1999 SENATE JUDICIARY

SB 2169

1999 SENATE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. SB2169

Senate Judiciary Committee

❑ Conference Committee

Hearing Date January 18, 1999

Tape Number	Side A	Side B	Meter #
1		x	0 - 3912
1-26-99 2	x		0 - 253
Committee Clerk Signature Jackie Tollman			

Minutes:

SB2169 relates to the Uniform Principal and Income Act (1997).

SENATOR STENEHJEM opened the hearing on SB2169 at 10:05 A.M.

All were present except SENATOR NELSON.

JAY BURINGRUD, Legislative Counsel, Commission on Uniform State Laws, testified to explain SB2169. Testimony attached.

SENATOR TRAYNOR asked with the example, the authority to allocate interest payments from income, under this bill the trustee can do this without consulting either beneficiary.

JAY BURINGRUD stated the trustee could do this but the trustee would have to follow the provisions. They are supposed to look at all of the circumstances of the beneficiaries.

MARILYN FOSS, North Dakota Bankers Association, testified in opposition to SB2169 as drafted. Testimony and amendments attached. If the amendments are adopted, we would be neutral on SB2169.

DAVID PURMAL, VP and Trust Manager for Norwest Bank ND NA, testified in opposition to SB2169 specifically Section 4. Testimony attached.

SENATOR TRAYNOR asked if the amendments were adopted, would you oppose SB2169.

DAVID PURMAL stated they would not oppose SB2169 with the amendments.

PAUL WOHNOATKA, Self and Western Dakota Estate Council, stated that he would like to echo what Marilyn and Dave said. We are opposed to Section 104. The rest of SB2169 we are neutral.

JACK MCDONALD, Independent Community Banks, testified in opposition to SB2169, Section 104. The rest we would generally support.

SENATOR TRAYNOR asked if any other state has adopted this bill.

JAY BURINGRUD stated Oklahoma has adopted a bill like this with Section 104. Four other states have introduced a bill like this one.

SENATOR STENEHJEM stated that we could adopt this bill without Section 104 and maybe we should see what the other states are doing with this Section of the Bill.

JAY BURINGRUD stated that Minnesota would probably be the key state to watch.

SENATOR STENEHJEM CLOSED the hearing on SB2169.

January 19, 1999 3:00 P.M.

SENATOR TRAYNOR made a motion for the AMENDMENTS, SENATOR BERCIER seconded. Motion carried.

SENATOR WATNE made a motion for DO PASS AS AMENDED, SENATOR TRAYNOR seconded.

SENATOR TRAYNOR will carry this bill.

6 - 0 - 0

January 26, 1999 Tape 2

SENATOR TRAYNOR made a Motion to Reconsider, SENATOR BERCIER seconded.

Motion carried.

SENATOR WATNE made a motion for FURTHER AMENDMENTS, SENATOR TRAYNOR seconded. Motion carried.

SENATOR WATNE made a motion for DO PASS AS AMENDED, SENATOR TRAYNOR seconded. Motion carried.

SENATOR TRAYNOR will carry this bill.

6 - 0 - 0

Prepared by the Legislative Council staff for
Senate Judiciary Committee
January 20, 1999

PROPOSED AMENDMENTS TO SENATE BILL NO. 2169

Page 3, line 4, remove "the power to adjust under subsection 1 of section 59-04.2-03 or"

Page 3, line 12, after the third boldfaced period insert "(Reserved)"

Page 3, remove lines 13 through 31

Page 4, remove lines 1 through 31

Page 5, remove lines 1 through 19

Page 13, line 26, after the third boldfaced period insert "(Reserved)" and remove "If a trustee determines that"

Page 13, remove lines 27 through 31

Page 14, remove lines 1 through 5

Page 17, line 3, after the third boldfaced period insert "(Reserved)"

Page 17, remove lines 4 through 16

Renumber accordingly

Date: 1-19-99
Roll Call Vote #: 1

1999 SENATE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. 2169

Senate Judiciary Committee

☐ Subcommittee on _____
or
☐ Conference Committee

Legislative Council Amendment Number _____

Action Taken Amendments

Motion Made By Traynor Seconded By Bercier

Senators	Yes	No	Senators	Yes	No
Senator Wayne Stenehjem	X				
Senator Darlene Watne	X				
Senator Stanley Lyson	X				
Senator John Traynor	X				
Senator Dennis Bercier	X				
Senator Caroloyn Nelson	X				

Total (Yes) 6 No 0

Absent _____

Floor Assignment _____

Date: 1-19-99
Roll Call Vote #: 2

1999 SENATE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. 2169

Senate Judiciary Committee

☐ Subcommittee on

or

☐ Conference Committee

Legislative Council Amendment Number

Action Taken Do Pass As Amended

Motion Made By Watne Seconded By Traynor

Senators	Yes	No	Senators	Yes	No
Senator Wayne Stenehjem	X				
Senator Darlene Watne	X				
Senator Stanley Lyson	X				
Senator John Traynor	X				
Senator Dennis Bercier	X				
Senator Caroloyn Nelson	X				

Total (Yes) 6 No 0

Absent

Floor Assignment Traynor

Date: 1-26-99

Roll Call Vote #: _____

1999 SENATE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. _____

Senate Judiciary Committee

☐ Subcommittee on _____

or

☐ Conference Committee

Legislative Council Amendment Number _____

Action Taken Motion to Reconsider

Motion Made By Traynor Seconded By Bercier

Senators	Yes	No	Senators	Yes	No
Senator Wayne Stenehjem	X				
Senator Darlene Watne	X				
Senator Stanley Lyson	X				
Senator John Traynor	X				
Senator Dennis Bercier	X				
Senator Caroloyn Nelson	X				

Total (Yes) 6 No 0

Absent _____

Floor Assignment _____

PROPOSED AMENDMENTS TO SB 2169

Page 3, remove lines 12 through 31

Page 4, remove lines 1 through 31

Page 5, remove lines 1 through 19

Renumber accordingly

Thank you.

Date: 1-26-99

Roll Call Vote #: 1

1999 SENATE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. _____

Senate Judiciary Committee

☐ Subcommittee on _____

or

☐ Conference Committee

Legislative Council Amendment Number _____

Action Taken Further Amendments

Motion Made By Watne Seconded By Traynor

Senators	Yes	No	Senators	Yes	No
Senator Wayne Stenehjem	X				
Senator Darlene Watne	X				
Senator Stanley Lyson	X				
Senator John Traynor	X				
Senator Dennis Bercier	X				
Senator Caroloyn Nelson	X				

Total (Yes) 6 No 0

Absent _____

Floor Assignment _____

Date: 1-26-99
Roll Call Vote #: 2

1999 SENATE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. 2169

Senate Judiciary Committee

☐ Subcommittee on _____
or
☐ Conference Committee

Legislative Council Amendment Number _____

Action Taken Do PASS As Amended.

Motion Made By Watne Seconded By Traynor

Senators	Yes	No	Senators	Yes	No
Senator Wayne Stenehjem	X				
Senator Darlene Watne	X				
Senator Stanley Lyson	X				
Senator John Traynor	X				
Senator Dennis Bercier	X				
Senator Caroloyn Nelson	X				

Total (Yes) 6 No 0

Absent _____

Floor Assignment Traynor

REPORT OF STANDING COMMITTEE

SB 2169: Judiciary Committee (Sen. W. Stenehjem, Chairman) recommends **AMENDMENTS AS FOLLOWS** and when so amended, recommends **DO PASS** (6 YEAS, 0 NAYS, 0 ABSENT AND NOT VOTING). SB 2169 was placed on the Sixth order on the calendar.

Page 3, line 4, remove "the power to adjust under subsection 1 of section 59-04.2-03 or"

Page 3, line 12, after the third boldfaced period insert "(Reserved)"

Page 3, remove lines 13 through 31

Page 4, remove lines 1 through 31
Page 5, remove lines 1 through 19

Page 13, line 26, replace "If a trustee determines that" with "(Reserved)"

Page 13, remove lines 27 through 31

Page 14, remove lines 1 through 5

Page 17, line 3, after the third boldfaced period insert "(Reserved)"

Page 17, remove lines 4 through 16

Renumber accordingly

1999 HOUSE JUDICIARY

SB 2169

1999 HOUSE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. 2169

House Judiciary Committee

❑ Conference Committee

Hearing Date : February 15, 1999

Tape Number	Side A	Side B	Meter #
1	X		13
Committee Clerk Signature			

Minutes:

JAY BURINGRUD (LC) This bill comes out of the Commission on Uniform State Laws. Suggested changes are proposed and then read twice, so it takes at least two years for changes to get made. Then, before they are finally adopted they go to the ABA for review. This is a revision of an act adopted in 1962. The provisions of this act are in force only when a trust document is silent on the subject. This will give more clear guidance to trustees on how to proceed.

MARLIN FOSSE (ND Bankers Assoc.) Presented written testimony, a copy of which is attached.

COMMITTEE ACTION: March 16, 1999

REP. DELMORE moved that the committee recommend that the bill DO PASS. Rep. Klemin seconded and the motion passed on a roll call vote with 12 ayes, 0 nays and 3 absent. Rep. Mahoney. was assigned to carry the bill on the floor.

Date: 2/16/

Roll Call Vote #: _____

1999 HOUSE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. 2169

House JUDICIARY Committee

☐ Subcommittee on _____

or

☐ Conference Committee

Legislative Council Amendment Number Do Pass

Action Taken _____

Motion Made By Delmore Seconded By Klemin

Representatives	Yes	No	Representatives	Yes	No
REP. DEKREY	✓		REP. KELSH	✓	
REP. CLEARY	✓		REP. KLEMIN	✓	
REP. DELMORE	✓		REP. KOPPELMAN	✓	
REP. DISRUD	✓		REP. MAHONEY	✓	
REP. FAIRFIELD			REP. MARAGOS		
REP. GORDER	✓		REP. MEYER		
REP. GUNTER	✓		REP. SVEEN	✓	
REP. HAWKEN	✓				

Total Yes 12 No 0

Absent 3

Floor Assignment Mahoney

If the vote is on an amendment, briefly indicate intent:

REPORT OF STANDING COMMITTEE

SB 2169, as engrossed: Judiciary Committee (Rep. DeKrey, Chairman) recommends **DO PASS** (12 YEAS, 0 NAYS, 3 ABSENT AND NOT VOTING). Engrossed SB 2169 was placed on the Fourteenth order on the calendar.

1999 TESTIMONY

SB 2169

PRESENTATION TO THE JUDICIARY COMMITTEE

Jay E. Buringrud, Secretary, ND Commission on Uniform State Laws

Monday, January 18, 1999

The North Dakota Commission on Uniform State Laws is established by North Dakota Century Code Section 54-55-01. The commission consists of:

- a practicing lawyer -- David Hogue, Minot
- a full-time faculty member of the UND Law School -- Professor Patricia Brumfield Fry, Grand Forks
- a law-trained judge of a court of record -- District Judge Gail Haggerty, Bismarck
- a member of the House -- Representative William Kretschmar (not reelected)
- a member of the Senate -- Senator Wayne Stenehjem
- a member of the Legislative Council staff -- Jay Buringrud
- life members of the conference -- Judge Eugene Burdick; Frank Jestrab
- residents with 5 years prior service -- Mike Unhjem; Owen Anderson

Commissioners are required to attend the annual meeting of the National Conference of Commissioners on Uniform State Laws. Major duties are to:

- promote uniformity in state laws on those subjects where uniformity may be deemed desirable and practicable; and
- promote uniform judicial application and construction of all uniform state laws.

The Commission requested introduction of 3 bills:

1. Senate Bill No. 2152 - The Uniform Child Custody Jurisdiction and Enforcement Act.

2. Senate Bill No. 2169 - The Uniform Principal and Income Act (1997).

This is a revision of the Uniform Principal and Income Act of 1962 (originally promulgated in 1931), which North Dakota enacted in 1969 as NDCC Chapter 59-04.1. A trustee of a trust must serve the interests of both income and remainder beneficiaries. Assets allocated to income are generally paid to the income beneficiaries and assets allocated to principal are distributed to the remainder beneficiaries at the termination of the trust. The Uniform Act has always provided the default rules for such allocation if the trust instrument is silent. The objectives of the 1997 revision are to:

- Make principal and income rules conform to prudent investor rules under the Uniform Prudent Investor Act, which North Dakota enacted in 1997 as NDCC Sections 59-02-08.1 through 59-02-08.11. Under that Act (59-02-08.2), the main principle is to invest for total return by evaluating the trust portfolio as a whole, rather than a certain level of "income".

  This Act deals conservatively with the tension between modern investment theory and traditional income allocation. If prudent investing of all the assets in the trust and traditional allocation effectuate the intent of the settlor, nothing need be done. But the Act 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 between income and principal beneficiaries. The Act gives that trustee a power to reallocate the portfolio return suitable. Otherwise, a trustee would not be able to fully implement modern portfolio theory. **104-** Purpose is to enable trustee to select investments using standards of a prudent investor with having to realize a particular portion of the portfolio's total return in the form of traditional accounting income such as interest, dividends, and rents. **Under 103(2) trustee must administer a trust impartially, based on what is fair and reasonable to all beneficiaries, unless the terms of the trust require favoritism to one or more beneficiaries.** Why is section important? For a trustee who is operating under the prudent investor rule and decides that portfolio should include financial assets whose total return will result primarily from capital appreciation rather than dividends or interest, and at that time can decide the extent to which an adjustment from principal to income may be necessary. Examples: (1) income to son, remainder to daughter; high inflation, double digit return on bonds, allows investment in bonds, T may transfer part of interest to principal. (2) trust includes large amount of undeveloped land, income covers taxes, land may be high value in near future, T may transfer cash from other principal to provide income to income beneficiary.

- Clarify better allocations of acquired assets: **401**- income from a partnership is based on actual distributions, the same as corporate distributions; **401(4)(b)-** distributions exceeding 20% of gross assets are considered principal.
- Provide for investment modalities that were not in existence in 1962, such as derivatives, options, deferred payment obligations, and synthetic financial assets.
- Deal with any problem of disbursements because of environmental laws.
- Deal with allocation imbalances as a result of tax laws.

3. Senate Bill No. 2174 - Technical amendments approved by the National Conference's Executive Committee which affect uniform acts enacted in North Dakota.

- **Section 1 (1-403) - (2) -** clarifies that an order binds others to the extent their interests are subject to the power and that minors are included as those bound by judicial orders.
- **Section 2 (2-606) -** clarifies language.
- **Sections 3 and 4 (2-803 and 2-804) -** clarifies that the interests are equal interests, without regard to individual contributions by either party (to address a Montana case).
- **Section 5 (3-703) -** last sentence is clarified to reflect original intended meaning that a personal representative does not owe a fiduciary duty to a person having a claim against the estate until the claim has been allowed.
- **Section 6 (3-803) -** "nonprobate transferees" added to clarify that the codes non-claim bar protects probate as well as nonprobate successors against claims of unsatisfied creditors of the decedent.

TESTIMONY OF MARILYN FOSS
GENERAL COUNSEL
NORTH DAKOTA BANKERS ASSOCIATION
OPPOSING SB 2169

UNIFORM PRINCIPAL AND INCOME ACT (1997)

Chairman Stenehjem, Members of the Interim Judiciary Committee, my name is Marilyn Foss. I am general counsel for the North Dakota Bankers Association (NDBA) and am appearing before the Committee on behalf of NDBA. NDBA is a financial institution trade association. Our members include 103 large and small banks and thrift institutions in North Dakota. We appreciate being invited to comment upon the Revised Uniform Principal and Income Act (1997), particularly since the NDBA Trust Committee has expressed substantial concern about one section of the revised Act. Committee members are all trust officers who work actively to provide trustee services throughout North Dakota.

The revised Act has favorable features. However, it also includes a section which is described in the American Bankers Association Trust Letter as "radical" and "without precedent in the law of trusts. . . ." This is section 104 of the Revised Act.

The premise upon which Section 104 is founded appears to be that the trustee should be able to decide what personal trust receipts are going to be allocated to principal and which will be allocated to income. This is hardly a minor decision because personal trust income is typically paid out to one class of beneficiaries, while trust principal is invested and typically distributed to an entirely different class of beneficiaries when the trust terminates or when there exist other conditions which have been pre-established by the trust grantor. If the trustee has discretion to reallocate receipts between income and principal, the trustee is very literally deciding how much each class of beneficiaries will ultimately receive from the trust

The Section 104 authority to reallocate receipts between principal and income is supposed to be a corollary to the section 103(b) obligation of a trustee to "administer a trust . . . 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." To those of us who are not in the trust business, the power to reallocate receipts to achieve "fairness" may seem to be reasonable. However, trust officers who review sections 103 and 104 have raised a number of strenuous objections to this grant of discretion to them:

1. <u>How is a trust officer to determine the circumstances under which the trustee's discretion arises?</u>

Section 104 refers to section 103(b) and the obligation to be impartial, fair and reasonable, but doesn't provide any practical guidance to a trustee who is trying to determine whether the Act gives him or her discretion to reallocate receipts under particular facts. What language in a trust instrument establishes the grantor's intention to favor a particular beneficiary? What facts establish that the investment results obtained by applying concepts of modern investment theory (i.e., investing for "total return" under the new prudent investor standards) are skewed in a manner not consistent with the grantor's directives? What must a trustee do to establish those facts?

2. <u>What standards is a trustee supposed to follow when exercising his or her discretion?</u>

Neither Section 104 nor other sections of the Act provide meaningful standards for a trustee to follow when exercising discretion or protect a trustee who exercises discretion in good faith. Section 104(b) provides that the trustee is to consider "all relevant factors" including those listed in 104(b) if they "are relevant". We think the very likely result of including section 104 in the Act is that trustees viewing the same facts will come to different conclusions and will exercise their discretion in different ways and with different results. This throws a "wild card" into the game for grantors, beneficiaries and trustees with no attendant, demonstrable improvement over current law.

3. Because the section is both broad and vague, it will encourage litigation between trustees and beneficiaries over the nature of the trust instrument (and the clarity of the grantor's intention to favor or not favor a particular class of beneficiary) and the extent of the beneficiary's interest in the trust.

4. It will increase the complexities and expense of administering a trust. Trustees will have to develop methods by which they will assess whether or not to exercise their Section 104 discretion. They will have to determine how courts have interpreted the section. And, they will have to document their efforts in order to have proof that they have acted properly - both for beneficiaries and for regulatory agencies.

Frankly, we don't believe there is a need for Section 104 of the Act. The vast majority of trust instruments give a trustee discretion to invade principal when an income beneficiary has a clear need for more money than is available under traditional methods of allocating receipts between

income and principal. There simply is no pressing need for all trustees to be given a broad power to reallocate receipts between principal and income as a matter of course and on a default basis without considerably more substantive guidance about how to exercise that power than is given by the Act.

The Act does contain a number of provisions to address matters about which North Dakota's current version of the UPIA is silent or less specific. For example, the new Act mentions partnership interests explicitly and subjects them to the same rules as apply to corporate distributions. As a general matter zero-coupon bond discounts are treated as principal if the bond has a maturity of more than one year. Deferred compensation and liquidating asset distributions are allocated 90% to principal and 10 % to income. Oil and gas receipts will now be allocated 90% to principal and 10% to income in what I understand to be a change from the current Act. Receipts from derivatives and options will now be considered to be principal as a general matter. Receipts from asset-backed securities are addressed in their own section. Environmental expenses will be charged against principal. And, depreciation is no longer mandatory, but left to the discretion of the trustee. NDBA does not take a position on these changes at this time.

The interim judiciary committee considered the UPIA. It is my understanding that the committee, at its October meeting, decided not to sponsor the bill for introduction before the legislature. We believe the committee's caution was well founded and reflected its concern about section 104.

To summarize, it is NDBA's position that Section 104 should not be adopted as part of the Revised UPIA in North Dakota. The changes made by that section are not well received in the trust industry, are not well founded in the current law and are not

necessary. The amendments which are attached to my testimony removes this section of the legislation.

TESTIMONY OF DAVID S. PURMAL
VP & TRUST MANAGER
NORWEST BANK ND NA

OPPOSING SB 2169

UNIFORM PRINCIPAL AND INCOME ACT (1997)

Chairman Stenehjem, Members of the Interim Judiciary Committee thank you for allowing me an opportunity to speak to you today. My name is David Purmal, and I am a Trust Manager for Norwest Bank ND, located here in Bismarck. I am here appearing before the committee on behalf of Norwest Bank Investment Management & Trust. Norwest conducts trust business throughout the State of North Dakota, from offices in Fargo, Bismarck, Minot and Dickinson. In current form, we oppose the proposed SB 2169.

In short, we believe the act to be less user friendly than the existing statute and are specifically opposed to section 104 of the revised act that refers to a trustee's power to make adjustments between income and principal.

Section 104 attempts to help Trustee's apply the prudent investor concept of focusing on total return and not specifically on the income generated by a collection of trust assets. However, the adoption of section 104 would do little to aid administration and would create several potential issues.

SECTION 104 CONCERNS

1. LACK OF GUIDANCE. Section 104 gives a great deal of discretion to trustee's to reallocate between principal and income without adequate guidance. First, it is unclear from the act, when a Trustee should use discretion and when it should not in terms of reallocating principal to income or income to principal. Second, Trustee's when reallocating, are to be "fair and impartial". This vague direction will increase the complexity of administration and increase the potential for litigation.

2. INCREASING COST OF ADMINISTRATION. As a result of the lack of guidance, we believe Trustee's, both corporate and individuals, will be pressured by current income beneficiaries to reallocate principal to income, in effect increasing distributions. Alternately, remainder beneficiaries would likely pressure Trustee's not to make such reallocations, effectively increasing the remainder share. The lack of guidance in the proposed act would make the new provisions difficult to administer, increasing the potential for litigation and/or increases in requests, by trustees' for court supervision. Both of which would increase the cost of administration.

3. CHANGING THE INTENT OF THE GRANTOR. Today in practice, the two most typical types of trusts are 1. Income Only (no discretion by the trustee) and 2. Income plus principal, under an ascertainable standard. Under an Income plus principal type trust, the Grantor (writer) may draft into the document very broad or narrow standards that express their intent (i.e. health, education, maintenance or support). In effect, if the Trustee deems there is a need to invade principal they may do so with adequate guidance.

In the case of an income only type trust, the original intent of the Grantor may be over turned if a Trustee is forced to allocate principal to income and effectively distribute income and principal. We believe that overturning the intent of the grantor to be a significant issue, one that courts are typically very reluctant to do. We prefer that the trust document dictate the Grantors intent rather than broad legislative change that may effect many documents in ways not foreseen or intended by the Grantor at the time of initial drafting.

In closing, Norwest generally supports the uniform approach and we are pleased that the committee is considering legislation to create uniform laws. However, due to section 104 and the overall lack of user – friendly language in the proposed Uniform Principal and Income Act (1997), **we respectfully urge you not to adopt SB 2169.**

TRUST OFFICER ALERT

The Uniform Principal and Income Act (1997)

Look Before You Leap

by Alexander P. Misheff

The National Conference of Commissioners on Uniform State Laws (NCCUSL), at its annual conference in Sacramento, California, July 25–August 1, 1997, adopted the Uniform Principal and Income Act (1997) (the Act). The Act has been approved by the American Bar Association and is now being offered for approval to the legislatures of the 50 states.

Trustee's Power To Adjust or Reallocate Principal to Income and Vice Versa

Rest assured that this is no ordinary update of the fundamental statute governing trust accounting. The Act in Section 104 contains a radical provision without precedent in the law of trusts that would allow a trustee in the exercise of its discretion to "adjust" or shift receipts and expenses that have long been considered to be principal assets of a trust to income and to be paid out as income to the income beneficiaries of the trust.

The Act would also permit the reverse—that is, a trustee would have discretion to adjust or reallocate receipts and expenses that have been traditionally allocated to income to be henceforth treated as principal and withheld from the income beneficiaries. This extraordinary grant of discretion to trustees is given notwithstanding the fact that the balance of the Act with Prefatory Note and Comments, running about 60 pages, contains a set of detailed and often sophisticated and salutary rules representing the traditional rules of trust accounting.

How is it that the Act confers such a wide and, as we shall see, basically undefined power in trustees to decide what is income and what is principal in personal trusts? The impetus for the Act is basically twofold: (1) it was felt that the Uniform Principal and Income Act, promulgated in 1931 and still the law in 8 states, and the Revised Uniform Principal and Income Act, promulgated in 1962 and currently in effect with varying degrees of modifications in 34 states, needed revision to correct perceived defects in and provide for new situations not covered in the two prior Acts; and (2) there was a need to alleviate an imagined tension between the principle of investing for total return under the Uniform Prudent Investor Act and traditional law about what constitutes the return on a trust portfolio traditionally thought to include interest, dividends, and rents.

The Act was prepared by an NCCUSL Drafting Committee, which spent about four years in preparing the final text. The American Bankers Association was invited to designate an observer to attend drafting committee sessions but without the right to vote. The American Bankers Association observer, and through him the American Bankers Association's Trust Counsel Committee, was an active participant and joined in modifying a number of crucial sections, including Section 104, to make the act more reflective of trust industry concerns rather than the more theoretical approach of some of the legal academics on the drafting committee. For policy reasons, the American Bankers Association has not endorsed or rejected the Act as a whole. However, the

erican Bankers Association erves the right to question various sections of the act that it believes to be detrimental to the interests of its member trust institutions and its trust customers.

American Bankers Association's Objection to Trustee's Power To Adjust or Reallocate

The American Bankers Association objected to the trustee's power to adjust or reallocate from inception of the drafting committee's work. In the beginning, the Act had a Section 20, Fiduciary Power To Reallocate, which was a mandatory power requiring the fiduciary to reallocate items between income and principal to preserve the respective interests of the ome beneficiaries and emainder beneficiaries. No standards to guide the trustee in the exercise of its discretion were included.

The Act then provided for a noncharitable unitrust as a device for dealing with the reallocation and created a statutory form of unitrust to be included in personal trusts. The statutory unitrust sank out of sight after the American Bankers Association joined others in pointing out the rigidity, administrative complexities, and potential marital deduction problems inherent in such a unitrust.

Section 104 of the 1997 Act, Trustee's Power To Adjust, continues to suffer from most of the same problems that bedeviled he former reallocation provisions and remains a totally flawed provision from the trust industry's perspective. It is true that Section 104 has been improved to make it applicable only to trusts and not estates and then only to those trusts following the prudent investor rule, and it is also true that it is now permissive and not mandatory. It should also be noted that the reallocation provision will not apply if it jeopardizes the marital deduction for federal transfer tax purposes. However, the following questions remain:

- When and under what circumstances does the trustee's discretion arise? Section 104 is silent on the matter and refers one to Section 103(b), which says only that a fiduciary must administer a trust estate "impartially," based on what is "fair and reasonable" to all of the beneficiaries.

  The quoted definitions are essentially circular and give no practical guidance to a trustee. The Official Comment to Section 104 says that the starting point is to use the traditional system of principal and income allocation, as modernized in the other 60-plus pages of the Act. But then what? How does a trustee know or is presumed to know when the investment results produced by the trust portfolio may be viewed as skewed in favor of a particular beneficiary or a class of beneficiaries? To protect itself from liability, is a trustee required to review annually or more frequently the investment results of each trust under its administration to determine whether it is being "fair and reasonable" to the beneficiaries of each trust?

- The Act gives no meaningful standards for trustees to follow in exercising discretion. The standards in Section 104(b) are vague, nonspecific, and of no help to trustees, and could justify a variety of outcomes regarding similar fact situations and among a variety of trustees. Even worse, the Act grants no specific protection to the trustee for even a good faith of discretion under Section 104.

- Because of the vagueness or non-specificity of Section 104, it opens up the possibility of continuing arguments and litigation between beneficiaries and trustees about the extent of a beneficial interest. What was formerly a routine and fairly well-understood part of trust administration could now become a new battleground among beneficiaries and between beneficiaries and trustees.

- It will increase the costs, delays, and complexities of administering trusts, a result that is in no one's best interest.

- There are other far better understood methods of increasing the amount going to an income beneficiary if the beneficiary requires more money than the amount traditionally allocated to income produced by the trustee's investment performance. Most trust instruments contain discretionary powers in

(continued on page 12)

(continued from page 11)

trustee, permitting invasion of principal for the benefit of the income beneficiary in a proper case.

While there is considerable variances in the degree of discretion conferred by trust agreements, if the trustee is investing in low-yield growth stocks and the instrument permits, the trustee could exercise its discretion to pay principal to the income beneficiary for the purposes stated by the settlor in the governing document.

Traditional Sections of the Act

In addition to Section 104 on the trustee's power to adjust or reallocate, the Act adds some new provisions and modifies or clarifies some of the traditional sections of the 1962 Act. Some of the highlights are as follows:

- The act now permits a fiduciary (executors and trustees), to make so-called *Warms-Bixby* Adjustments. This is contrary to existing law and practice in some states (for example, Michigan and Illinois). *Section 506.*

- Receipts from partnerships are mentioned for the first time and subject to the same rules as dividends and other corporate distributions. *Section 401.*

- Zero-coupon bonds likewise are covered for the first time, and the discount thereon is deemed principal unless the bond has a maturity of less than one year. *Section 412(b) and similar to the Illinois Act.*

- Deferred compensation and liquidating asset distributions are generally allocated 90 percent to principal and 10 percent to income. *Sections 421 and 422.*

- Treatment of oil and gas receipts is changed to provide 90 percent of net receipts are principal and 10 percent to income. *Section 423.*

- Receipts from timber are dealt with in *Section 424.*

- The unproductive property apportionment rule at common law and of the prior acts has been abolished. *See Section 425.*

- Receipts from derivatives and options are generally considered principal *(Section 426)* unless separately accounted for as a business *(Section 403).*

- Receipts from asset-backed securities are set forth in *Section 427.*

- Expenses related to environmental matters are paid out of principal. *Section 502(a)(7).*

- Depreciation of a principal asset is no longer mandatory but permissive in the discretion of the trustee. *See Section 503(b).*

The Act Deserves a Very Careful Look

The Commissioners on Uniform State Laws are to be commended for undertaking such a thorough-going and timely examination of one of the fundamental statutes of trust administration. It behooves every personal trust banker to obtain a copy of the Act[1] and analyze each section to see what it covers so that an unwanted provision does not creep into the Act by inattention.

The American Bankers Association will continue to oppose Section 104 on the ground that beneficiaries and trustees will be driven away from the safe-harbor or default rules of the Act into a nebulous world where the trustee is given untrammeled power subject only to the intervention of a court to determine what an income beneficiary receives and what is left for the remaindermen. ■

Note

[1] The almost-final copy of the Act is available by writing or calling the NCCUSL office at 211 E. Ontario St., Suite 1300, Chicago, IL 60611; Telephone (312) 915-0195. E-mail: J.Nelson@NCCUSL.org.

Alexander P. Misheff is a Chicago attorney with extensive in-bank trust administration experience. He served as the American Bankers Association's observer to the NCCUSL Drafting Committee for the Uniform Principal and Income Act. *Mr. Misheff would like to thank Alan Hammer of Harris Trust, Chicago, and Herbert Hoover of NationsBank Trust of Florida for their thoughtful suggestions to this article.*

TESTIMONY OF MARILYN FOSS
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UNIFORM PRINCIPAL AND INCOME ACT (1997)

Chairman DeKrey, Members of the House Judiciary Committee, my name is Marilyn Foss. I am general counsel for the North Dakota Bankers Association (NDBA) and am appearing before the Committee on behalf of NDBA. NDBA is a financial institution trade association. Our members include 103 large and small banks and thrift institutions in North Dakota. We appreciate being invited to comment upon the Revised Uniform Principal and Income Act (1997), particularly since the NDBA Trust Committee has expressed substantial concern about one section of the revised Act. Committee members are all trust officers who work actively to provide trustee services throughout North Dakota.

The revised Act has favorable features. However, as it was originally introduced it also included a section which was described in the American Bankers Association Trust Letter as "radical" and "without precedent in the law of trusts. . . ." This is section 104 of the Revised Act and, before the Senate Judiciary Committee NDBA and others opposed its inclusion in the UPIA as adopted in North Dakota. It related to a trustee's power to allocate trust receipts to income or principal and to thereby very literally change the amount of money which would be available for distribution to an income beneficiary or to a principal beneficiary of a trust. This discretionary authority was not included in the Act at the request of trust professionals and, in fact, was authority which North Dakota trust bankers did not want included in the Act. NDBA proposed and supported the amendments which removed section 104 from the bill as adopted by the Senate.

In its favor, the Act does contain a number of provisions to address matters about which North Dakota's current version of the UPIA is silent or less specific. For example, the new Act mentions partnership interests explicitly and subjects them to the same rules as apply to corporate distributions. As a general matter zero-coupon bond discounts are treated as principal if the bond has a maturity of more than one year. Deferred compensation and liquidating asset distributions are allocated 90% to principal and 10 % to income. Oil and gas receipts will now be allocated 90% to principal and 10% to income in what I understand to be a change from the current Act. Receipts from derivatives and options will now be considered to be principal as a general matter. Receipts from asset-backed securities are addressed in their own section. Environmental expenses will be charged against principal. And, depreciation is no longer mandatory, but is left to the discretion of the trustee.

These changes do appear to be improvements to the current law . Accordingly, NDBA does support Engrossed SB 2169.

Repealed by 2169

CHAPTER 59-04.1
UNIFORM PRINCIPAL AND INCOME ACT

Section