated to income must be paid from income.
- (b) A tax required to be paid by a trustee based on receipts allocated to principal must be paid from principal, even if the tax is called an income tax by the taxing authority.
- (c) A tax required to be paid by a trustee on the trust's share of an entity's taxable income must be paid proportionately:
  - (1) from income to the extent that receipts from the entity are allocated to income; and
  - (2) from principal to the extent that:
    - (A) receipts from the entity are allocated to principal; and
    - (B) the trust's share of the entity's taxable income exceeds the total receipts described in paragraphs (1) and (2)(A).
- (d) For purposes of this section, receipts allocated to principal or income must be reduced by the amount distributed to a beneficiary from principal or income for which the trust receives a deduction in calculating the tax.

## Comment

*Electing Small Business Trusts.* An Electing Small Business Trust (ESBT) is a creature created by Congress in the Small Business Job Protection Act of 1996 (P.L. 104-188). For years beginning after 1996, an ESBT may qualify as an S corporation stockholder even if the trustee does not distribute all of the trust's income annually to its beneficiaries. The portion of an ESBT that consists of the S corporation stock is treated as a separate trust for tax purposes (but not for trust accounting purposes), and the S corporation income is taxed directly to that portion of the trust even if some or all of that income is distributed to the beneficiaries.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

A trust normally receives a deduction for distributions it makes to its beneficiaries. Subsection (d) takes into account the possibility that an ESBT may not receive a deduction for trust accounting income that is distributed to the beneficiaries. Only limited guidance has been issued by the Internal Revenue Service, and it is too early to anticipate all of the technical questions that may arise, but the powers granted to a trustee in Sections 506 and 104 to make adjustments are probably sufficient to enable a trustee to correct inequities that may arise because of technical problems.

## Section 506. Adjustments Between Principal and Income Because Of Taxes.

(a) A fiduciary may make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from:

- (1) elections and decisions, other than those described in subsection (b), that the fiduciary makes from time to time regarding tax matters;
- (2) an income tax or any other tax that is imposed upon the fiduciary or a beneficiary as a result of a transaction involving or a distribution from the estate or trust; or
- (3) the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary.

(b) If the amount of an estate tax marital deduction or charitable contribution deduction is reduced because a fiduciary deducts an amount paid from principal for income tax purposes instead of deducting it for estate tax purposes, and as a result estate taxes paid from principal are increased and income taxes paid by an estate, trust, or beneficiary are decreased, each estate, trust, or beneficiary that benefits from the decrease in income tax shall reimburse the principal from which the increase in estate tax is paid. The total reimbursement must equal the increase in the estate tax to the extent that the principal used to pay the increase would have qualified for a marital deduction or charitable contribution deduction but for the payment. The proportionate share of the reimbursement for each estate, trust, or beneficiary whose income taxes are reduced must be the same as its proportionate share of the total decrease in income tax. An estate or trust shall reimburse principal from income.

### Comment

*Discretionary adjustments.* Section 506(a) permits the fiduciary to make adjustments between income and principal because of tax law provisions. It would permit discretionary adjustments in situations like these: (1) A fiduciary elects to deduct administration expenses that are paid from principal on an income tax return instead of on the estate tax return; (2) a distribution of a principal asset to a trust or other beneficiary causes the taxable income of an estate or trust to be carried out to the distributee and relieves the persons who receive the income of any obligation to pay income tax on the income; or (3) a trustee realizes a capital gain on the sale of a principal asset and pays a large state income tax on the gain, but under applicable federal income tax rules the trustee may not deduct the state income tax payment from the capital gain in calculating the trust's federal capital gain tax, and the income beneficiary receives the benefit of the deduction for state income tax paid on the capital gain. See generally Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

Section 506(a)(3) applies to a qualified Subchapter S trust (QSST) whose income beneficiary is required to include a pro rata share of the S corporation's taxable income in his return. If the QSST does not receive a cash distribution from the corporation that is large enough to cover the income beneficiary's tax liability, the trustee may distribute additional cash from principal to the income beneficiary. In this case the retention of cash by the corporation benefits the trust principal. This situation could occur if the corporation's taxable income includes capital gain from the sale of a business asset and the sale proceeds are reinvested in the business instead of being distributed to shareholders.

*Mandatory adjustment.* Subsection (b) provides for a mandatory adjustment from income to principal to the extent needed to preserve an estate tax marital deduction or charitable contributions deduction. It is derived from New York's EPTL § 11-1.2(A), which requires principal to be reimbursed by those who benefit when a fiduciary elects to deduct administration expenses on an income tax return instead of the estate tax return. Unlike the New York provision, subsection (b) limits a mandatory reimbursement to cases in which a marital deduction or a charitable contributions deduction is reduced by the payment of

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

additional estate taxes because of the fiduciary's income tax election. It is intended to preserve the result reached in *Estate of Britenstool v. Commissioner*, 46 T.C. 711 (1966), in which the Tax Court held that a reimbursement required by the predecessor of EPTL § 11-1.2(A) resulted in the estate receiving the same charitable contributions deduction it would have received if the administration expenses had been deducted for estate tax purposes instead of for income tax purposes. Because a fiduciary will elect to deduct administration expenses for income tax purposes only when the income tax reduction exceeds the estate tax reduction, the effect of this adjustment is that the principal is placed in the same position it would have occupied if the fiduciary had deducted the expenses for estate tax purposes, but the income beneficiaries receive an additional benefit. For example, if the income tax benefit from the deduction is \$30,000 and the estate tax benefit would have been \$20,000, principal will be reimbursed \$20,000 and the net benefit to the income beneficiaries will be \$10,000.

*Irrevocable grantor trusts.* Under Sections 671-679 of the Internal Revenue Code (the "grantor trust" provisions), a person who creates an irrevocable trust for the benefit of another person may be subject to tax on the trust's income or capital gains, or both, even though the settlor is not entitled to receive any income or principal from the trust. Because this is now a well-known tax result, many trusts have been created to produce this result, but there are also trusts that are unintentionally subject to this rule. The Act does not require or authorize a trustee to distribute funds from the trust to the settlor in these cases because it is difficult to establish a rule that applies only to trusts where this tax result is unintended and does not apply to trusts where the tax result is intended. Settlers who intend this tax result rarely state it as an objective in the terms of the trust, but instead rely on the operation of the tax law to produce the desired result. As a result it may not be possible to determine from the terms of the trust if the result was intentional or unintentional. If the drafter of such a trust wants the trustee to have the authority to distribute principal or income to the settlor to reimburse the settlor for taxes paid on the trust's income or capital gains, such a provision should be placed in the terms of the trust. In some situations the Internal Revenue Service may require that such a provision be placed in the terms of the trust as a condition to issuing a private letter ruling.

## [Article] 6 - Miscellaneous Provisions

### **Section 601. Uniformity Of Application and Construction.**

In applying and construing this Uniform Act, consideration must be given to the need to promote uniformity of the law with respect to its subject matter among States that enact it.

### **Section 602. Severability Clause.**

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 603. Repeal.**

The following acts and parts of acts are repealed:

- (1) .....
- (2) .....
- (3) .....

### **Section 604. Effective Date.**

This [Act] takes effect on .....

### **Section 605. Application Of [ACT] To Existing Trusts and Estates.**

This [Act] applies to every trust or decedent's estate existing on [the effective date of this [Act]] except as otherwise expressly provided in the will or terms of the trust or in this [Act].←

## G. LIST OF STATES ADOPTING THE UNIFORM PRINCIPAL AND INCOME ACT

(As of August 5, 2004)

**The following states have adopted the 1997 revision to the Uniform Principal and Income Act:**

1. Alabama
2. Alaska
3. Arizona
4. Arkansas
5. California
6. Colorado
7. Connecticut
8. District of Columbia
9. Florida
10. Hawaii
11. Idaho
12. Indiana
13. Iowa
14. Kansas
15. Maine
16. Maryland
17. Montana
18. Missouri
19. Nebraska
20. Nevada
21. New Jersey
22. New Mexico
23. New York
24. North Carolina
25. North Dakota
26. Ohio
27. Oklahoma
28. Oregon
29. Pennsylvania
30. South Carolina
31. Tennessee
32. Texas
33. Utah
34. Virginia
35. Washington
36. West Virginia
37. Wyoming

The legislation has been introduced in Massachusetts and Michigan.

**The following states have adopted the Uniform Principal and Income Acts of 1931 and 1962:**

1. Alabama 1931 Code 1975, §§ 19-3-270 to 19-3-382
2. Alaska 1962 AS 13.38.010 to 13.38.140
3. Arizona 1962 A.R.S. §§ 14-7401 to 14-7413
4. Arkansas 1997 ACA §§ 28-70-101 to 28-70-603
5. California 1997 West's Ann. Cal. Civ. Code §§ 16320 to 16375
6. Colorado 1931 West's C.R.S.A. §§ 15-1-401 to 15-1-417

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

7. Connecticut 1997 PA-164 (no statute number available)
8. Florida 1962 West's F.S.A. §§ 738.01 to 738.15
9. Georgia 1962 OCGA §§ 53-12-210 to 53-12-219
10. Hawaii 1962 HRS §§ 557-1 to 557-16
11. Idaho 1962 I.C. §§ 68-1001 to 68-1016
12. Illinois 1962 S.H.A. 760 ILCS 15/1 to 15/17
13. Indiana 1962 West's A.I.C. 30-4-5-1 to 30-4-5-11
14. Iowa 1997 I.C.A. §§ 637.101 to 637.601
15. Kansas 1962 K.S.A. 58-901 to 58-917
16. Kentucky 1962 K.R.S. §§ 386.191 to 386.349
17. Maryland 1962 Code, Estates & Trusts, §§ 14-201 to 14-214
18. Michigan 1962 M.L.C.A. §§ 555.51 to 555.68
19. Minnesota 1962 M.S.A. §§ 501B.59 to 501B.76
20. Mississippi 1962 Code 1972, §§ 91-17-1 to 91-17-31
21. Missouri 1962 V.A.M.S §§ 456.700 to 456.820
22. Montana 1962 M.C.A. §§ 72-34-401 to 72-34-416
23. Nebraska 1962 R.R.S. 1943, §§ 30-3101 to 30-3115
24. Nevada 1962 N.R.S. 164.140 to 164.370
25. New Jersey 1962 N.J.S.A. §§ 3B:19A-1 to 3B:19A-35
26. New Mexico 1962 NMSA 1978 §§ 46-3-1- to 46-3-15
27. New York 1962 McKinney's EPTL 11.2.1
28. North Carolina 1962 G.S. §§ 37-16 to 37-40
29. North Dakota 1997 NDCC 59-04.2-01 to 59-04.2-30
30. Ohio 1962 R.C. §§ 134.01 to 134.13; 2190.66 to 2190.68
31. Oklahoma 1997 60 Okl.St. Ann. §§ 175.101 to 175.602
32. Oregon 1962 ORS 129.005 to 129.125
33. Pennsylvania 1931 20 Pa.C.S.A. §§ 8101 to 8112
34. South Carolina 1962 Code 1976 §§ 62-7-401 to 62-7-421
35. South Dakota 1962 SDCL 55-13-1 to 55-13-17
36. Tennessee 1931 T.C.A. §§ 35-6-101 to 35-6-115
37. Texas 1962 V.T.C.A., Property Code §§ 113.101 to 113.111
38. Utah 1962 U.C.A. 1953, 22-3-1- to 22-3-16
39. Vermont 1931 14 V.S.A. §§ 3301 to 3313
40. Virginia 1997 Code 1950, §§ 55-277.1 to 55-277.33
41. Washington 1962 West's RCWA 11.104.010 to 11.104.940
42. West Virginia 1931 Code, 36-6-1 to 36-6-17
43. Wisconsin 1962 W.S.A. 701.20
44. Wyoming 1962 W.S. 1977, §§ 2-3-601 to 2-3-614

←

## H. FDIC MEMORANDUMS REGARDING CONSENT TO EXERCISE TRUST POWERS

*Federal Deposit Insurance Corporation  
Washington 25  
Office of Chief  
Division of Examination*

*June 30, 1958*

*Memorandum to -*

*Supervising Examiners  
Federal Deposit Insurance Corporation*

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

## *Subject: Applications to the Federal Deposit Insurance Corporation For Consent to Exercise Trust Powers*

On June 25, 1958, the Board of Directors approved a recommendation of the Deputy Chief, Division of Examination, and the General Counsel, pertaining to applications to the Federal Deposit Insurance Corporation for consent to exercise trust powers. This decision by the Board establishes the circumstances under which an application will be required.

The following is excerpted from the recommendation submitted to the Board of Directors:

"1. That regulation Part 333 is not applicable, and this Corporation's written consent is not necessary, when an insured nonmember bank proposes to exercise trust powers which it had, either by statute or by charter, at the time of its admission to Federal deposit insurance, unless the record shows that at the time of its admission it was understood and agreed between the Corporation and the bank that it should not exercise such powers.

(Application Forms No. 2; No. 84, No. 84 revised December 15, 1948, and the corresponding forms for use by incorporators of proposed banks, do not provide such a contract.)

"However, the regulation is applicable to such an insured nonmember bank, and this Corporation's written consent is necessary, if the bank may not exercise trust powers without first obtaining the consent of the State supervisory authority although it has trust powers, either by statute or charter. The term 'consent' should not be construed to include a situation where a bank can as a matter of right exercise trust powers by merely increasing its capital to the prescribed statutory amount, or by complying with the statutory requirements in respect to the filing of bonds or securities.

"2. That regulation Part 333 is applicable to such an insured nonmember bank which has executed by itself, or by its incorporators and ratified by the bank, any of the above forms revised December 1, 1950, viz:

Form 84 revised December 1, 1950 - 'Application for Federal Deposit Insurance'

Form 82 revised December 1, 1950 - 'Application of Proposed Bank for Federal Deposit Insurance'

Form 85 revised December 1, 1950 Application to Establish Branch'

Form 85a revised December 1, 1950 'Application to Move Main Office or Branch'

Or amendments thereof which show the general character of the business exercised by the bank and which contain an agreement that the bank will not engage in any other business without the prior written consent of the Corporation, and such a bank may not exercise trust powers without the prior written consent of this Corporation."

In summary, if inquiry or application relating to the inauguration of the exercise of trust powers is received, the Supervising Examiner, before requiring formal application for consent, must determine by review of the District Office files whether regulation Part 333 is applicable. The review of the files should determine:

(1) If the consent of the State Supervisory Authority is necessary; or

(2) If an agreement that the bank will not engage in trust business without consent of the Corporation as indicated on FDIC Forms 82, 84, 85, or 85a, has been filed by the bank subsequent to December 1, 1950. The agreement referred to is in the form of a paragraph on the application forms placed in use as of December 1, 1950, and revised May 1, 1952, viz:

"It is understood that the Board of Directors of the Federal Deposit Insurance Corporation in applying the factors set out in Section 6 of the Federal Deposit Insurance Act to this Application, will consider it only with respect to the general character or types of business above stated and that the Bank will not engage in any other business without the prior written consent of the Corporation."

In the event application to the Corporation for consent to exercise trust powers is required from an insured bank, such application must be made on Forms 102, "Application to Federal Deposit Insurance Corporation," and 103, "Supplementary Information to

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Application to Federal Deposit Insurance Corporation for Consent to Exercise Trust Powers." Form 103 must also be used as a supplement to Form 82, "Application of Proposed New Bank for Federal Deposit Insurance," if applicant desires to exercise trust powers.

Applications at hand, regardless of date of receipt, will be processed in accordance with these instructions.

Edward H. DeHority  
*Deputy Chief*  
Division of Examination

June 16, 1958

Memorandum to --

The Special Committee  
and  
The Board of Directors

*Question:* Whether under regulation Part 333 banks which had trust powers when they became insured but did not exercise them, must obtain this Corporation's prior consent to the exercise of such powers. The regulation reads as follows:

§ 333.1 Classification of General character of business. State nonmember insured banks are divided into five categories for the purpose of classifying their general character or type of business, viz: commercial banks, banks and trust companies, savings banks (including mutual and stock), industrial banks, and cash depositories.

§ 333.2 Change in general character of business. No State nonmember insured bank (except a District bank) or branch thereof shall hereafter cause or permit any change to be made in the general character or type of business exercised by it after the effective date of this part without the prior written consent of the Corporation.

§ 333.101 Prior consent not required. The extension by any State nonmember insured bank of its business to include personal, character or instalment loans, or the extension by an industrial bank of its business to include the business of a commercial bank, is not a change in the general character or type of business requiring the prior written consent of the Corporation.

Historical:

The first two sections of the regulation, namely, § 333.1 and § 333.2, were adopted by the Board on August 30, 1946. The memorandum to the Special Committee and the Board recommending its adoption points out that when a bank applies for insurance, the Board gives consideration to the factors prescribed in the Federal Deposit Insurance Act and considers each factor in the light of the bank's powers at that time; that if the bank subsequently enlarges its corporate powers or changes the general character of its business, it may materially affect the basis upon which the Board considered the factors and the bank would be exercising different rights, powers, and types of business from that considered by the Board.

It referred to a memorandum of Mr. Oppegard's to Mr. Sailor dated July 25, 1945, a copy of which was attached to the memorandum, for a more complete discussion of the proposal. The gist of that memorandum was that when an insured nonmember bank changed its type of banking from one of the categories mentioned in the proposed regulation to include one or more of the other categories and the insurance risk was thus enlarged, the Corporation should have the power to determine whether it will accept such additional potential risk. It pointed out that this power was inherent in the statute and was consistent with other provisions therein which prohibited, in certain instances, consolidations, mergers, or assumptions of liabilities and transfer of assets without the prior written consent of the Corporation; the reduction or retirement of common or preferred capital stock, notes, or debentures, without such consent, and other statutory provisions, including the general authority to prescribe regulations, which clearly evidence the intention of Congress to give to the Corporation such powers as its Board of Directors deem necessary to protect the insurance fund.

*The memorandum recommended:*

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

1. That our examiners, in their report of examination upon the bank's application for deposit insurance show that the investigation, with respect to the factors set out in subsection (g) was made only for the type of bank shown in the application;
2. That the application form be revised to contain an agreement of the bank that it will not enlarge its powers, change its essential characteristics, convert to any other type or types of banking, or move its main office to another location without the prior written consent of this Corporation;
3. That the following statement be eliminated from the present application form: "The establishment of a trust department (is) (is not) contemplated."

The interpretative provision set out in § 333.101 of the regulation was adopted January 21, 1948. The memorandum in support of its adoption stated that it was consistent with the practice of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System. We quote the following from the memorandum:

"The Board of Governors of the Federal Reserve System requires of each state bank, as a condition for membership in that system, an agreement that it will not '... except with the permission of the Board of Governors of the Federal Reserve System, cause or permit any change to be made in the general character of its business or in the scope of its corporate powers exercised by it at the time of membership, ...' The Board of Governors has ruled, with respect to commercial banks taking on small loan business of the Morris Plan type, that '... While such extension of activities may to some extent constitute a change in the general character of the bank's business and in some cases) at least, involve a change in the scope of the corporate powers exercised by the bank, the change is not felt to be such as would come within the intent of the general condition of membership. Accordingly, banks desiring to engage in such activity will not be required to obtain the permission of the Board under the general conditions of membership..."

In this connection it is pointed out that § 9 of the Federal Reserve Act, which relates to applications for membership by State banks in the Federal Reserve System, provides that the Federal Reserve Board may prescribe conditions under which a State bank may become a member of that System; whereas there is no like provision in the Federal Deposit Insurance Act in respect to nonmember banks applying for Federal deposit insurance.

## Practice under the regulation:

In a memorandum of October 23, 1946 to the Chief of the Division of Examination, entitled "Administrative Procedure Act--Corporation's Rules and Regulations" various recommendations were made by legal counsel in respect to amending the procedural forms governing applications and memoranda presented to the Board. This memorandum included these recommendations in respect to Part 333, here discussed:

"No definite standards can clearly be laid down as guides by which to determine when a state nonmember bank must make, and when it need not make, application for consent under Part 333 except such as are implicit in the regulation itself, namely, whether the proposal changes the general character or type of applicant's business. However, it may be said as a general rule that the regulation is applicable:

1. When the proposed type of business to be conducted requires an amendment of the institution's articles of incorporation; and
2. When the proposed type of business to be conducted requires the consent of the state supervising authority.

Other applications will have to be handled on a case by case basis. The regulations should not be invoked to require consent when the bank merely takes on some additional functions which do not materially change its general character or type of business. The paramount consideration in each such case should be whether the proposal affects the insurance risk. As a general matter, if the proposal does not come within III and '21 above and does not materially affect the insurance risk, the regulation should not be invoked."

In a memorandum of March 2, 1950 to Mr. Sailor, legal counsel referred to the above memorandum of October 23, 1946, and added the following:

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

"And we will now add that, in our opinion, the regulation is not applicable where an insured nonmember bank merely proposes to exercise a power which it had at the time of its admission to deposit insurance (1) unless the record shows that, at the time of its admission to deposit insurance, it was understood or agreed by and between the bank and this Corporation that any specified power should not be exercised without the prior written consent of the Corporation; or (2) unless the power is one which is inconsistent with the purposes of the Federal deposit insurance law and its exercise is precluded by reason thereof. In my opinion, nonuse of a power for any particular period of time is not a criterion for invoking the provisions of Part 333 unless it can clearly be shown from the record that such nonuse constituted an abandonment of the power and it was the intention of the bank that our Board should disregard the power in passing upon its application for deposit insurance, and our Board did disregard the same in so doing."

This involved the Iowa Trust and Savings Bank, Oskaloosa, Iowa, which had trust powers in its charter but did not exercise them at the time of its admission to Federal deposit insurance.

Corporation forms used by the banks in applying for Federal deposit insurance:

4. Form 2 used by the banks in applying for membership in the temporary Federal deposit insurance fund under the Banking Act of 1933 (a majority of the banks became insured under this Act) contained this statement in respect to the operation of a trust department:  
"This Corporation does operate a trust department."  
The banks were required to insert in the blank space whether or not they were operating a trust department.
5. Form 84 used by banks in making application for Federal deposit insurance under the Banking Act of 1933 contained the same statement.
6. In Form 84 revised December 15, 1948 (being the first revised form in use after the adoption of Part 333) the above-quoted statement was stricken. We quote as follows from that form as pertinent here:

"The (Name of Bank) City or Town and State) hereby makes application to the Federal Deposit Insurance Corporation to become an insured bank under the provisions of Section 12B of the Federal Reserve Act, as amended, hereinafter referred to as the Federal Deposit Insurance law. The general character or types of business now exercised by the Bank are as follows:

(See Footnote\*)

It is understood that the Board of Directors of the Federal Deposit Insurance Corporation in applying the factors set out in subsection (g) of the Federal Deposit Insurance Law to this Application, will consider it only with respect to the general character or types of business above stated.

\*Here outline the nature and extent of the banking business conducted by the Bank. Show whether the business is that of a commercial bank, a bank and trust company, a trust company (without banking powers), a savings bank (stock), an industrial bank, or a cash depository."

In Form 84 revised December 1, 1950 (being the second revised form in use after the adoption of Part 333) the two paragraphs above quoted from Form 84 revised December 15, 1948, were amended to read as follows:

"The (Name of Bank) (Street Address) (City or Town and State) hereby makes application to the Federal Deposit Insurance Corporation to become an insured bank under the provisions of the Federal Deposit Insurance Act. The general character or types of business now exercised by the Bank are: (Check all appropriate items) ( ) Commercial banking; ( ) Savings Banking; ( ) Industrial banking; ( ) Trust business; ( ) Cash depository; ( ) Others. Specify

It is understood that the Board of Directors of the Federal Deposit Insurance Corporation in applying the factors set out in Section 6 of the Federal Deposit Insurance Act to this Application, will consider the Application only with respect to the general character or type of business above stated and that the Bank will not engage in any other business without the prior written consent of the Corporation." (Emphasis supplied.)

Form 82 revised (1950), being an application form for execution by prospective incorporators of a proposed bank, contains the same above provisions as Form 84 revised (1950), except the necessary modification to show that the incorporators are making

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

the application for the proposed bank, and an additional form (Form 82A revised 12-1-50) for execution by the bank itself after its incorporation containing a resolution in which the board of directors of the bank --

"hereby approves the said action of the prospective incorporators of the Bank in preparing and presenting to the Federal Deposit Insurance Corporation said Application, and hereby ratifies and confirms the same, with the same force and effect as if said Application had been made in behalf of the Bank by this Board;

Form 85 revised December 1, 1950, a form for use in making an "Application to Establish a Branch", and Form 85A revised December 1, 1950, a form for use in making an "Application to Move Main Office or Branch", both contain the same statements and agreement as are contained in Form 84 revised December, 1950, quoted above, in respect to the general character of the business exercised by the bank and the agreement that the bank will not engage in any other business without the prior written consent of the Corporation.

## Discussion and Opinion:

We hereby confirm the opinion of the legal Division in its memorandum of October 23, 1946 to Mr. Sailor, Chief, Division of Examination, in which we stated that the regulation is not applicable where an insured nonmember bank merely proposes to exercise a power which it had at the time of its admission to deposit insurance, unless the record shows that at the time of its admission it was understood and agreed by and between the bank and this Corporation that any of its specified powers should not be exercised without the prior written consent of the Corporation; and that nonuse of a power for any particular period of time is not a criterion for invoking the provisions of the regulation unless it can be clearly shown from the record that such nonuse constituted an abandonment of the power and it was the intention of the bank that our Board should disregard the power in passing upon its application for deposit insurance, and our Board did disregard the same in so doing.

It is quite obvious that Forms 2 and 84 provide no such agreement or understanding between the applicant bank and this Corporation; and we doubt that such an agreement can be predicated upon the provisions contained in application Form 84 revised December 15, 1948. The basis for that doubt is that it contains no affirmative statement by the bank that it will not engage in any other business without the prior consent of the Corporation. On the other hand, it does advise the bank that the Corporation in applying the statutory factors will consider the application only with respect to the general character or types of business stated therein. However, since there is a doubt about its sufficiency as a contract and as it was used for a period of only two years, we believe it should be placed in the same category as Forms 2 and 84.

We believe, however, that under Form 84 revised December 1, 1950. Form 82 revised December 1, 1950, Form 85 revised December 1, 1950, and Form 85A revised December 1, 1950, an enforceable contract exists between the bank and this Corporation whereby the bank has agreed not to exercise trust powers without the prior written consent of the Corporation, unless so indicated on the application.

For the purpose of the question presented, we shall therefore place banks in two categories, namely, those which became insured prior to the use of the above application forms revised December 1, 1950, and those which became insured under forms revised December 1, 1950.

It is our opinion that the banks in the first category which had, at the time of admission to Federal deposit insurance, either by statute or by charter provisions, trust powers but did not exercise the same at the time of their admission, may exercise such powers without first obtaining this Corporation's written consent, in the absence of any collateral agreement with the Corporation that the bank should not execute such powers without the Corporation's consent. We do believe, however, that in any State, where the bank although it has such powers under the statute may not exercise the same without obtaining the consent of the State supervisory authority, the bank should be required to obtain this Corporation's consent, i.e., that the regulation is applicable in such a case.

We believe that all banks in the second category which had the power, either by statute or by charter, to exercise trust powers but did not exercise them at the time of obtaining Federal deposit insurance should be required to obtain this Corporation's prior written consent to the exercise of such powers. As stated, we believe these application forms constitute an adequate contract between the Corporation and a commercial bank, that it "will not engage in any other business without the prior written consent of the Corporation ..." and that such "other business" would embrace the exercise of its trust powers.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

## Recommendation:

It is recommended that the Board of Directors approve the following interpretation and application of regulation Part 333 relating to the extension of corporate powers by insured nonmember banks, viz:

That regulation Part 333 is not applicable, and this Corporation's written consent is not necessary, when an insured nonmember bank proposes to exercise trust powers which it had, either by statute or by charter, at the time of its admission to Federal deposit insurance, unless the record shows that at the time of its admission it was understood and agreed between the Corporation and the bank that it should not exercise such powers.

(Application Forms No. 2, No. 84, No. 84 revised December 15, 1948, and the corresponding forms for use by incorporators of proposed banks, do not provide such a contract.)

However, the regulation is applicable to such an insured nonmember bank, and this Corporation's written consent is necessary, if the bank may not exercise trust powers without first obtaining the consent of the State supervisory authority although it has trust powers, either by statute or charter. The term "consent" should not be construed to include a situation where a bank can as a matter of right exercise trust powers by merely increasing its capital to the prescribed statutory amount, or by complying with the statutory requirements in respect to the filing of bonds or securities.

That regulation Part 333 is applicable to such an insured nonmember bank which has executed by itself, or by its incorporators and ratified by the bank, any of the above forms revised December 1, 1950, viz:

Form 84 revised December 1, 1950 - "Application for Federal Deposit Insurance"

Form 82 revised December 1, 1950 - "Application of Proposed Bank for Federal Deposit Insurance"

Form 85 revised December 1, 1950 - "Application to Establish Branch"

Form 85A revised December 1, 1950 - "Application to Move Main Office or Branch"

or amendments thereof which show the general character of the business exercised by the bank and which contain an agreement that the bank will not engage in any other business without the prior written consent of the Corporation, and such a bank may not exercise trust powers without the prior written consent of this Corporation.

Edward H. DeHority  
*Deputy Chief*  
*Division of Examination*

Royal L. Coburn  
*General Counsel*

*Recommendation of the Deputy Chief, Division of Examination, and the General Counsel*

*Approved by the Special Committee*

*Recommendation of Special Committee*

*Approved by the Board of Directors, June 25, 1958 ←*

## I. FDIC LEGAL OPINION ON FRB SECTION 23B FEES AND AFFILIATED EMPLOYEE BENEFIT PLANS

*Federal Deposit Insurance Corporation*

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Appendix C

*Dallas Regional Office  
1601 Bryan Street, Dallas, Texas 75201 (214) 220-3400 Legal Division*

*March 10, 1995*

*Memorandum to: Michael M. Sawyer  
Review Examiner*

*From: Terry G. Youngblood  
Counsel/Senior Litigator*

*Subject:*

*\* Bank & Trust Company  
\* Texas*

*\* Bank & Trust Company* is the trustee of its holding company's profit sharing plan, and the trust department has been waiving fees for the profit sharing plan. An opinion has been requested as to whether or not this violates Section 23B(a)(1)(A).

As set forth in Advisory Opinion 93-53, the Federal Reserve has determined that a profit sharing plan is a company within the meaning of Section 23A. If the profit sharing plan is controlled by a person or persons who control the bank, the profit sharing plan is an affiliate of the bank.

Section 23A(b)(1)(C)(i) states that if a company is controlled by a group of shareholders who control the bank or its holding company, that company is an affiliate of the bank. At \* Bank & Trust Company, the directors own 34 percent of the holding company, and if they act in concert they are deemed to control the bank pursuant to Section 23A(b)(3)(A)(i). By virtue of their control of the bank, they would also control the profit sharing plan because the bank is the trustee of the plan.

Likewise, Section 23A(b)(1)(C)(ii) states that if a majority of the directors or trustees of a bank constitutes a majority of the directors or trustees of a company, the other company is an affiliate of the bank. In the instant case, the directors of the bank are automatically the directors of the trustee of the profit sharing plan by virtue of the trust department's status as trustee, and the directors thereby control the profit sharing plan.

The profit sharing plan is therefore an affiliate of the bank within the meaning of Section 23A and Section 23B.

The trust department's failure [to] charge the profit sharing plan for services rendered is a violation of Section 23B(a)(1) unless the bank would in good faith waive fees for comparable transactions with nonaffiliated companies.

Page 3-E of the Report of Examination states that the trust department waives fees for a good customer of the commercial department, but this does not appear to be a comparable transaction because the profit sharing plan does not generate income for the commercial department of the bank.←

## **J. FDIC FINANCIAL INSTITUTION LETTER 76-93: PROBLEMS FROM CUSTOMER "FREE-RIDING" IN CUSTODY ACCOUNTS**

*FIL-76-93  
November 4, 1993  
Trust Accounts*

*To: Chief Executive Officer*

*Subject: Problems from Customer "Free-Riding" in Custody Accounts*

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Appendix C

The FDIC is alerting banks under its supervision to problems and potential risks from customers who are "free-riding" securities in trust department custody accounts. Free-riding occurs when customers buy and sell securities, usually on the same day, in amounts greatly exceeding the amount allowed under margin collateral requirements. Banks, as well as brokerage houses, have incurred losses when these customers failed to pay for their trades. The Securities and Exchange Commission has been investigating several banks and brokerage firms for possible problems in this area.

Free-riding often begins when a custodial account is opened with a bank trust department. The customer also establishes brokerage accounts for directing securities trade. The customer advises the broker-dealer that payment for the trades will be made through the custodial account.

The free-rider attempts to profit from short-term changes in market prices of securities without placing significant personal funds at risk. Free-riders frequently place a buy order for securities, anticipating a near-term price increase and intending to pay for the securities with the proceeds from the sale of the same securities.

Banks that permit these transactions without requiring adequate margin collateral face significant risks when a customer's custody account does not contain enough money to complete a purchase order or enough securities to complete a sale order. The risks to bank include: (1) enforcement actions for violation of the Federal Reserve Board's margin lending standards in Regulation U (12 CFR221) or for aiding and abetting violations of Regulation X (12 CFR 224) or Regulation T (12 CFR 220); and (2) the loss of bank funds needed to complete the trades of customers who fail to pay.

Although the FDIC does not believe free-riding is a significant problem at FDIC-supervised banks at this time, the agency is recommending that banks review their policies and procedures for accepting custodial agency accounts and clearing securities transactions. These policies and procedures should:

Set standards for the acceptance of new custodial accounts, including customer background and credit information;

Require identification of broker-dealers sending securities to, and receiving funds from, customer accounts;

Establish systems to track accounts involving numerous broker-dealers;

Reject customer trades where acceptance would result in a violation of Regulation U; and

Determine that each account has sufficient funds to perform any trade or, if margin credit is extended, that collateral requirements are met.

Banks also may wish to refer to the supervisory letter recently issued by the staff of the Federal Reserve Board discussing the Federal reserve's margin lending requirements as they apply to free-riding (SR93-13, dated March 16, 1993).

For more information, please contact John F. Harvey, the trust review examiner in the FDIC's Division of Supervision at 202-898-6762.

*Stanley J. Poling, Director*

*Distribution: FDIC-Supervised Banks (Commercial and Savings)*

←

## K. FRB MEMORANDUM ON "FREE RIDING"

*Board of Governors  
of the  
Federal Reserve System*

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Appendix C

*Washington, D. C. 20551*

*SR 93-13 (FIS)*

*Division of Banking  
Supervision and Regulation*

*March 16, 1993*

*To the Officer in charge of supervision  
at each Federal Reserve Bank*

*Subject: Violations of Federal Reserve Margin Regulations in Custodial Agency Accounts Resulting From "Free-Riding" Schemes*

Federal Reserve examiners should be aware of recent targeted examinations and investigations by the Federal Reserve and the Enforcement Division of the Securities Exchange Commission (SEC), as well as court actions, that have found banks in violation of Regulation U (12 CFR 221) (Credit by Banks for the Purpose of Purchasing or Carrying Margin Stock) in connection with extensions of credit by bank trust departments, using bank or other fiduciary funds, to individuals involved in illegal "day trading" or "free-riding" schemes. These activities also involved the aiding and abetting of violations of two other securities credit regulations: Regulation T (12 CFR 220) (Credit by Brokers and Dealers) and Regulation X (12 CFR 224) (Borrowers of Securities Credit). Day trading and free-riding schemes involve the purchase and sale of stock on the same day (or within a very short period of time) and the funding of the purchases by the sales' proceeds.

Because of the illegal activities described below, banking organizations have been exposed to disciplinary proceedings, as well as to substantial credit risk. To date, several banks have sustained monetary losses in their trust departments as a result of their involvement in these schemes.

In the late 1980's, the SEC started to uncover illegal free-riding schemes and addressed them through injunctive actions filed against broker-dealers and banks in federal district court. In one case, *SEC v. Hansen, et al.*, 726 F.Supp. 74 (S.D.N.Y. 1989), a bank was found to have violated Regulation U by knowingly participating in a free-riding scheme. This was the first case in which the SEC sued a bank for illegal securities clearance activities associated with a free-riding scheme. It appears that over the past several months these illegal schemes have resurfaced. Investigations and examinations by SEC and Federal Reserve staffs have detected similar violations by state member and national banks' trust departments, leading to follow-up enforcement actions. Thus, increased vigilance by Federal Reserve examiners is called for to ensure that state member banks' trust departments, as well as bank holding companies' nonbank subsidiaries and U.S. branches and agencies of foreign banks that conduct trust-related activities, take all steps necessary to prevent their customers from involving them in the customers' attempts at free-riding. Prompt enforcement action may be necessary to accomplish this in some situations.

## Summary of Illegal Activities

The free-riding conduct in question typically involves individuals trading large amounts of securities without depositing the necessary money or appropriate collateral in their customer accounts. The customer seeks to free-ride--that is, purchase and sell the same securities and pay for the purchase with the proceeds of the sale. Often, free-riding schemes involve initial public offerings because broker-dealers are prohibited from financing these new issues. If the money to pay for the securities is not in the account when the securities are delivered in a delivery-versus-payment or receive-versus-payment (DVP) transaction, a bank or other financial institution that permits completion of the transaction creates a temporary overdraft in the customer's account. This overdraft is an extension of credit that is subject to Regulation U.

The typical device used by the perpetrators of a free-riding scheme is for a new customer to open a custodial agency account into which a number of broker-dealers will deliver securities or funds on a DVP basis. Although a deposit may be made into the custodial agency account, the amount of trading is greatly in excess of the original deposit causing the bank to extend its own credit to meet the payment and delivery obligations of the account. Thus, while the financial institution may be generating fees based on the activity of these accounts, it is subjecting itself to substantial losses should the market prices for the purchased

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

securities fall or failed transactions otherwise occur. In addition, other liabilities under federal banking and securities laws may be involved.

## Securities Credit Regulations

Regulation U. Because there is no exemption in Regulation U for trust activities in a bank or other financial institution,<sup>1</sup> any extension of credit in the course of settling customer securities transactions must comply with all of the provisions of Regulation U.<sup>2</sup> This includes the requirement that all extensions of credit that are secured by marginable stock be within the 50 percent margin limit set by Regulation U.

To avoid violations of the Board's securities credit regulations, the customer's account must hold sufficient funds on settlement date to pay for each transaction and the funds may not include the proceeds of their sale. If a financial institution is relying on the proceeds of the sale of securities as its source of payment for accepting delivery of the securities, Board staff, the SEC, and the courts have viewed the institution as extending credit secured by the securities to the customer. Because Regulation U limits the amount of credit that can be extended in these cases to 50 percent of the securities' current market value if the securities qualify as margin stock and, generally, in a free-riding scheme a customer's account does not have funds to pay for all such purchases or a customer instructs the institution to pay for the purchase of securities with the proceeds from those securities' sale, a banking organization that has extended credit in a free-riding scheme has violated Regulation U.

Although the proscriptions of Regulation U apply only to transactions in margin stock, free-riding in nonmargin stocks in custodial agency accounts could, as described below, result in aiding and abetting violations by the banking organization of Regulations T and X, other securities laws, and raise financial safety and soundness issues.

Regulations T and X. Because the custodial agency accounts described above are used to settle transactions effected by the customer at broker-dealers, a banking organization that opens this type of account should have some general understanding of how Regulation T restricts the customer's use of the account at the institution. Regulation T requires the use of a cash account for customer purchases or sales on a DVP basis. Section 220.8(a) of Regulation T specifies that cash account transactions are predicated on the customer's agreement that he or she will make full cash payment for securities before selling them and does not intend to sell them before making such payment. Therefore, free-riding is prohibited in a cash account. A customer who instructs his or her agent bank or other financial institution to pay for a security in reliance on the proceeds of its sale in a DVP transaction is causing, or aiding or abetting, the broker-dealer to violate the credit restrictions of Regulation T. Regulation X, which generally prohibits borrowers from willfully causing credit to be extended in contravention of Regulations T or U, also applies to the customer in such cases.

As described above, banking organizations involved in free-riding schemes may be aiding and abetting violations of Regulation T by the broker-dealers delivering securities or funds to the institutions' customers' accounts. As long as the bank or other financial institution uses its funds to complete a customer's transactions, the broker-dealers may not discover that they are selling securities to the customer in violation of their obligations under Regulation T. A similar aiding and abetting violation of Regulation X could occur with respect to violations by the customers who have used the financial institution to induce their broker-dealers to violate Regulation T.

## New Customer Inquiries and Warning Signals

Trust examiners, as well as commercial examiners, should make sure that all banking organizations follow appropriate written policies and procedures concerning the establishment of custodial agency accounts or any new account involving customer securities transactions. They should address, among other things, ways an institution can protect against free-riding schemes. One of the ways financial institutions can protect themselves is to obtain adequate background and credit information from new clients, including whether the customer intends to obtain bank credit to use the account for transactions as if it were a margin account at a broker-dealer. This type of activity requires more extensive monitoring than the typical DVP account in which no credit is extended. It would be prudent to inquire why a new customer is not utilizing the margin account services of its broker-dealers. Regulation U Form FR U-1 must be obtained and constantly updated if the account is to be used as a margin account.

It also would be advisable for the financial institution to obtain from the customer a list of broker-dealers that will be sending securities to or receiving funds from the account on a DVP basis. If it appears that a number of broker-dealers may be used on a

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

DVP basis, the banking organization should obtain an undertaking from the customer, as part of the new account agreement, that all transactions with the broker-dealer will be in conformance with Regulations T and X and that the customer is aware that a cash account security is not to be sold until it is paid for. Similarly, in obtaining instructions for settling DVP transactions for a customer, the institution should clarify that it will not pay for the purchase of securities with the proceeds from the sale of those securities.

Examiners should also ensure that banking organizations monitor such accounts closely for an initial period to detect patterns typical of free-riding, including intraday overdrafts, and ensure that sufficient funds or margin collateral are on deposit at all times. Frequent transactions in securities being offered in an initial public offering may suggest an avoidance of Regulations T and X. In the event it appears that a customer is attempting to free-ride, an institution immediately should alert the broker-dealers involved and take steps to minimize its own credit risk and legal liability.

At a minimum, examiners should also evaluate a trust institution's ability to ensure that it does not extend more credit on behalf of the banking organization to a customer than is permitted under Regulation U. Any overdraft related to a purchase or sale of margin stock is an extension of credit subject to the regulation, including overdrafts that are outstanding for less than a day. Board staff has published a number of opinions discussing the application of Regulation U to various transactions relating to free-riding in the Federal Reserve Regulatory Service. See, for example, Federal Reserve Regulatory Service, at 5-942.2 (1992); 5-942.18 (1990); and 5-942.15 (1989).

## SEC and Federal Reserve Sanctions and Enforcement Actions

As noted earlier, the SEC has exercised its broad authority to enforce the Board's securities credit regulations. This has included the initiation of several enforcement actions in federal district court against banks involved in activities similar to those outlined above, as well as the preparation of other cases that are pending. In each completed case, the SEC obtained permanent injunctions against future violations from the banks involved. The SEC also required the banks to establish credit compliance committees to formulate written policies and procedures concerning the extension of purpose credit in their securities clearance business, establish training programs for bank personnel responsible for the conduct of their securities clearance business and submit to outside audits to ascertain whether the banks met their undertakings under the injunctions.

It should be noted that under section 21 of the Securities Exchange Act of 1934, the SEC may, and has stated an intention to, seek civil money penalties in addition to federal district court injunctive actions. Civil penalties and aiding and abetting liability may be assessed by the SEC against a banking organization if the customer or its broker-dealer is found in violation of Regulations X or T, and if the financial institution has knowledge of the facts and assists the scheme -- that is, by extending credit to finance the free-riding.

In addition, the Board may institute enforcement proceedings against the banking organizations supervised by the Federal Reserve and their institution-affiliated parties involved in these activities, including cease and desist, civil money penalty assessment, and removal and permanent prohibition actions.

## Notification to State Member Banks

Reserve Bank staff should notify the state member banks, bank holding companies, and the U.S. branches and agencies of foreign banks in their Districts about the potential for violations of the Board's Regulation U and other securities credit regulations. A suggested notification letter is attached.

Please contact Scott Holz, Senior Attorney, or Angela Desmond, Senior Attorney, at (202) 452-2781, with any questions concerning the Board's margin regulations and free-riding arrangements, and Herbert A. Biern, Deputy Associate Director, at (202) 452-2620, for enforcement-related matters.

Stephen C. Schemering  
Deputy Director←

## ~~L. FFIEC EXAMINATION COUNCIL SUPERVISORY POLICY ON REPURCHASE AGREEMENTS OF DEPOSITORY INSTITUTIONS WITH SECURITIES DEALERS AND OTHERS~~

### ~~Purpose~~

~~Depository institutions and others involved with the purchase of United States Government and Agency obligations under agreements to resell (reverse repurchase agreement), have sometimes incurred significant losses. The most important factors causing these heavy losses have been inadequate credit risk management and the failure to exercise effective control over securities collateralizing the transactions.~~

~~The following minimum guidelines address the need for managing credit risk exposure to counterparties under securities repurchase agreements and for controlling the securities in those transactions, and should be followed by depository institutions that enter into repurchase agreements with securities dealers and others.~~

~~Depository institutions that actively engage in repurchase agreements are encouraged to have more comprehensive policies and controls to suit their particular circumstances. The examining staffs of the federal bank, thrift and credit union supervisory agencies will review written policies and procedures of depository institutions to determine their adequacy in light of these minimum guidelines and the scope of each depository's operations.~~

### ~~I. Credit Policy Guidelines~~

~~The apparent safety of short term repurchase agreements which are collateralized by highly liquid, U.S. Government and federal agency obligations has contributed to an attitude of complacency. Some portfolio managers have underestimated the credit risk associated with the performance of the counterparty to the transaction, and have not taken adequate steps to assure control of the securities covered by the agreement.~~

~~All depository institutions that engage in securities repurchase agreement transactions should establish written credit policies and procedures governing these activities. At a minimum, those policies and procedures should cover the following:~~

~~Written policies should establish "know your counterparty" principles. Engaging in repurchase agreement transactions in volume and in large dollar amounts frequently requires the services of a counterparty who is a dealer in the underlying securities. Some firms which deal in the markets for U.S. Government and federal agency securities are subsidiaries of, or related to, financially stronger and better known firms. However, these stronger firms may be independent of their U.S. Government securities subsidiaries and affiliates and may not be legally obligated to stand behind the transactions of related companies. Without an express guarantee, the stronger firm's financial position cannot be relied upon in assessing the creditworthiness of a counterparty.~~

~~It is important to know the legal entity that is the actual counterparty to each repurchase agreement transaction. A depository institution should know about the actual counterparty's character, integrity of management, activities, and the financial markets in which it deals. Depository institutions should be particularly careful in conducting repurchase agreements with any firm that offers terms that are significantly more favorable than those currently prevailing in the market.~~

~~In certain situations depository institutions may use, or serve as, brokers or finders in order to locate repurchase agreement counterparties or particular securities. When using or acting as this type of agent the names of each counterparty should be fully disclosed. Depository institutions should not enter into undisclosed agency or "blind brokerage" repurchase transactions in which the counterparty's name is not disclosed.~~

~~Dealings with unregulated securities dealers. A dealer in U.S. Government and federal agency obligations is not necessarily a federally insured bank or thrift, or a broker/dealer registered with the Securities and Exchange Commission. Therefore, the dealer firm may not be subject to any federal regulatory oversight.~~

~~A depository institution doing business with an unregulated securities dealer should be certain that the dealer voluntarily complies with the Federal Reserve Bank of New York's minimum capital guideline, which currently calls for liquid capital to exceed measured risk by 20 percent (that is, the ratio of a dealer's liquid capital to risk of 1.2: 1). This ratio can be calculated by a dealer~~

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

using either the Securities and Exchange Commission's Net Capital Rule for Brokers and Dealers (Rule 15c3-1) or the Federal Reserve Bank of New York's Capital Adequacy Guideline for United States Government Securities Dealers. To ensure that an unregulated dealer complies with either of those capital standards, it should certify its compliance with the capital standard and provide the following three forms of certification:

A letter of certification from the dealer that the dealer will adhere on a continuous basis to the capital adequacy standard; audited financial statements which demonstrate that as of the audit date the dealer was in compliance with the standard and the amount of liquid capital; and a copy of a letter from the firm's certified public accountant stating that it found no material weaknesses in the dealer's internal systems and controls incident to adherence to the standard.

Periodic evaluations of counterparty creditworthiness should be conducted by individuals who routinely make credit decisions and who are not involved in the execution of repurchase agreement transactions.

Prior to engaging in initial transactions with a new counterparty, depository institutions should obtain audited financial statements and regulatory filings (if any) from its counterparties, and should insist that similar information be provided on a periodic and timely basis in the future. Recent failures of government securities dealers have typically been foreshadowed by delays in producing these statements. Many firms are registered with the Securities and Exchange Commission as broker/dealers and have to file financial statements and should be willing to provide a copy of these filings.

The counterparty credit analysis should consider the financial statements of the entity that is to be the depository institution's counterparty as well as those of any related companies that could have an impact on the financial condition of the counterparty. When transacting business with a subsidiary, consolidated financial statements of a parent are not adequate. Repurchase agreements should not be entered into with any counterparty that is unwilling to provide complete and timely disclosure of its financial condition. As part of this analysis, the depository institution should make inquiry about the counterparty's general reputation and whether there have been any formal enforcement actions against the counterparty or its affiliates by state or federal securities regulators.

Maximum position and temporary exposure limits for each approved counterparty should be established based upon credit analysis performed. Periodic reviews and updates of those limits are necessary.

Individual repurchase agreement counterparty limits should consider overall exposure to the same or related counterparty throughout the depository institution. Repurchase agreement counterparty limitations should include the overall permissible dollar positions in repurchase agreements, maximum repurchase agreement maturities and limits on temporary exposure that may result from decreases in collateral values or delays in receiving collateral.

**Lending Limitations.** Federally chartered savings institutions and federal credit unions are subject to all federal regulations in this area. State chartered banks or savings institutions should consult with their counsel and/or state banking or thrift authorities as to the applicability of state lending restrictions to repurchase transactions.

Except as otherwise provided in applicable agency regulations and state law, it should be assumed that unless the depository institution's interest in securities held as collateral under a repurchase agreement is assured, a repurchase agreement transaction with any single counterparty will be subject to the lending limitations applicable to that institution. Conversely, the market value of securities sold under a repurchase agreement in excess of the amount of proceeds received by the depository institution could be viewed as an unsecured extension of credit to the repurchase agreement counterparty subject to the depository institution's lending limits.

The application of lending limitations on loans by national banks to certain types of repurchase transactions is currently under review by the Comptroller of the Currency. Until this review is completed, national banks as a matter of prudent banking should treat repurchase agreements as if they are subject to the lending limit unless the bank has control of the underlying securities.

## **II. Guidelines for Controlling Repurchase Agreement Collateral**

Repurchase agreements can be a useful asset and liability management tool, but repurchase agreements can expose a depository institution to serious risks if they are not managed appropriately. It is possible to reduce repurchase agreement risk if the

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

~~depository institution negotiates written agreements with all repurchase agreement counterparties and custodian banks. Compliance with the terms of these written agreements should be monitored on a daily basis. If prudent management control requirements of repurchase agreements are too burdensome for a depository institution, other asset/liability management tools should be used.~~

~~The marketplace perceives repurchase agreement transactions as similar to lending transactions collateralized by highly liquid government securities. However, experience has shown that the collateral securities will probably not serve as protection if the counterparty becomes insolvent or fails, and the purchasing institution does not have control over the securities. This policy statement provides general guidance on the steps depository institutions should take to protect their interest in the securities underlying repurchase agreement transactions (see "C. Control of Securities,") However, ultimate responsibility for establishing adequate procedures rests with management of the institution. Management should obtain a written legal opinion as to the adequacy of the procedures utilized to establish and protect the depository institution's interest in the underlying collateral.~~

## General Requirements

~~A written agreement specific to a repurchase agreement transaction or master agreement governing all repurchase agreement transactions should be entered into with each counterparty. The written agreement should specify all the terms of the transaction and the duties of both the buyer and seller. Senior managers of depository institutions should consult legal counsel regarding the content of the repurchase and custodial agreements. The repurchase and custodial agreements should specify, but should not be limited to, the following:~~

- ~~1. acceptable types and maturities of collateral securities;~~
- ~~2. initial acceptable margin for collateral securities of various types and maturities;~~
- ~~3. margin maintenance, call, default and sellout provisions;~~
- ~~4. rights to interest and principal payments;~~
- ~~5. rights to substitute collateral; and~~
- ~~6. the persons authorized to transact business on behalf of the depository institution and its counterparty.~~
- ~~7. Confirmations. Some repurchase agreement confirmations may contain terms that attempt to change the depository institution's rights in the transaction. The depository institution should obtain and compare written confirmations for each repurchase agreement transaction to be certain that the information on the confirmation is consistent with the terms of the agreement. The confirmation should identify specific collateral securities.~~
- ~~8. Control of Securities. As a general rule, a depository institution should obtain possession or control of the underlying securities and take necessary steps to protect its interest in the securities. The legal steps necessary to protect its interest may vary with applicable facts and law and accordingly should be undertaken with the advice of counsel. Additional prudential management controls may include:~~
  - ~~○ Direct delivery of physical securities to the institution, or of book entry securities by appropriate entry in an account maintained in the name of the depository institution by a Federal Reserve bank which maintains a book entry system for U.S. Treasury securities and certain agency obligations (for further information as to the procedures to be followed, contact the Federal Reserve bank for the district in which the depository institution is located);~~
  - ~~○ delivery of either physical securities to, or in the case of book entry securities, making appropriate entries in the books of a third party custodian designated by the depository institution under a written custodial agreement which explicitly recognizes the depository institution's interest in the securities as superior to that of any other person; or~~
  - ~~○ appropriate entries on the books of a third party custodian acting pursuant to a tripartite agreement with the depository institution and the counterparty, ensuring adequate segregation and identification of either physical or book entry securities.~~

~~Where control of the underlying securities is not established, the depository institution may be regarded only as an unsecured general creditor of the insolvent counterparty. In such instance, substantial losses are likely to be incurred. Accordingly, a depository institution should not enter into a repurchase agreement without obtaining control of the securities unless all of the following minimum procedures are observed: (1) it is completely satisfied as to the creditworthiness of the counterparty; (2) the transaction is within credit limitations that have been pre approved by the board of directors, or a committee of the board, for unsecured transactions with the counterparty; (3) periodic credit evaluations of the counterparty are conducted; and (4) the depository institution has ascertained that collateral segregation procedures of the counterparty are adequate. Unless prudential~~

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

~~internal procedures of these types are instituted and observed, the depository institution may be cited by its financial supervisory agency for engaging in unsafe or unsound practices.~~

~~All receipts and deliveries of either physical or book entry securities should be made according to written procedures, and third party deliveries should be confirmed in writing directly by the custodian. It is not acceptable to receive confirmation from the counterparty that the securities are segregated in a depository institution's name with a custodian; the depository institution should, however, obtain a copy of the advice of the counterparty to the custodian requesting transfer of the securities to the depository institution. Where securities are to be delivered, payment for securities should not be made until the securities are actually delivered to the depository institution or its agent. The custodial contract should provide that the custodian takes delivery of the securities subject to the exclusive direction of the depository institution.~~

~~Substitution of securities should not be allowed without the prior consent of a depository institution. The depository institution should give its consent before the delivery of the substitute securities to the depository institution or a third party custodian. Any substitution of securities should take into consideration the following discussion of "margin requirements."~~

- ~~○ Margin Requirements. The amount paid by a depository institution under the repurchase agreement should be less than the market value of the securities, including the amount of any accrued interest, with the difference representing a predetermined margin. Factors to be considered in establishing an appropriate margin include the size and maturity of the repurchase transaction, the type and maturity of the underlying securities, and the creditworthiness of the counterparty. Margin requirements on U.S. Government and federal agency obligations underlying repurchase agreements should allow for the anticipated price volatility of the security until the maturity of the repurchase agreement. Less marketable securities may require additional margin to compensate for less liquid market conditions. Written repurchase agreement policies and procedures should require daily mark to market of repurchase agreement securities to the bid side of the market. Repurchase agreements should provide for additional securities or cash to be placed with the depository institution or its custodian bank to maintain the margin within the predetermined level.~~
- ~~○ Margin calculations should also consider accrued interest on underlying securities and the anticipated amount of accrued interest over the term of the repurchase agreement, the date of interest payment and which party is entitled to receive the payment. In the case of pass through securities, anticipated principal reductions should also be considered when determining margin adequacy.~~
- ~~○ Prudent management procedures should be followed in the administration of any repurchase agreement. Longer term repurchase agreements require management's daily attention to the effects of securities substitutions, margin maintenance requirements (including consideration of any coupon interest or principal payments) and possible changes in the financial condition of the counterparty. Engaging in open repurchase agreement transactions without maturity dates may be regarded as an unsafe and unsound practice unless the depository institution has retained rights to terminate the transaction quickly to protect itself against changed circumstances. Similarly, automatic renewal of short term repurchase agreement transactions without reviewing collateral values and adjusting collateral margin may be regarded as an unsafe and unsound practice. If additional margin is not deposited when required, the depository institution's rights to sell securities or otherwise liquidate the repurchase agreement should be exercised without hesitation.~~
- ~~○ Overcollateralization. A depository institution should use current market values, including the amount of any accrued interest, to determine the price of securities that are sold under repurchase agreements. Counterparties should not be provided with excessive margin. Thus, the written repurchase agreement contract should provide that the counterparty must make additional payment or return securities if the margin exceeds agreed upon levels. When acquiring funds under repurchase agreements it is prudent business practice to keep at a reasonable margin the difference between the market value of the securities delivered to the counterparty and the amount borrowed. The excess market value of securities sold by a depository institution may be viewed as an unsecured loan to the counterparty subject to the unsecured prudential limitations for the depository institution and should be treated accordingly for credit policy and control purposes.~~

~~By order of the Board of Directors, November 12, 1985.~~

~~Source: FDIC bank letter (BL-43-85), dated November 18, 1985~~

## ~~M. FFIEC EXAMINATION COUNCIL SUPERVISORY POLICY ON SECURITIES LENDING~~

### **Purpose**

~~Financial institutions are lending securities with increasing frequency. In some instances a financial institution may lend its own investment or trading account securities. More and more often, however, financial institutions lend customers' securities held in custody, safekeeping, trust or pension accounts. Not all institutions that lend securities or plan to do so have relevant experience. Because the securities available for lending often greatly exceed the demand for them, inexperienced lenders may be tempted to ignore commonly recognized safeguards. Bankruptcies of broker-dealers has heightened regulatory sensitivity to the potential for problems in this area. Accordingly, we are providing the following discussion of guidelines and regulatory concerns.~~

### **Securities Lending Market**

~~Securities brokers and commercial banks are the primary borrowers of securities. They borrow securities to cover securities fails (securities sold but not available for delivery), short sales, and option and arbitrage positions. Securities lending, which used to involve principally corporate equities and debt obligations, increasingly involves loans of large blocks of U.S. government and federal agency securities.~~

~~Securities lending is conducted through open-ended "loan" agreements, which may be terminated on short notice by the lender or borrower. The objective of such lending is to receive a safe return in addition to the normal interest or dividends. Securities loans are generally collateralized by U.S. government or federal agency securities, cash, or letters of credit. At the outset, each loan is collateralized at a predetermined margin. If the market value of the collateral falls below an acceptable level during the time a loan is outstanding, a margin call is made by the lender institution. If a loan becomes over-collateralized because of appreciation of collateral or market depreciation of a loaned security, the borrower usually has the opportunity to request the return of any excessive margin.~~

~~When a securities loan is terminated, the securities are returned to the lender and the collateral to the borrower. Fees received on securities loans are divided between the lender institution and the customer account that owns the securities. In situations involving cash collateral, part of interest earned on the temporary investment of cash is returned to the borrower and the remainder is divided between the lender institution and the customer account that owns the securities.~~

### **Definitions Of Capacity**

~~Securities lending may be done in various capacities and with differing associated liabilities. It is important that all parties involved understand in what capacity the lender institution is acting. For the purposes of these guidelines, the relevant capacities are:~~

~~*Principal:* A lender institution offering securities from its own account is acting as principal. A lender institution offering customers' securities on an undisclosed basis is also considered to be acting as principal.~~

~~*Agent:* A lender institution offering securities on behalf of a customer owner is acting as an agent. For the lender institution to be considered a bona fide or "fully disclosed" agent, it must disclose the names of the borrowers to the customer owners (or give notice that names are available upon request), and must disclose the names of the customer owner to borrowers (or give notice that names are available upon request). In all cases the agent's compensation for handling the transaction should be disclosed to the customer owner. Undisclosed agency transactions, i.e. "blind brokerage" transactions in which participants cannot determine the identity of the counterparty, are treated as if the lender institution were the principal. (See definition above.)~~

~~*Directed Agent:* A lender institution which lends securities at the direction of the customer owner is acting as a directed agent. The customer directs the lender institution in all aspects of the transaction, including to whom the securities are loaned, the terms of the transaction (rebate rate and maturity/call provisions on the loan), acceptable collateral, investment of any cash collateral, and collateral delivery.~~

~~*Fiduciary:* A lender institution which exercises discretion in offering securities on behalf of and for the benefit of customer owners is acting as a fiduciary. For purposes of these guidelines, the underlying relationship may be as agent, trustee, or custodian.~~

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

~~*Finder:* A finder brings together a borrower and a lender of securities for a fee. Finders do not take possession of the securities or collateral. Securities and collateral are delivered directly by the borrower and the lender without the involvement of the finder. The finder is simply a fully disclosed intermediary.~~

## **Guidelines**

~~All financial institutions that participate in securities lending should establish written policies and procedures governing these activities. At a minimum, policies and procedures should cover each of the topics in these guidelines.~~

## **Recordkeeping**

~~Before establishing a securities lending program, a financial institution must establish an adequate recordkeeping system. At a minimum, the system should produce daily reports showing which securities are available for lending, and which are currently lent, outstanding loans by borrower, outstanding loans by account, new loans, returns of loaned securities, and transactions by account. These records should be updated as often as necessary to ensure that the lender institution fully accounts for all outstanding loans, that adequate collateral is required and maintained, and that policies and concentration limits are being followed.~~

## **Administrative Procedures**

~~All securities lent and all securities standing as collateral must be marked to market daily. Procedures must ensure that any necessary calls for additional margin are made on a timely basis.~~

~~In addition, written procedures should outline how to choose the customer account that will be the source of lent securities when they are held in more than one account. Possible methods include: loan volume analysis, automated queue, a lottery, or some combination of these methods. Securities loans should be fairly allocated among all accounts participating in a securities lending program.~~

~~Internal controls should include operating procedures designed to segregate duties and timely management reporting systems. Periodic internal audits should assess the accuracy of accounting records, the timeliness of management reports, and the lender institution's overall compliance with established policies and procedures.~~

## **Credit Analysis and Approval of Borrowers**

~~In spite of strict standards of collateralization, securities lending activities involve risk of loss. Such risks may arise from malfeasance or failure of the borrowing firm or institution. Therefore, a duly established management or supervisory committee of the lender institution should formally approve, in advance, transactions with any borrower.~~

~~Credit and limit approvals should be based upon a credit analysis of the borrower. A review should be performed before establishing such a relationship and reviews should be conducted at regular intervals thereafter. Credit reviews should include an analysis of the borrower's financial statement, and should consider capitalization, management, earnings, business reputation, and any other factors that appear relevant. Analyses should be performed in an independent department of the lender institution, by persons who routinely perform credit analyses. Analyses performed solely by the person(s) managing the securities lending program are not sufficient.~~

## **Credit and Concentration Limits**

~~After the initial credit analysis, management of the lender institution should establish an individual credit limit for the borrower. That limit should be based on the market value of the securities to be borrowed, and should take into account possible temporary (overnight) exposures resulting from a decline in collateral values or from occasional inadvertent delays in transferring collateral. Credit and concentration limits should take into account other extensions of credit by the lender institution to the same borrower or related interests. Such information, if provided to an institution's trust department conducting a securities lending program, would not be considered material inside information and therefore, not violate "Chinese Wall" policies designed to protect against~~

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

~~the misuse of material inside information. Violation of securities laws would arise only if material inside information were used in connection with the purchase or sale of securities.~~

~~Procedures should be established to ensure that credit and concentration limits are not exceeded without proper authorization from management.~~

~~When a lender institution is lending its own securities as principal, statutory lending limits may apply. For national banks and federal savings associations, the limitations in 12 USC 84 apply. For state chartered institutions, state law and applicable federal law must be considered. Certain exceptions may exist for loans that are fully secured by obligations of the United States government and federal agencies.~~

## **Collateral Management**

~~Securities borrowers pledge and maintain collateral at least 100 percent of the value of the securities borrowed. The minimum amount of excess collateral, or "margin", acceptable to the lender institution should relate to price volatility of the loaned securities and the collateral (if other than cash).~~

~~Generally, the minimum initial collateral on securities loans is at least 102 percent of the market value of the lent securities plus, for debt securities, any accrued interest. Collateral must be maintained at the agreed margin. A daily "mark to market" or valuation procedure must be in place to ensure that calls for additional collateral are made on a timely basis. The valuation procedures should take into account the value of accrued interest on debt securities.~~

~~Securities should not be lent unless collateral has been received or will be received simultaneously with the loan. As a minimum step toward perfecting the lender's interest, collateral should be delivered directly to the lender institution or an independent third party trustee.~~

## **Cash as Collateral**

~~When cash is used as collateral, the lender institution is responsible for making it income productive. Lenders should establish written guidelines for selecting investments for cash collateral. Generally, a lender institution will invest cash collateral in repurchase agreements, master notes, a short term investment fund, U.S. or Eurodollar certificates of deposits, commercial paper or some other type of money market instrument. If the lender institution is acting in any capacity other than as principal, the written agreement authorizing the lending relationship should specify how cash collateral is to be invested.~~

~~Investing cash collateral in liabilities of the lender institution or its holding company would be an improper conflict of interest unless that strategy was specifically authorized in writing by the owner of the lent securities. Written authorizations for participating accounts are further discussed later in these guidelines.~~

## **Letters of Credit as Collateral**

~~Since May 1982, letters of credit have been permitted as collateral in certain securities lending transactions outlined in Federal Reserve Regulation T. If a lender institution plans to accept letters of credit as collateral, it should establish guidelines for their use. Those guidelines should require a credit analysis of the financial institution issuing the letter of credit before securities are lent against that collateral. Analyses must be periodically updated and reevaluated. The lender institution should also establish concentration limits for the institutions issuing letters of credit and procedures should ensure they are not exceeded. In establishing concentration limits on letters of credit accepted as collateral, the lender institution's total outstanding credit exposures from the issuing institution should be considered.~~

## **Written Agreements**

~~Securities should be lent only pursuant to a written agreement between the lender institution and the owner of the securities specifically authorizing the institution to offer the securities for loan. The agreement should outline the lender institution's authority to reinvest cash collateral (if any) and responsibilities with regard to custody and valuation of collateral. In addition, the~~

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

~~agreement should detail the fee or compensation that will go to the owner of the securities in the form of a fee schedule or other specific provision. Other items which should be covered in the agreement have been discussed earlier in these guidelines.~~

~~A lender institution must also have written agreements with the parties who wish to borrow securities. These agreements should specify the duties and responsibilities of each party. A written agreement may detail: acceptable types of collateral (including letters of credit); standards for collateral custody and control, collateral valuation and initial margin, accrued interest, marking to market, and margin calls; methods for transmitting coupon or dividend payments received if a security is on loan on a payment date; conditions which will trigger the termination of a loan (including events of default); and acceptable methods of delivery for loaned securities and collateral.~~

## **Use of Finders**

~~Some lender institutions may use a finder to place securities, and some financial institutions may act as finders. A finder brings together a borrower and a lender for a fee. Finders should not take possession of securities or collateral. The delivery of securities loaned and collateral should be direct between the borrower and the lender. A finder should not be involved in the delivery process.~~

~~The finder should act only as a fully disclosed intermediary. The lender institution must always know the name and financial condition of the borrower of any securities it lends. If the lender institution does not have that information it and its customers are exposed to unnecessary risks.~~

~~Written policies should be in place concerning the use of finders in a securities lending program. These policies should cover the circumstances in which a finder will be used, which party pays the fee (borrower or lender), and which finders the lender institution will use.~~

## **Employee Benefit Plans**

~~The Department of Labor has issued two class exemptions which deal with securities lending programs for employee benefit plans covered by the Employee Retirement Income Security Act (ERISA) – Prohibited Transaction Exemption 81-6 (46 FR 7527 (January 23, 1981), supplemented 52 FR 18754 (May 19, 1987)), and Prohibited Transaction Exemption 82-63 (47 FR 14804 (April 6, 1982) and correction published at 47 FR 16437 (April 16, 1982)). The exemptions authorize transactions which might otherwise constitute unintended "prohibited transactions" under ERISA. Any institution engaged in lending of securities for an employee benefit plan subject to ERISA should take all steps necessary to design and maintain its program to conform with these exemptions. Prohibited Transaction Exemption 81-6 permits the lending of securities owned by employee benefit plans to persons who could be "parties in interest" with respect to such plans, provided certain conditions specified in the exemption are met. Under those conditions neither the borrower nor an affiliate of the borrower can have discretionary control over the investment of plan assets, or offer investment advice concerning the assets, and the loan must be made pursuant to a written agreement. The exemption also establishes a minimum acceptable level for collateral based on the market value of the loaned securities.~~

~~Prohibited Transaction Exemption 82-63 permits compensation of a fiduciary for services rendered in connection with loans of plan assets that are securities. The exemption details certain conditions which must be met.~~

## **Indemnification**

~~Certain lender institutions offer participating accounts indemnification against losses in connection with securities lending programs. Such indemnifications may cover a variety of occurrences including all financial loss, losses from a borrower default, or losses from collateral default. Lender institutions that offer such indemnification should obtain a legal opinion from counsel concerning the legality of their specific form of indemnification under federal and/or state law.~~

~~A lender institution which offers an indemnity to its customers may, in light of other related factors, be assuming the benefits and, more importantly, the liabilities of a principal. Therefore, lender institutions offering indemnification should also obtain written opinions from their accountants concerning the proper financial statement disclosure of their actual or contingent liabilities.~~

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Appendix C

## Regulatory Reporting

~~Securities borrowing and lending transactions should be reported by commercial banks according to the Instructions for the Consolidated Reports of Condition and Income and by thrifts according to Thrift Financial Report instructions.~~

~~By order of the Board of Directors, July 22, 1997.~~

~~Source: 62 Fed. Reg. 40816, July 30, 1997, effective July 30, 1997←~~

~~N.L.~~

S

## TATE STATUTES AUTHORIZING FIDUCIARY INVESTMENTS IN PROPRIETARY MUTUAL FUNDS

Revised Through September 1, 2000

### State Statutes

### Authorizing Fiduciary Investments in Proprietary Mutual Funds

<i>State</i>	<i>Citation</i>	<i>Fees</i>	<i>Disclosure to Whom/How/When/What</i>	<i>Other</i>
AL	Ala. Code § 19-3-120.1	Allows fee as investment advisor and as trustee.	To the current income beneficiaries.  By prospectus, account statement or otherwise.  Requires disclosure of the basis (expressed as a percentage of asset value or otherwise) of fees.	Mutual Fund Investment Restrictions  Portfolio of investment trust or company must consist of investments authorized by law or trust agreement.
AK	Alaska Stat. § 13.36.225	Prudent Investor Rule: Fees to be "appropriate and reasonable" in relation to trust investments		
AZ*	Ariz. Rev. Stat. Ann. 6-246		To all persons whose funds are invested in the company or trust.  In the statement of the fiduciary account  That the bank or trust company provides services for and receives fees from the open-end or closed-end management company or investment trust	Mutual Fund Investment Restrictions  Portfolio of investment company must consist of investments permitted by applicable fiduciary instrument
AR	Ark. Stat. Ann § 28-71-104	Allows fees as an investment advisor and a trustee		Mutual Fund Investment Restrictions

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Appendix C

				Portfolio of investment company must consist of investments permitted by applicable fiduciary instrument
CA	Cal. Finance Code § 1561.1	Fees received from trust accounts "reasonably attributable" to investment advisory or investment management services to the trust shall be reduced by any fees that are received for providing "investment advisory" or "investment management" services to the mutual fund.	At least annually by prospectus, the following items must be disclosed to trust account holders: Statement of the trust account and brief description of the fees received by the bank trust department for its investment advisory or investment management services for the mutual fund.	
CO	Colo. Rev. Stat. § 11-10-107  (1990)	Allows fee as investment advisor and as trustee		
CT*	Conn. Gen. Stat 45a-235,-209	Unless specifically permitted by governing instrument, neither investment advisory fee nor trustee fee may be charged	Annually to each current income beneficiary  By mailing separate notices  Notices shall cover (1) disclosure of provision of services and compensation and (2) provide prospectus, statement, (and/or?) letter.	Limits on Authorization  Investment permissible if:  Not prohibited by governing instrument  Portfolio consists of investments not prohibited  Duty of prudence not affected
DE	Del. Code Ann. tit. 12, § 3312	Permits investment advisor fee.  Bank may receive fiduciary fees or commissions from account at the same rate bank would be entitled to receive if account was not invested in mutual funds	To all current income beneficiaries  Disclose the full amount of fees or commissions received by the bank	

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Appendix C

DC*	DC Code Ann. § 21-- 1721	Fees may not exceed "customary or prevailing amount" charged by bank for providing comparable service to nonfiduciary accounts	To all current income beneficiaries  Disclose the rate, formula or other method for which bank receives services to mutual fund	Investment expressly allowed
FL	Fla. Stat. Ann. § 660.417 & § 737.402		To all persons to whom statements of such account are rendered  Disclose the basis upon which compensation is calculated	Mutual Fund Investment Restrictions  Portfolio of investment company must consist substantially of investments not prohibited by the governing instrument
GA	Ga. Code Ann. § 3-8- 3,-4	Allows fee as investment advisor and as trustee		
HI	Haw. Rev. Stat. § 412: 8- 400	Prudent Investor Rule: Fees to be "appropriate and reasonable" in relation to trust investments		
ID	Idaho Code § 68-404A	Allows fee as investment advisor and as trustee		
IL	Ill. Ann. Stat. 5/5.1	Allows fee as investment advisor and as trustee if total compensation paid by trust estate as trustee fees and mutual fund fees, including any advisory or management fees, are reasonable.  Trustee may receive 12b-1 fees equal to the amount of those fees that would be paid to any other party		
IN	Ind. Code Ann. § 28-1- 12-3  (West Supp. 1992)	Allows fee as investment advisor and as trustee		
IA	Iowa Code Ann. 633.123(2)	Allows fee as investment advisor and as trustee		Mutual Fund Investment Restrictions

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Appendix C

				Portfolio of investment company or trust must consist substantially of investments not prohibited by the governing instrument
KS*	Kan. Stat. Ann. § 17-5005(c)	Allows fee as investment advisor and as trustee  Total of all fees, charges and compensation from fiduciary account, and remuneration for services provided by bank to mutual fund, shall be reasonable	To all current income beneficiaries  By statement, prospectus, or otherwise  Conspicuously disclose the rate, formula, or other method of compensation for services by bank to mutual fund	Fiduciary Standard  Investment must be in best interest of fiduciary account beneficiary and must meet Prudent Investor standard
KY	Ky. Rev. Stat. Ann. § 386.020(g)	statute does not specify whether fiduciary may receive reasonable compensation for investment advisor services		
LA	La. Rev. Stat. Ann. § 9:2127	Allows fee as investment advisor and as trustee	To all persons having an ownership, contractual, or beneficial interest in such accounts  By prospectus, account statement, or otherwise  The basis on which fee is calculated expressed as a percentage of asset value or otherwise	Mutual Fund Investment Restrictions  Portfolio of investment company or trust must consist substantially of investments not prohibited by the governing instrument
ME	Me. Rev. Stat. Ann. 18-A Section 7-408	Fees are limited to either the investment advisory fee or the trustee fee	Disclosure of any affiliated relationship must be given	Limits on Authorization  Investment not permitted if prohibited by instrument, judgement, decree or order creating the fiduciary relationship
MD	Md. Est. & Trusts Code Ann. § 15-106	Allows fee as investment advisor and as trustee if disclosures given or beneficiary consent received	To current income beneficiaries  Disclose description of services, and the rate, formula or other method by which compensation is paid	Limits on Authorization  Investment must be authorized by the agreement or instrument that gives corporate fiduciary

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Appendix C

				<p>investment authority, or by court order</p> <p>Investment Restrictions</p> <p>Investment limited to no-load open-end management type investment company or trust that does not impose a contingent sales charge or distribution charge on investment of fiduciary assets</p>
MA*	Mass. Ann. Laws Chapter 167G section 3(11)	<p>Either:</p> <p>Investment advisory fees to which trustee entitled to receive as trustee shall be reduced by the amount of any investment advisory fees paid to the trustee by the investment company, or</p> <p>Investment advisory fees paid to the trustee by the investment company shall be received in lieu of any investment advisory fees that the trustee would otherwise be entitled to receive for the investment management of the trust</p>	In any written communication or account statement reflecting such a purchase, bank shall disclose any capacity in which it acts for the issuer of the securities	<p>Limits on Authorization</p> <p>Purchase of any investment company for which bank acts as adviser is allowed unless there is an express provision to the contrary in the instrument creating trust relationship.</p> <p>Miscellaneous</p> <p>General standard of prudence required of fiduciaries still applies</p> <p>Any bonds or securities shall have sufficient liquidity to satisfy the principles of fiduciary investment</p>
MI	Mich. Comp. Laws § 700.1508	Prudent Investor Rule: Fees to be "appropriate and reasonable" in relation to trust investments		
MN	Minn. Stat. § 48A.07	Allows fee as investment advisor and as trustee in the absence of an express prohibition in trust instrument	<p>To all current income beneficiaries</p> <p>Disclose the rate, formula and method of compensation</p>	

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Appendix C

MS	Miss. Code Ann. § 81-5-33	Allows fee as investment advisor and as trustee if total compensation is reasonable	To all current income beneficiaries  By statement, prospectus or otherwise  Disclose the basis, expressed as a percentage of asset value or otherwise, upon which compensation is calculated	
MO	Mo. Rev. Stat. 362.550(11)	Bank entitled to only normal fiduciary fees		
MT*	Mont. Code Ann § 32-1-420	Allows fee as investment advisor and as trustee unless expressly prohibited in trust instrument	To all current income beneficiaries  The rate, formula and method of compensation	
NE	1993 Rev. Stat. § 30-3205	Bill allows fee as investment advisor and as trustee if disclosures made	To all persons entitled to receive statements of account activity  Initially by prospectus and at least annually thereafter by account statement or any other written means  Disclose the basis of the compensation as investment advisor expressed as a percentage of the asset value, a percentage of the income earned, or the actual amount charged	Consents Required  Must be consented to in writing by all persons entitled to receive statements of account activity  Miscellaneous  Portfolio of investment company or trust must substantially consist of investments not prohibited by the governing instrument
NV	Nev. Rev. Stat. Ann. § 669.225	Allows fee as investment advisor and as trustee if disclosures made	To the person currently receiving the benefits of the fiduciary relationship  By prospectus, statement of account, or otherwise  Disclose the manner in which compensation is calculated	Mutual Fund Investment Restrictions  Portfolio of investment company or trust must substantially consist of investments not prohibited by the governing instrument
NH	N.H. Rev. Stat. Ann. § 384:65	Two categories of permissible fees from mutual fund providers: (1) investment advisory fees that the fiduciary is entitled to receive as trustee reduced by the amount of any investment	Written communications to trust account holders must reflect the purchase of such securities, the nature of the relationship, and whether such bank or affiliate received any fee for providing such services.	Fiduciary purchases of proprietary mutual fund stock must be expressly authorized by the trust instrument, a court order, the written

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Appendix C

		advisory fees paid to the fiduciary by the investment company or investment trust; and (2) investment advisory fees paid to the fiduciary from an investment company in lieu of any investment advisory fees that the fiduciary would otherwise be entitled to receive for the investment management of the trust account.		consent of the grantor of the trust, or the written consent of the beneficiaries of the trust.
NJ	N.J.S. 3B: 14-23(W)	Allows for either investment advisor or trustee fee		Limits on Authorization  No written objection is received prior to the initial investment, after all current income beneficiaries are provided 30 days written notice of the bank's intent to invest fiduciary assets
NM	1993 N.M. Laws 51 § 46-2A-1		Disclosure required	
NY	N.Y. Estate Powers & Trusts Law ("EPTL") § 11-2.2(b)(1)	fiduciary shall elect annually to receive either its fiduciary's commissions or its fee as investment advisor		Limits on Authorization  Investment permitted unless trust document, will or order appointing the fiduciary provides otherwise
NC	1993 N.C. Sess. Laws § 32-27  (ratified 6-7-93)	Allows for reasonable fee as investment advisor and as a trustee	To all current income beneficiaries Conspicuously by statement, prospectus or otherwise  Disclose the rate, formula or other method by which the remuneration for those services is determined. The trustee fee must also be disclosed.	
ND	N.D. Cent. Code §§ 4-9-105 and -107	Prudent Investor Rule: Fees to be "appropriate and reasonable" in relation to trust investments		

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

## Appendix C

OH	Ohio Rev. Code Ann. § 1109.10(H)	Allows fees as investment advisor and as trustee	<p>To all persons entitled to receive statements of account activity</p> <p>By prospectus, account statement, or any other means</p> <p>At least annually</p> <p>Disclosure of fee charged as a percentage of either asset value or income earned or actual amount charged.</p> <p>Disclosure in at least ten-point boldface type, that the mutual fund is not insured or guaranteed by the FDIC or any other governmental agency</p>	In any periodic statements, mutual fund must report the net asset value of the shares comprising the investment of the trust fund in the affiliated investment company
OK	Okl. St. § 175.55	Allows for either trustee or investment advisor fee		
OR	Or. Rev. Stat. § 709.175	Does not specify whether fiduciary may receive reasonable compensation for investment advisor services		
PA	20 Pa. Cons. Stat. § 7314.1	Allows for trustee and investment advisor fees	<p>To all persons to whom statements of the accounts are rendered</p> <p>By prospectus, account statement or otherwise</p> <p>Disclosure of the basis upon which compensation is calculated, expressed as a percentage of asset value or otherwise</p>	<p>Mutual Fund Investment Restrictions</p> <p>Portfolio of investment company must substantially consist of investments not prohibited by the governing instrument</p>
RI	R.I. Gen. Laws § 18-15-5,-7,-9	Consistent with Prudent Investor Rule		
SC	S.C. Code Ann. § 62-7-302	Allows for trustee and investment advisor fees		
SD	S.D. Codified Laws Ann. Section 55-1A-9	Allows for trustee and investment advisor fees	<p>To all current income beneficiaries</p> <p>Disclose the rate, formula and method of the compensation</p>	
TN	Tenn Code Ann. § 35-3-117(h)	Allows for trustee and investment advisor fees		

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Appendix C

TX	Tex. Property Code Ann. Section 113.053(g)  (Vernon)	Allows for trustee and investment advisor fees	Disclose compensation by prospectus, account statement, or otherwise	Limits on Authorization  Executor or administrator may not invest unless authorized by court  Miscellaneous  Portfolio of investment company must substantially consist of investments not prohibited by the governing instrument
UT	Utah Code Ann. § 75-7-402	Allows for trustee and investment advisor fees		
VA	Va. Code Ann. § 26-44.1	Cannot take fee as investment advisor and as trustee unless expressly agreed to in writing by creator of trust or affected beneficiary  Compensation for such advice and services shall not exceed the customary or prevailing amount that is charged by a fiduciary for providing comparable advice and services for the benefit of nonfiduciary accounts	To all current income beneficiaries of an account  By prospectus, statement of the account, or otherwise  Disclose the rate, formula, or other method by which compensation is received or to be received	
WA*	Wash. Rev. Code § 11.100.35	Allows for investment advisor and trustee fees	To each person to whom a regular periodic accounting would ordinarily be rendered under trust instrument, or upon request  Prospectus must be furnished to above	
WV	W.Va. § 44-6-9	Allows for fee as investment advisor and as trustee		Mutual Fund Investment Restrictions  Portfolio of investment company must substantially consist of investments not prohibited by the governing instrument.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Appendix C

WI	Wis. Stat. 881.01	Allows for fee as either advisor or as trustee. Bank or trust company must waive its fiduciary fee for the assets that it invests in proprietary mutual fund or its investment advisory fee.		
WY	Wyo. Stat. Ann §§ 4-9-105, 4-9-107	Prudent Investor Rule: Fees to be "appropriate and reasonable" in relation to trust investments		

←

## **Q.M. SUPERVISORY GUIDANCE REGARDING THE INVESTMENT OF FIDUCIARY ASSETS IN MUTUAL FUNDS AND POTENTIAL CONFLICTS OF INTEREST S**

*The Board of Governors of the  
Federal Reserve System  
Washington, D. C. 20551  
Division of Banking  
Supervision and Regulation*

*SR 99-7 (SPE)*

*March 26, 1999*

*to the officer in charge of supervision and appropriate  
supervisory and examination staff at each federal  
Reserve Bank and to each domestic and foreign banking organization supervised by the Federal Reserve.*

*Subject: Supervisory Guidance Regarding the Investment of Fiduciary Assets in Mutual Funds and Potential Conflicts of Interest*

### Summary

Increasingly, banks and trust institutions are encountering various direct or indirect financial incentives to place trust assets with particular mutual funds. These incentives range from payments structured as reimbursements for services or for transferring business to an unaffiliated fund family, to the financial benefits arising from the use of mutual funds that are managed by the institution or an affiliate. In some cases, such as service fees for administrative and record-keeping functions performed by the trust institution, the permissibility of such payments may be specifically addressed under state law. In the case of other financial incentives, guidance under applicable law may be less clear. In all cases, however, decisions to place fiduciary assets in particular investments must be consistent with the underlying trust documents and must be undertaken in the best interest of the trust beneficiary.

The primary supervisory concern is that an institution may fail to act in the best interest of beneficiaries if it stands to benefit independently from a particular investment. As a result, an institution may expose itself to an increased risk of legal action by account beneficiaries, as well as to potential violations of law or regulation. The Federal Reserve is issuing this guidance to help institutions minimize these risks and to help ensure that their activities meet fiduciary standards.

### Background

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Certain mutual fund providers offer compensation in the form of "service" fees to institutions that invest fiduciary assets in particular mutual funds. These fees, referred to variously as shareholder, sub-accounting or administrative service fees, are structured as payments to reimburse the institution for performing standard recordkeeping and accounting functions for the institution's fiduciary accounts, such as maintaining shareholder subaccounts and records, transmitting mutual fund communications as necessary, and arranging mutual fund transactions. These fees are typically based on a percentage or basis point amount of the dollar value of assets invested, or on transaction volume.

In recent years, nearly every state legislature has modified its laws explicitly to allow the acceptance of such fees by fiduciaries under certain conditions. These conditions often include compliance with standards of prudence, quality and appropriateness for the account, and a determination of the "reasonableness" of the fees received by the institution. The Office of the Comptroller of the Currency (OCC) has also adopted these general standards for national banks.<sup>1</sup> However, the Employee Retirement Income Security Act of 1974 (ERISA) generally prohibits fee arrangements between fiduciaries and third parties, such as mutual fund providers, with limited exceptions.<sup>2</sup> ERISA requirements supersede state laws and guidelines put forth by the bank regulatory agencies.

While there has been no comprehensive review of the extent to which these types of incentive payments are presently being offered by mutual fund providers, the practice appears to have become more common in recent years. In addition to the service fees cited above, another form of compensation reportedly offered by some mutual fund providers is a lump-sum payment based on assets transferred into a mutual fund.

Similar conflict of interest concerns are raised by the investment of fiduciary account assets in mutual funds for which the institution or an affiliate acts as investment adviser (referred to as "proprietary" funds). In this case, the institution receives a financial benefit from management fees generated by the mutual fund investments. This activity can be expected to become more prevalent as banking organizations become more active in offering proprietary mutual funds.<sup>3</sup>

## Supervisory Guidance

Although many state laws now explicitly authorize certain fee arrangements in conjunction with the investment of trust assets in mutual funds, institutions nonetheless face heightened legal and compliance risks from activities in which a conflict of interest exists, particularly if proper fiduciary standards are not observed and documented. Even in the case of investments where the institution does not exercise investment discretion, disclosure or other requirements may apply. Therefore, institutions should ensure that they perform and document an appropriate level of due diligence before entering into any fee arrangements similar to those described above or placing fiduciary assets in proprietary mutual funds. The following measures should be included in this process: Reasoned Legal Opinion - The institution should obtain a reasoned opinion of counsel that addresses the conflict of interest inherent in the receipt of fees or other forms of compensation from mutual fund providers in connection with the investment of fiduciary assets. The opinion should address the permissibility of the investment and compensation under applicable state or federal laws, trust instrument, or court order, as well as any applicable disclosure requirements or "reasonableness" standard for fees set forth in the law.

Establishment of Policies and Procedures - The institution should establish written policies and procedures governing the acceptance of fees or other compensation from mutual fund providers as well as the use of proprietary mutual funds. The policies must be reviewed and approved by the institution's board of directors or its designated committee. Policies and procedures should, at a minimum, address the following issues: (1) designation of decision-making authority; (2) analysis and documentation of investment decisions; (3) compliance with applicable laws, regulations and sound fiduciary principles, including any disclosure requirements or "reasonableness" standards for fees; and (4) staff training and methods for monitoring compliance with policies and procedures by internal or external audit staff.

Analysis and Documentation of Investment Decisions - Where fees or other compensation are received in connection with fiduciary account investments over which the institution has investment discretion or where such investments are made in the institution's proprietary mutual funds, the institution should fully document its analysis supporting the investment decision. This analysis should be performed on a regular, ongoing basis and would typically include factors such as historical performance comparisons to similar mutual funds, management fees and expense ratios, and ratings by recognized mutual fund rating services. The institution should also document its assessment that the investment is, and continues to be, appropriate for the individual

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Appendix C

account, in the best interest of account beneficiaries, and in compliance with the provisions of the Prudent Investor or Prudent Man Rules, as appropriate.

Please distribute this letter to the appropriate supervision staff, particularly all examiners of fiduciary and securities activities, and to all domestic and foreign banking organizations with fiduciary activities supervised by the Federal Reserve. A suggested transmittal letter is attached. To the extent that examiners identify issues and concerns pertaining to the acceptance of fees from mutual fund providers or investments in proprietary mutual funds, please forward such information to the Manager, Specialized Activities Section, Mail Stop 182, at the Federal Reserve Board. Any matters of significant concern should be noted in examination reports and corrective action pursued as appropriate.

Questions concerning this letter may be addressed to Michael G. Martinson, Deputy Associate Director, at (202) 452-3640 or Heidi Richards, Manager, at (202) 452-2598.

*Richard Spillenkothen*  
*Director*

Attachment

Supersedes: "Trust Services - Extra Fees in Connection with 12b-1 Funds or Cash Sweep Systems," FRRS 3-1596

Notes:

1 In general, national banks may make these investments and receive such fees if the practice is authorized by applicable law and if the investment is prudent and appropriate for fiduciary accounts and consistent with established state law fiduciary requirements. This includes a "reasonableness" test for any fees received by the institution. OCC Interpretive Letter No. 704, February 1996.

2 ERISA section 406(b)(3); Department of Labor, Pension Welfare and Benefits Administration Advisory Opinion 97-15A and Advisory Opinion 97-16A.3 A Board interpretation of Federal Reserve Regulation Y addresses investment of fiduciary account assets in mutual funds for which the trustee bank's holding company acts as investment adviser. In general, such investments are prohibited unless specifically authorized by the trust instrument, court order, or state law. FRRS 4-177.←

## **P.N. F** **DIC GENERAL COUNSEL'S OPINION NO. 12: "ENGAGED IN THE BUSINESS OF RECEIVING DEPOSITS OTHER THAN TRUST FUNDS"**

February 17, 2000

*Memorandum TO: The Board of Directors*

*From: William F. Kroener, III*  
*General Counsel*

*Subject: General Counsel's Opinion No. 12: "Engaged in the Business of Receiving Deposits Other Than Trust Funds"*

Background

In recent years, the FDIC has received applications for deposit insurance from an increasing number of non-traditional depository institutions. Some of these applicants have been credit card banks; others have been trust companies. These applications have raised the issue of whether these institutions would be "engaged in the business of receiving deposits other than trust funds" as required by section 5 of the FDI Act. See 12 U.S.C. § 1815(a)(1). The purpose of this General Counsel's opinion is to clarify the agency's interpretation of the statutory phrase.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

## Summary and Recommendation

The FDIC has approved applications from a number of institutions that planned to maintain a single non-trust deposit account. Typically in recent years the amount of this deposit account has been \$500,000. The FDIC thus has found that institutions holding this amount of deposited funds in one or more non-trust deposit accounts are "engaged in the business of receiving deposits other than trust funds." The FDIC in acting on deposit insurance applications has not required the acceptance of non-trust deposits from the general public. This interpretation of the statutory phrase by the FDIC is confirmed by this General Counsel's opinion. I recommend that the Board of Directors approve the publication of this General Counsel's opinion in the Federal Register.

Staff member knowledgeable about this case:

Christopher Hencke, Legal Division (898-8839)

## Discussion

Section 5 of the FDI Act provides that an applicant for deposit insurance must be "engaged in the business of receiving deposits other than trust funds." 12 U.S.C. § 1815(a)(1). The corollary to section 5 is section 8. Under the latter section, the FDIC must terminate the insured status of any depository institution "not engaged in the business of receiving deposits, other than trust funds." 12 U.S.C. § 1818(p).

For many years the FDIC has approved applications from institutions that did not plan to accept deposits from the general public. The FDIC has determined that being "engaged in the business of receiving [non-trust] deposits" does not require the acceptance of non-trust deposits from the general public. Rather, the acceptance of non-trust deposits from a particular group (such as trust customers or affiliates) has been regarded by the FDIC as sufficient to satisfy the threshold requirement of the statute. The FDIC's long-standing interpretation is consistent with the language of the FDI Act. Although the Act refers to the "receiving" of deposits, the Act also defines "deposit" in such a way as to equate "receiving" and "holding." See 12 U.S.C. § 1813(l)(1). This is appropriate because the "holding" of a single deposit account involves a continuing business relationship with periodic withdrawals, deposits, rollovers and the accrual of interest. In other words, the opening of a deposit account is not a completed, isolated transaction. Also, the FDIC is mindful that a single deposit account can be divided into portions. If the FDIC required the periodic receipt of a particular number of non-trust deposits, institutions holding one deposit account would simply arrange for the account to be divided into portions. At periodic intervals, funds would be withdrawn and redeposited. Under these circumstances, the FDIC has regarded one non-trust deposit account in the amount of \$500,000 as sufficient.

The FDIC's interpretation of "engaged in the business of receiving [non-trust] deposits" also is consistent with the past practice of the Office of the Comptroller of the Currency (OCC). Prior to 1991 the OCC was responsible for determining whether a new national bank would be "engaged in the business of receiving deposits other than trust funds." (Since the enactment of FDICIA in 1991 that responsibility has rested with the FDIC for national as well as State banks.) By chartering national banks with limited deposit-taking functions, the OCC effectively found that being "engaged in the business" did not require the acceptance of non-trust deposits from the general public.

The FDIC's interpretation is also consistent with other federal banking law as well as State banking laws. The Bank Holding Company Act (BHCA) as amended by the Competitive Equality Banking Act (CEBA) contemplates that an institution could be insured by the FDIC even though substantially all of the institution's deposits are trust funds. See 12 U.S.C. § 1841(c)(2)(D). Similarly, a Virginia statute defines a "credit card bank" in such a way that the bank must be insured by the FDIC even though the bank may accept deposits only from affiliates. See Va. Code §§ 6.1-391; 6.1-392.1.A. A number of other States have statutes to similar effect. These federal and State statutes presume that an institution may be "engaged in the business of receiving [non-trust] deposits" even though the institution accepts no such deposits from the general public.

The leading case on being "engaged in the business of receiving [non-trust] deposits" is *Meriden Trust and Safe Deposit Company v. FDIC*, 62 F.3d 449 (2d Cir. 1995). In that case, the court found that a particular bank was "engaged in the business" even though the bank held only two non-trust deposit accounts in the aggregate amount of \$200,000. This case supports the FDIC's interpretation.

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

Recently a contrary ruling was issued on a preliminary jurisdictional motion by a federal district court in Louisiana. The litigation was initiated by a group of credit card holders in Louisiana against a credit card bank chartered in Georgia. The cardholders charged the bank with violating Louisiana restrictions on fees and interest rates. In its defense, the bank cited 12 U.S.C. § 1831d. That section of the FDI Act allows a "State bank" to avoid State restrictions on fees and interest rates when operating outside its State of incorporation. The issue before the federal district court was whether the Georgia bank was a "State bank" as defined at 12 U.S.C. § 1813(a)(2). Under the statutory definition, an institution cannot be a "State bank" unless it is "engaged in the business of receiving deposits, other than trust funds." 12 U.S.C. § 1813(a)(2)(A).

In its recent ruling, the federal district court found that the Georgia bank insured by the FDIC was not "engaged in the business of receiving [non-trust] deposits" because it held only two deposits owned by affiliates. This ruling is inconsistent with the factors noted above supporting a broader, less restrictive interpretation of being "engaged in the business of receiving [non-trust] deposits." Also, the court's ruling is inconsistent with section 8 of the FDI Act. Under that section, the FDIC is authorized to make "conclusive" findings that an insured institution is "not engaged in the business of receiving deposits, other than trust funds." 12 U.S.C. § 1818(p). The FDIC has made no such determination in the case of the Georgia credit card bank. In any event, the district court's ruling has been appealed by the Georgia bank to the United States Court of Appeals for the Fifth Circuit. The case is pending before the Court of Appeals.

## Conclusion

For the reasons summarized above, in my opinion the holding of one or more non-trust deposits in the aggregate amount of \$500,000 is sufficient to satisfy the threshold requirement of being "engaged in the business of receiving deposits other than trust funds." I recommend that the Board authorize the publication of this General Counsel's opinion in the Federal Register. The publication of the opinion would be beneficial to future applicants for deposit insurance.←

## ~~Q. FDIC FINANCIAL INSTITUTION LETTER 38-2002: CREDIT RISKS ARISING FROM BANK INVESTMENT SECURITIES AND CUSTODIAL ACCOUNTS HELD AT SECURITIES BROKER-DEALERS~~

### ~~Alert Regarding Bank Investment Securities and Custodial Accounts Held At Securities Broker-Dealers~~

~~FIL 38-2002~~

~~April 25, 2002~~

~~To: Chief Executive Officer~~

~~Subject: Credit Risks Arising From Bank Investment Securities and Custodial Accounts Held at Securities Broker-Dealers~~

~~The Federal Deposit Insurance Corporation (FDIC) is alerting you to concerns it has identified regarding bank custodial relationships with failed broker-dealers. These concerns have arisen following the failure of a large regional securities broker-dealer and its liquidation by the Securities Investor Protection Corporation (SIPC). For this liquidation (which was the largest in SIPC history), the bankruptcy trustee has informed banks with securities held in safekeeping that they will incur a loss. This alert provides banks basic information regarding SIPC coverage and reminds banks of the credit risks associated with custodial relationships. Bank management is advised to review existing custodial relationships, evaluate the creditworthiness and reputation of custodians, and ensure that the bank maintains properly diversified custodial relationships.~~

~~The Securities Investor Protection Act of 1970 (SIPA) created SIPC to provide certain protections to customers against losses from the failure of a securities broker-dealer. Under SIPA, only customers of a SIPC member firm qualify for SIPC protection and only "customer property" as defined in SIPA and determined to be in the member firm's custody are covered. Although SIPC coverage allows a bank, for its own account, to share in "customer property," banks cannot receive advances from SIPC. In the event that a bank demonstrates that it is acting as an agent for an investor, that investor is entitled to separate status as a "customer" and is eligible to receive advances from SIPC.~~

# Fiduciary Law Excerpts or Digest of Applicable Laws, Regulations and Principles

## Appendix C

~~In general, during a liquidation proceeding, the trustee for the failed broker-dealer will (1) return to customers property that is registered in a specific customer's name, (2) pay those customers their pro rata share of "customer property," and (3) provide customers (other than banks and broker-dealers for their own accounts) SIPC advances up to the \$500,000 limit. Customers not subject to SIPC protection, such as banks, will receive a pro rata distribution of "customer property." Banks should be aware of SIPC's coverage and claims procedures and be able to differentiate between bank-owned and bank-customer-owned accounts and securities held at failed broker-dealers.~~

~~These events serve as an opportunity to remind banks of their obligation under existing supervisory policy to exercise due diligence when selecting broker-dealers and establishing a custodial relationship. Banks should establish and periodically review broker-dealer selection criteria that would include a review of the broker-dealer's financial statements and an assessment of the firm's ability to honor its commitments. An inquiry into the broker-dealer's reputation should be conducted. Such information can be obtained from state and federal securities regulators and industry self-regulatory organizations such as the National Association of Securities Dealers (NASD). The custodian's reputation and creditworthiness should be periodically reviewed. Banks should review their existing custodial relationships and underlying documentation and practices so that bank management can fully understand the nature and extent of potential credit risks that can arise from existing custodial relationships. Where needed, banks should consult with their attorneys and independently review their agreements and business practices with broker-dealers.~~

~~These events also instruct that even sound due diligence practices may not adequately minimize banks' exposure. In order to avoid unforeseen credit exposure in similar circumstances, banks should ensure that their custodial relationships are properly diversified. Maintaining relationships with different custodians can minimize the bank's exposure in this area.~~

~~Michael J. Zamorski~~

~~Director~~

~~Distribution: FDIC Supervised Banks (Commercial and Savings)~~

~~Note: Paper copies of FDIC financial institution letters may be obtained through the FDIC's Public Information Center, 801 17th Street, NW, Room 100, Washington, DC 20434 (800-276-6003 or 202-416-6940).~~