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UNIFORM TRUST ACT

NATIONAL CONFERENCE OF COMMISSIONERS

ON UNIFORM STATE LAWS

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UNIFORM TRUST ACT

With Prefatory Note and Reporter's Notes

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UNIFORM TRUST ACT

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UNIFORM TRUST ACT

PREFATORY NOTE

The Uniform Trust Act is the first comprehensive attempt at the national level to codify the law of trusts. A Study Committee was appointed in 1993. The Drafting Committee was appointed in 1994, met once during the 1994-1995 year, and twice yearly during 1995-1996, 1996-1997, and 1997-1998.

Reasons for Trust Act – There are several reasons why the drafting of a Uniform Trust Act is timely. The primary stimulus is the much greater use of trusts in recent years, particularly the revocable living trust, even among those of moderate wealth. This greater use of the trust, and consequent rise in the number of day-to-day questions involving trusts, has led to a recognition that the trust law in many States is quite thin – a few scattered statutes and even less in the way of reported cases. It has also led to a recognition that the existing Uniform Acts relating to trusts, while numerous, are incomplete. The primary source of trust law in most States is thus the Restatement (Second) of Trusts and the multivolume treatises by Scott and Bogert, sources which fail to address numerous practical issues and which on others provide insufficient guidance. While there are numerous Uniform Acts related to trusts, none is comprehensive. The Uniform Trust Act hopefully will provide States with precise answers to these trust law questions and in an easily findable place.

Existing Uniform Laws on Trust Law Subjects – There are numerous Uniform Acts on trusts and related subjects, but none provide comprehensive coverage of trust law issues. Certain of these Acts are incorporated into the larger Uniform Trust Act. Others, addressing more specialized topics, will continue to be available for enactment in their free-standing form. The following are the most relevant Acts:

Uniform Trustee Powers Act – approved in 1964, it has been enacted in 16 States. The Act, as its name implies, contains a list of specific trustee powers and deals with selected other issues, particularly rights of third parties. The Trustee Powers Act, at a minimum, needs to be updated to reflect the recently approved Uniform Prudent Investor Act. Revisions are also needed due to changes in commercial practice, such as the invention of the LLC. The substantive issues covered by the Trustee Powers Act, but with numerous updates, are fully incorporated into the draft of the Uniform Trust Act, principally a Sections 817 and 1108. States enacting the Uniform Trust Act should repeal this other uniform act.

Uniform Prudent Investor Act – approved in 1994, this Act has been enacted in over half of the States. This Act, and variant forms enacted in a number of other States, will soon displace the obsolete “prudent man” concept. The Prudent

Investor Act is incorporated into the Uniform Trust Act as Article 9. States which have enacted the Uniform Prudent Investor Act are encouraged to recodify it as part of this Act.

Revised Uniform Principal and Income Act – a major revision of this widely enacted Uniform Act was approved in 1997. The Act extensively revises the accounting rules applicable to both trusts and estates. The Revised Uniform Principal and Income Act (1997) is incorporated into the Uniform Trust Act as Article 10.

Uniform Management of Institutional Funds Act – approved in 1972, this Act has been enacted in 46 jurisdictions. This Act governs the administration of endowment funds held by charitable, religious, and other eleemosynary institutions. The Act establishes a standard of prudence for use of appreciation on assets, provides specific authority for the making of investments, authorizes the delegation of this authority, and specifies a procedure, through either donor consent or court approval, for removing restrictions on the use of donated funds.

Uniform Custodial Trust Act – approved in 1987, this Act has been enacted in 13 jurisdictions. This Act, which allows standard trust provisions to be automatically incorporated into the terms of the trust simply by referring to the Act, is not displaced by the Uniform Trust Act but complements it.

Uniform Probate Code Article VII – approved in 1969, Article VII has been enacted in about 15 jurisdictions. Article VII, although titled "Trust Administration," is a modest statute, addressing only a limited number of topics, such as trust registration, jurisdiction, and trustee liability to third parties. The substance of Article VII, other than its provisions on trust registration, are absorbed into the Uniform Trust Act, the provisions on jurisdiction in Article 2, and the provision on limitation of trustee liability to third parties at Section 1107.

Uniform Common Trust Fund Act – approved in 1938, this Act has been enacted in 34 States. The drafters of the Uniform Trust Act have elected not to address the subject of common trust funds and will leave this Act undisturbed. In recent years, many banks have their replaced their common trust funds with proprietary mutual funds that may also be made available to non-trust customers. The Uniform Trust Act addresses the use of proprietary funds, principally at Section 803.

Uniform Trust Act (1937) – this largely overlooked Act of the same name was enacted in only six States, none within the past several decades. Despite a title suggesting comprehensive coverage of its topic, this Act addresses even less topics than does Article VII of the UPC. This Act is not being used in the drafting of the current Act. States enacting the current Uniform Trust Act should repeal this earlier namesake.

Uniform Supervision of Trustees for Charitable Purposes Act – approved in 1954, this Act has been enacted in four States. This Act is limited to mechanisms for monitoring the actions of charitable trustees and does not address the substantive law of charitable trusts, including the doctrine of cy pres. Cy pres is addressed in Section 414 of the Uniform Trust Act.

Uniform Testamentary Additions to Trusts Act – this Act is available in two versions: the 1960 Act, with 32 enactments; and the 1991 Act, with 15 enactments through 1996. This Act validates pourover devises to trusts. While not incorporated into the Uniform Trust Act, the Testamentary Additions to Trusts Act, like the Uniform Trust Act, is designed to facilitate the use of the revocable living trust.

Uniform Probate Code – approved in 1969, and enacted in close to complete form in about 20 States but influential in all, the UPC overlaps with trust topics in several areas. One area of overlap, already mentioned, is UPC Article VII. Another area of overlap concerns representation of beneficiaries. UPC Section 1-403 provides principles of representation for achieving binding judicial settlements of matters involving both estates and trusts. The Uniform Trust Act adopts these representation principles, and extends them to nonjudicial settlements concerning trusts and to notices and consents required by or which may be given under the Act. See Uniform Trust Act, Article 3. A final area of overlap between the UPC and trust law topics concerns rules of construction. The UPC, in Article II, Part 7, provides rules of construction applicable to wills, trusts, and other nonprobate instruments. The Drafting Committee has elected not to incorporate these rules into the Uniform Trust Act but encourages states considering this Act to also consider enacting Article II, Part 7 of the UPC.

Role of Restatement of Trusts – The Restatement (Second) of Trusts was approved by the American Law Institute in 1957. But beginning in the late 1980s, work on the Restatement Third began. The portion of Restatement Third relating to the prudent investor rule and other investment topics was completed and approved in 1992. A tentative draft of the portion of Restatement Third relating to the rules on the creation and validity of trusts was approved in 1996. The Uniform Trust Act is being drafted in close coordination with the writing of the Restatement Third. To the extent feasible, the Uniform Trust Act follows the portions of the Restatement Third which have been completed to date. Through close consultation with the other project's reporter, efforts are being made as well to coordinate the drafting of this Act with the current best guess on the probable substance of the uncompleted portions of the

Restatement. Given the current pace of the Restatement Third, the Uniform Trust Act will likely be completed several years ahead of the other project.

Models for Drafting – While the Uniform Trust Act is the first comprehensive *Uniform* Act on the subject of trusts, comprehensive trust statutes are already in effect in several States. Notable examples include the statutes in California, Georgia, Indiana, and Texas, all of which have been referred to in the drafting process. Most influential has been the 1986 California statute, which was used by the Drafting Committee as its initial model. The California statute is known as the Trust Law and is found at Division 9 of the California Probate Code (Sections 15000 *et seq*.). There are several reasons why the California statute was selected. First, the California statute addresses many more issues than do the statutes of the other States. Second, the California law draws extensively from the other state models. Most importantly, the California Law Revision Commission, which drafted the California Trust Law, conformed its drafting with the text of the Restatement of Trusts, although of the Restatement Second, not Restatement Third. The California law was only a starting point, however. The draft at this point is entirely the Drafting Committee's work product. Since drafting began in 1995, each of the California provisions had been discussed by the Drafting Committee and either accepted, rejected or revised. The provisions which remain have also been reorganized.

Act as Default Law – The Act contains a series of default rules which may be modified by the terms of a trust. But there are certain provisions not subject to change by the settlor. These include the methods for creating a trust and the procedures for terminating of modifying a trust other than by its express terms (Article 4), the exceptions to enforcement of a spendthrift provision (Article 5), and the standard of capacity for creating a revocable trust (Section 601). While the settlor is free to modify the powers and duties of a trustee, a trustee must always act in good faith and with regard to the purpose of the trust and the interest of the beneficiaries. See Sections 801 and 1105.

Overview of Act

Article 1 – General Provisions and Definitions – In addition to definitions (Section 105), this article addresses miscellaneous but important issues, including clarification that the common law of trusts supplements the Act (Section 103), and that the settlor, absent overriding public policy concerns, is free to select the governing law with respect to interpretation of the trust's terms.

Article 2 - Jurisdiction of Court - This article addresses selected issues involving judicial proceedings concerning trusts, particularly trusts with contacts to more than one State or country. The key concept is locating the trust's principal place of administration, which determines where the trustee and beneficiaries have consented to jurisdiction and which court has primary jurisdiction over proceedings involving the trust's administration. A procedure for changing the principal place of administration is also provided.

Article 3 - Representation of Beneficiaries and Settlement Agreements – This article deals with the important topic of representation of beneficiaries, both representation by fiduciaries (personal representatives, guardians and conservators), and what is known as virtual representation. The representation principles of the article apply for purposes of settlement of disputes, whether by a court or nonjudicially. They apply for the giving of required notices. They apply for the giving of consents to certain actions.

Article 4 – Creation, Validity, Modification and Termination of Trust – This article specifies the requirements for creating, modifying and terminating trusts. Most of the requirements relating to creation of trusts (Sections 401 through 406) track traditional doctrine, including intention, capacity, a requirement of property, and a trust purpose. This article develops a three-part classification system for trusts; noncharitable, charitable, and honorary. Noncharitable trusts require an ascertainable beneficiary and a purpose of benefit to its beneficiaries. Charitable trusts, on the other hand, are by their very nature created to benefit the public at large. Honorary trusts are trusts for noncharitable purposes which are valid despite the absence of an ascertainable (i.e., human) beneficiary. These include trusts for the care of an animal and trusts for other noncharitable purposes such as the maintenance of a cemetery lot.

Sections 407 through 415 provide a series of interrelated rules on when a trust may be terminated or modified other than by its express terms. The overall objective of these sections is to liberalize the common law rules but without losing sight of the principle that preserving the settlor's intent is paramount. Termination or modification may be allowed upon beneficiary consent if the trust no longer serves a material purpose or if the settlor concurs (Section 408), by the court in response to unanticipated circumstances (Section 409), or if continued administration under the trust's existing terms would be uneconomical (Section 410). Trusts may be reformed to correct a mistake of law or fact (Section 411), or modified to achieve the settlor's tax objectives (Section 412). Trusts may be combined or divided (Section 413). Charitable trusts may be modified or terminated under cy pres to better fulfill the settlor's charitable purpose (Section 414). A settlor, trustee, or beneficiary has standing to petition the court with respect to a proposed termination or modification (Section 415).

Article 5 – Spendthrift Provisions and Claims by Creditors – This article addresses the validity of a spendthrift provision and other issues relating to the rights of creditors, both of the settlor and beneficiaries, to reach the trust to collect a debt. Section 501 specifies the requirements for a valid spendthrift provision and, if valid, its effect. For trusts without valid spendthrift provisions, Section 502 describes the circumstances under which a beneficiary's creditors may reach the beneficiary's interest. Section 503 lists the categories of creditors whose claims are not subject to a spendthrift bar, and the extent to which such a creditor may reach the debtor beneficiary's interest. Sections 504 through 506 address special categories where the rights of a beneficiary's creditors may not depend on whether the trust contains a spendthrift provision. Section 504 deals with discretionary trusts and trusts which provide for a standard of distribution. Section 505 addresses creditor claims against a settlor, whether the trust is revocable or irrevocable, and if revocable, whether the claim is made during the settlor's lifetime or incident to the settlor's death. Section 506 provides a creditor with a remedy if a trustee fails to make a required distribution within a reasonable time.

Article 6 - Revocable Trusts – Because of the widespread use in recent years of the revocable trust as an alternative to a will, this short article is one of the more important articles of the Act. Each section of this article deals with issues of significance not totally settled under current law. A general theme of this article and of the other parts of the Act is to treat the revocable trust as the functional equivalent of a will. The article specifies a standard of capacity, provides that a trust is presumed revocable unless its terms provide otherwise, prescribes the procedure for revocation or modification of a revocable trust, and provides a statute of limitations on contests.

Article 7 - Office of Trustee – This article contains a series of default rules dealing with the office of trustee, all of which may be modified by the terms of the trust. Sections 701 and 702 address the process for getting a trustee into office, including the procedures for indicating an acceptance of office and whether bond will be required. Section 703 covers the office of cotrustee, permitting cotrustees to act by majority action, specifying the extent to which one trustee may delegate to another, and describing the circumstances under which a cotrustee may be held responsible for the actions of the other trustee or trustees. Sections 704 through 708 address changes in the office of trustee, specifying the circumstances when a vacancy must be filled, the procedure for resignation, the grounds for removal, and the process for appointing a successor. Sections 709 and 710 prescribe the standard for determining trustee compensation and reimbursement for expenses advanced.

Article 8 - Duties and Powers of Trustee – This article states the fundamental duties of a trustee and lists the trustee's powers. The duties listed are not new, but how the particular duties are formulated and applied has changed over the years. This article was drafted where possible to conform with the 1994 Uniform Prudent Investor Act. The Uniform Prudent Investor Act prescribes a trustee's responsibilities with respect to the management and investment of trust property. This article also addresses a trustee's duties with respect to distributions to beneficiaries.

Article 9 - Uniform Prudent Investor Act – This article reproduces the Uniform Prudent Investor Act as approved in 1994. Because of the widespread adoption of the Uniform Prudent Investor Act, no effort has been made to interweave the Prudent Investor Act into the preceding part of this Act. States adopting this Act which have previously enacted the Prudent Investor Act are encouraged to recodify their version of the Prudent Investor Act by reenacting it as part of this Act. By enacting the Prudent Investor Act as a separate part of this Act, uniformity with States which have enacted the Prudent Investor Act in its free-standing form will be preserved.

Article 10 - Revised Uniform Principal and Income Act – This article reproduces the Revised Uniform Principal and Income Act as approved by the Uniform Law Conference at its 1997 Annual Meeting. The Revised Act supercedes previous Uniform Principal and Income Acts approved in 1931 and 1962. States enacting the 1997 revision should repeal their previous version of the act.

Article 11 - Liability of Trustees and Rights of Beneficiaries – Sections 1101 through 1106 lists the remedies for breach of trust, describes how money damages are to be determined, provides a statute of limitations on claims against a trustee, and specifies other defenses, including consent of a beneficiary and recognition of and limitations on the effect of an exculpatory clause. Sections 1107 through 1109 addresses trustee relations with third parties. The emphasis is on encouraging trustees and third parties to engage in commercial transactions to the same extent as would occur if the property were not held in trust. Section 1109 permits a trustee to rely on a certification of trust, thereby hopefully reducing requests by third parties for copies of the complete trust instrument.

Article 12 - Transitional and Miscellaneous Provisions – The Act is intended to have the widest possible application, consistent with constitutional limitations. The Act applies not only to trusts created on or after the effective date, but also applies to trusts in existence on the date of enactment.

UNIFORM TRUST ACT

ARTICLE 1

GENERAL PROVISIONS AND DEFINITIONS,

SECTION 101. SHORT TITLE. This [Act] may be cited as the Uniform Trust Act.

SECTION 102. CONSTRUCTION AGAINST IMPLIED REPEAL. This [Act] is a general act intended to provide unified coverage of its subject matter.

SECTION 103. COMMON LAW OF TRUSTS. The common law of trusts supplements this [Act] except to the extent that it is modified by this [Act] or another statute of this State.

Comment

The Act codifies those portions of the law of express trusts that are most amenable to codification. The Act is supplemented by the common law of trusts, including principles of equity, particularly as articulated in the Restatement of Trusts and the Restatement of Restitution. The common law of trusts is not static but includes the contemporary and evolving rules of decision developed by the courts in exercise of their power to adapt the law to new situations and changing conditions.

SECTION 104. CHOICE OF LAW. The meaning and effect of the terms of a trust are determined by the law of the State designated in those terms, unless the application of that State’s law is contrary to the public policy of this State applicable to the trust.

Comment

This section, which is derived from Section 2-703 of the Uniform Probate Code, allows a settlor to select the law to govern the meaning and effect of the terms of a trust, regardless of where the trust property may be physically located, whether it consists of real or personal property, and whether the trust was created by will or during the settlor's lifetime. Because this section deals solely with matters of interpretation, and not with choice of law as to the validity of a trust, the law selected by the settlor need not have any other connection with the trust.

The section does not attempt to specify the particular public policies sufficient to override a settlor's expression of intent. These public policies will vary depending upon the locale and may change over time. But certain examples do reoccur. Trusts which seek to defeat the marital property rights of a surviving spouse or to encourage a beneficiary to divorce are examples of trusts which, depending on the particular jurisdiction, may be overridden on public policy grounds. The mere fact that a term of a trust violates the public policy of the forum jurisdiction does not necessarily mean that the term is invalid. The public policy violated must also have some connection to the trust. The fact that the forum is a convenient location to resolve a dispute does not mean that it should apply its own public policy restrictions if it is neither the trust's principal place of administration or another jurisdiction having a significant connection with the trust or its beneficiaries.

This Act does not attempt to prescribe choice of law rules should the trust not include a governing law provision, preferring to leave this often complex issue to the courts. Nor does this Act prescribe choice of law rules with respect to the validity of a trust. For a discussion of the validity and effect of governing law clauses, see 5A Austin W. Scott & William F. Fratcher, The Law of Trusts §§ 591, 596, 606, and 611 (4th ed. 1989). For a discussion of the choice of law rules applicable to trusts more generally, see id. §§ 553-666.

SECTION 105. DEFINITIONS. In this [Act]:

(1) "Beneficiary" means a person who has any present or future beneficial interest in a trust, whether vested or contingent, or a power of appointment.

(2) "Charitable trust" means a trust created for a charitable purpose as described in Section 404. The term excludes the interests in the trust of a noncharitable beneficiary.

(3) "Conservator" means a person appointed by a court to manage the estate of a minor or adult individual.

(4) "Fiduciary," used as a noun, includes a personal representative, guardian, conservator, and trustee.

(5) "Good faith" means:

(A) when used in reference to a trustee, honesty in fact and the observance of fiduciary principles; or

(B) when used in reference to a third party, honesty in fact and the observance of reasonable standards of fair dealing.

(6) "Guardian" means a person appointed by a court [,parent, or spouse] to make decisions regarding the support, care, education, health, and welfare of a minor or adult individual. The term does not include a guardian ad litem.

(7) "Know," with respect to a fact, means to have knowledge of the fact or have reason to know, based upon all of the facts and circumstances known to the person at the time, that the particular fact exists.

(8) "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.

(9) "Petition" includes complaint and statement of claim.

(10) "Property" means anything that may be the subject of ownership, whether real or personal, legal or equitable, or any interest therein. The term includes a chose

in action, claim, or beneficiary designation under a policy of insurance, financial instrument, employees' trust, or other arrangement, whether revocable or irrevocable.

(11) "Qualified beneficiary" means a beneficiary who, on the date the beneficiary's qualification is determined, is entitled or eligible to receive a distribution of trust income or principal or who would be entitled to receive a distribution if the event causing the trust's termination occurred.

(12) "Settlor" means a person who creates a trust. The term includes a testator.

(13) "Spendthrift provision" means a term of a trust which restrains the voluntary and involuntary transfer of a beneficiary's interest.

(14) "State" means a State of the United States, the District of Columbia, Puerto Rico, the United States Virgin Islands, or any territory or insular possession subject to the jurisdiction of the United States.

(15) "Terms of a trust" means the manifestation of the intent of a settlor regarding a trust's provisions at the time of the trust's creation or amendment which is expressed in a manner admitting of its proof in a judicial proceeding, whether by written or spoken words or by conduct.

(16) "Trust" means an express trust, charitable or noncharitable, with additions thereto, wherever and however created, including a trust created pursuant to a statute, judgment, or decree under which the trust is to be administered in the manner of an express trust.

(17) "Trustee" includes an original, additional, successor, or cotrustee, whether or not appointed or confirmed by a court.

Comment

"Beneficiary" (paragraph (1)) refers only to a beneficiary of a trust as defined in the Act. The term includes not only beneficiaries who received their interests under the terms of the trust but also beneficiaries who received their interests by any other means, including by an assignment, the exercise of a power of appointment, by a resulting trust upon the failure of an interest or gap in a disposition, or through the operation of an antilapse statute upon the predecease of a named beneficiary. The fact that a person incidentally benefits from the trust does not mean that the person is a beneficiary. For example, neither a trustee nor persons hired by the trustee become beneficiaries merely because they receive compensation from the trust. See Restatement (Third) of Trusts § 48 (Preliminary Draft No. 4, 1998). See also Restatement (Second) of Trusts § 126 cmt. f (1959).

Under the Act, only the charitable portion of a trust with both charitable and noncharitable beneficiaries qualifies as a "charitable trust" (paragraph (2)). Consequently, a split-interest trust will in certain instances be governed by two sets of provisions, one applicable to the charitable interests, the other the noncharitable.

The definition of "fiduciary" (paragraph (4)) refers to the person holding a fiduciary office as opposed to the duties or obligations of the office. A trustee may engage in transactions with another trust, decedent's estate or conservatorship estate of which the trustee is the fiduciary. See Section 803(f)(3). A trustee has a duty to redress a breach of trust committed by a former trustee or other fiduciary from whom the trustee received trust property. See Section 813.

Under the Act, more is required than honesty of intent before a trustee, in dealing with the beneficiaries, or a third party, in dealing with a trustee, can be said to have been acting in "good faith" (paragraph (5)). The trustee or third party must also have exhibited honesty in conduct. For a third party, this requires the observance of reasonable standards of fair dealing, a requirement based on comparable provisions of the Uniform Commercial Code. See Unif. Commercial Code § 3-103(4). For a trustee, honesty in conduct is exhibited by acting in accordance with fiduciary principles, particularly the obligation not to place the trustee's own interests above those of the beneficiaries. See Section 803 (duty of loyalty). The obligation of a trustee to act in good faith may not be waived in the terms of the trust. See Section 801 (modification of duties and powers of settlor); Section 815 (duty with regard to discretionary power). Nor is a term of a trust which exculpates a trustee for not acting in good faith enforceable. See Section 1105 (exculpation of trustee). With respect to a third person, good faith, and the associated requirement of observance of reasonable standards of fair dealing, is required before the third person may be protected in dealings with the trustee (see Section 1108), or for rejecting a certification of trust. See Section 1109.

Under the Act, a "guardian" (paragraph (6)) makes decisions with respect to personal care; a "conservator" (paragraph (3)) manages property. The terminology used is that employed in Article V of the Uniform Probate Code, and in its free-standing Uniform Guardianship and Protective Proceedings Act. Enacting jurisdictions not using these terms in the defined sense should substitute their own terminology. The definition of "guardian" accommodates those jurisdictions which allow appointment of a guardian by a parent or spouse in addition to appointment by a court. Enacting jurisdictions which allow appointment of a guardian solely by a court should delete the bracketed language.

The fact that a person does not have actual knowledge of a particular fact does not mean that the person did not "know" the fact (paragraph (7)). But neither is a person charged with knowledge of facts the person would have discovered upon investigation. This definition takes an intermediate approach. A fact is known to a person if the person had actual knowledge of the fact or had reason to know of the fact's existence based on all of the circumstances and other facts actually known to the person. "Know" is used in its defined sense in Section 809 (trustee knows holder of power to direct has violated fiduciary duty owes to beneficiaries), and Section 1108 (protection of persons dealing with trustee). But actual knowledge is required if the knowledge requirement relates to a proceeding in court. See Sections 604(b) (limitation on contest of revocable trust), 307 (notice of judicial settlement), and 308 (appointment of guardian ad litem). And for certain actions, a person is charged with knowledge of facts the person would have discovered upon reasonable inquiry. See Sections 1104 (limitation of action against trustee following final report or other statement), and 1106 (nonliability of trustee for beneficiary's consent, release, or ratification).

The definition of "property" (paragraph (10)) removes any lingering uncertainty that a revocable designation under an employee plan or life insurance contract is not a sufficient property interest to activate a trust. See also Section 401 and Comment (methods of creating trust).

Because of the difficulty of identifying beneficiaries with remote contingent interests and their probable lack of interest in the day-to-day affairs of the trust, the Act uses the concept of "qualified beneficiary" (paragraph (11)) to limit the class of beneficiaries to whom certain notices must be given or consents received. The definition of qualified beneficiaries is used to define the class to whom notice must be given of a trustee resignation. See Section 705. The qualified beneficiary must receive the trustee's annual report and other notices required by Section 814. Notice to the qualified beneficiaries is also required before a trust may be combined or divided. See Section 413. Actions which may be accomplished by the consent of the qualified beneficiaries include the transfer of a trust's jurisdiction and the appointment of a successor trustee. See Sections 205 (transfer of jurisdiction) and 708 (filling vacancy in trusteeship).

The qualified beneficiaries are limited to the beneficiaries currently eligible to receive a distribution from the trust as well as what might be termed the first line remaindermen, that is, the beneficiaries who would receive the principal were the event triggering the trust's termination to occur on the date in question. Such a terminating event will typically be the death or deaths of the beneficiaries currently eligible to receive the income. Should a qualified beneficiary be a minor, incapacitated, unknown or unascertained, the representation and virtual representation principles of Article 3 may apply, including the possible appointment of a guardian ad litem or special representative to represent the beneficiary's interest.

Determining the identity of the "settlor" (paragraph (12)) is usually not an issue. The same person will both sign the trust instrument and fund the trust. Ascertaining the identity of the settlor becomes more difficult when more than one person signs the trust instrument or funds the trust. The fact that a person is designated as the "settlor" by the terms of the trust is not necessarily determinative. For example, the person who executes the trust instrument may be acting as the agent for the person who will be funding the trust. In that case, the person funding the trust, and not the person signing the trust instrument, will be the settlor. Similarly, should more than one person contribute to a trust, all of the contributors will ordinarily be treated as settlors in proportion to their respective contributions, regardless of which one signed the trust instrument. However, in the case of a revocable trust, transfers made to the trust by a person who did not participate in the trust's creation will frequently be intended as a donative transfer to the person who originally created the trust. In that event, only the person who created the trust, and not the later donor, will be the settlor.

Ascertaining the identity of the settlor is important for a variety of reasons. It is important for determining rights in revocable trusts. See Sections 505(a)(2)-(3) (creditor claims against settlor of revocable trust), 602 (revocation or modification of revocable trust), and 604 (limitation on contest of revocable trust). It is also important for determining rights of creditors in irrevocable trusts. See Section 505(a)(1) (creditor can reach maximum amount trustee could distribute to settlor). While the settlor of an irrevocable trust traditionally has no continuing rights over the trust except for a right to terminate the trust with the beneficiaries' consent (see Section 408), under the Act the settlor of an irrevocable trust may also petition for removal of the trustee or for a court order relating to trust termination or modification. See Sections 415 (petitions for approval or disapproval), and 706 (removal of trustee). Section 415 also permits a settlor to maintain an action to enforce or modify a charitable trust.

"Spendthrift provision" (paragraph (13)) means a term of a trust which restrains the transfer of a beneficiary's interest, both by a voluntary act of the beneficiary and by an action by a beneficiary's creditor or assignee, which at least as far as the beneficiary is concerned, would be involuntary. The effect of a spendthrift provision is addressed in Article 5. The presence of a spendthrift provision may also constitute a material purpose sufficient to prevent the termination of a trust by agreement of the beneficiaries, although the Act does not presume this result. See Section 408(a).

"Terms of a trust" (paragraph (15)) is a defined term used with some frequency in the Act. While the wording of a written trust instrument is almost always the most important determinant of a trust's terms, the definition is not so limited. Oral statements, the settlor's family circumstances, and, to the extent the settlor was otherwise silent, rules of construction, all may have a bearing on determining a trust's meaning. If a trust established by order of court is to be administered as an express trust, the terms of the trust are determined from the court order as interpreted in light of the general rules governing interpretation of judgments. See Restatement (Third) of Trusts § 4 and cmt. f (Tentative Draft No. 1, 1996). See also Restatement (Second) of Trusts § 4 (1959).

Not all evidence may necessarily be considered in determining the terms of a trust. A manifestation of a settlor's intention does not constitute evidence of a trust's terms if it would be inadmissible in a judicial proceeding in which the trust's terms are in question. See Restatement (Second) of Trusts § 4 cmt. a, b (1959); Restatement (Third) of Trusts § 4 cmt. b (Tentative Draft No. 1, 1996). See also Restatement (Third) Property: Donative Transfers §§ 10.2, 11.1-11.3 (Tentative Draft No. 1, 1995). For example, in many States a trust of real property is unenforceable unless evidenced by a writing, although this Act does not so require, leaving this issue to be covered, if the enacting jurisdiction so elects, by separate statute. See Section 403 (evidence of oral trust). Evidence otherwise relevant to determining the terms of a trust may also be excluded under other principles of law, such as the parol evidence rule.

Under the Act, a "trust" (paragraph (16)) means an express trust, whether private or charitable, including a trust created by court judgment or decree which is to be administered in the manner of an express trust. Excluded from the Act's coverage are constructive trusts, which are not express trusts but remedial devices imposed by law. The Act is directed primarily at express trusts which arise in an estate planning or other donative context, but the definition of "trust" is not so limited. Trusts created pursuant to a divorce action would be included, even though such a trust is not donative but is created pursuant to a bargained for exchange. The extent to which even more commercially-oriented trusts are subject to the Act will vary depending on the type of trust and the laws, other than this Act, under which the trust was created.

Commercial type trusts come in numerous different forms, including trusts created pursuant to a state business trust act and trusts created for special purposes, such as to pay a pension or managed pooled investments. See John H. Langbein, The Secret Life of the Trust: The Trust as an Instrument of Commerce, 107 Yale L.J. 165 (1997).

ARTICLE 2

JURISDICTION OF COURT

General Comment

This article addresses selected issues involving judicial proceedings concerning trusts, particularly trusts with contacts in more than one State or country. This article is not intended to provide comprehensive coverage of court jurisdiction or procedure with respect to trusts. Many of these issues are better addressed elsewhere, such as in the State's rules of civil procedure or as provided by court rule.

While the intervention of the court in the administration of a trust is not encouraged, the jurisdiction of the court is available as invoked by persons interested in the trust or as otherwise provided by law, including by the court acting on its own initiative (Section 201). Proceedings involving the administration of a trust will normally be brought in the court at the trust's principal place of administration, which is determined under Section 202. If not specified in the terms of the trust, the principal place of administration will usually be the place where the day-to-day activity of the trust is carried out. The trustee, by operation of law, is deemed to have consented to the jurisdiction of the court at the principal place of administration (Section 203), although courts in other places may also entertain proceedings involving the administration of a trust if the parties consent or the interests of justice so require (Section 204).

Changing a trust's principal place of administration is sometimes desirable, particularly to lower a trust's state income tax. Many trust instruments expressly authorize such a transfer, but for those which do not, Section 205 provides a procedure for transfer, either with the consent of the "qualified" beneficiaries or upon approval of court.

Sections 206 and 207 are optional, bracketed provisions relating to subject-matter jurisdiction and venue.

The jurisdictional issues addressed in this part are also addressed in Article VII of the Uniform Probate Code, but the Drafting Committee has elected not to adopt the UPC provisions relating to trust registration. In this it is following the example of a number of States which have enacted Article VII of the UPC without the trust registration feature.

SECTION 201. ROLE OF COURT IN ADMINISTRATION OF TRUST. The court may not intervene in the administration of a trust except to the extent the jurisdiction of the court is invoked by persons interested in the trust or otherwise exercised as provided by law.

Comment

The Act encourages the resolution of disputes without resort to the courts. However, the court is always available to the extent its jurisdiction is invoked by persons interested in the trust. Also, this section does not restrict the court's inherent and historical jurisdiction in trust matters, including the ability to provide the trustee with instructions even in the absence of a dispute. A trustee should not resort to the court as a matter of routine. Excessive resort to the court, with its attendant costs, may constitute a breach of the duty to incur only reasonable costs of administration. See Section 806.

This section is based on Uniform Probate Code § 7-201(b). It is also consistent with National Probate Court Standard 3.2.1 (Nat'l Center for State Courts 1993) and Article III of the Uniform Probate Court, which encourage the settlement of decedent's estates with a minimum of court oversight.

SECTION 202. PRINCIPAL PLACE OF ADMINISTRATION. The principal place of administration of a trust must be determined in the following order of priority:

(1) as transferred pursuant to Section 205;

(2) as designated in the terms of the trust;

(3) the usual place where the day-to-day activity of the trust is carried on by the trustee or the trustee's representative who is primarily responsible for the administration of the trust; or

(4) if the trust has one trustee, the trustee's residence or usual place of business, or if the trust has more than one trustee:

(A) the usual place of business of the financial-service institution acting as trustee if there is only one financial-service institution acting as trustee;

(B) the residence or usual place of business of the individual who is a professional fiduciary if there is only one such individual and no cotrustee that is a financial-service institution; or

(C) the residence or usual place of business of the greater number of the cotrustees, or if there is no such place, the residence or usual place of business of any of the cotrustees.

Comment

This section prescribes rules for determining a trust's principal place of administration. Locating a trust's principal place of administration will ordinarily determine where the trustee and beneficiaries are subject to suit concerning the trust. It may also be important for other matters, such as payment of state income tax.

Under the Act, the fixing of a trust's principal place of administration will determine where the trustee and beneficiaries have consented to suit (Section 203), the circumstances when a proceeding concerning the administration of the trust may be entertained by a court of another jurisdiction (Section 204), the procedure for transferring jurisdiction to another State or country (Section 205), and the rules for locating venue within a particular State (Section 207).

This section prescribes a priority list for ascertaining the principal place of administration, but settlors who expect to name a trustee or cotrustees with significant contacts in more than one State may wish to address this issue in the terms of the trust. Pursuant to paragraph (2), a designation in the terms of the trust is controlling absent a later transfer of jurisdiction to another place. Designating the principal place of administration should be distinguished from designating the law to determine the meaning and effect of the trust's terms, as allowed by Section 104. A settlor is free to designate one jurisdiction as the principal place of administration and another to control the meaning of the dispositive provisions. Also, the law governing the construction of the beneficial provisions of a trust does not change if the principal place of administration is transferred to another State. See Section 205(e).

Most trusts will be controlled by paragraph (3), which fixes the principal place of administration at the place where the day-to-day activity of the trust is carried on.

The place where the day-to-day activity is carried on will fix the principal place of administration even if the trust is created by will or contains real property. For financial-service institution trustees, the place where the day-to-day activity is carried on will usually be the place where the personal trust officer is located and not the place where the investments are safeguarded or records processed.

If the trust is not administered at a fixed location, absent other priority under this section, the principal place of administration will be determined under paragraph (4), which looks to the trustee's or cotrustees' residence or usual place of business. Under paragraph (4), it is possible that more than one jurisdiction will qualify as the trust's principal place of administration. This could occur, for example, if cotrustees are located in more than one place. The practical result of such dual residence or place of business may be to grant a beneficiary the choice of forum in which to bring suit against a trustee.

SECTION 203. JURISDICTION OVER TRUSTEE AND BENEFICIARY.

(a) By accepting the trusteeship of a trust having its principal place of administration in this State, or by moving the principal place of administration to this State, the trustee submits personally to the jurisdiction of the courts of this State as to any matter relating to the trust.

(b) A beneficiary of a trust having its principal place of administration in this State is subject to the jurisdiction of the courts of this State as to any matter relating to the trust.

Comment

This section, which is based on Arizona Revised Statutes § 14-7202, clarifies that the courts of the principal place of administration have jurisdiction to enter orders relating to the trust that will be binding on both the trustee and beneficiaries. Consent to jurisdiction does not dispense with any required notice, however. This Act leaves to other law the procedures for giving notice, including the extent to which substituted service might be available if a trustee or beneficiary cannot be located or evades service of process. With respect to jurisdiction over a beneficiary, the Comment to Uniform Probate Code § 7-103, upon which the Arizona statute is based, is instructive:

> It also seems reasonable to require beneficiaries to go to the seat of the trust when litigation has been instituted there concerning a trust in which they claim beneficial interests, much as the rights of shareholders of a corporation can be determined at a corporate seat. The settlor has indicated a principal place of administration by its selection of a trustee or otherwise, and it is reasonable to subject rights under the trust to the jurisdiction of the Court where the trust is properly administered.

Obtaining jurisdiction over the trustee and beneficiaries pursuant to this section does not preclude jurisdiction elsewhere on some other basis.

SECTION 204. DISMISSAL OF MATTERS RELATING TO FOREIGN TRUSTS.

(a) The court, over the objection of a party, may not entertain judicial proceedings brought by a trustee or beneficiary concerning the administration of a trust that has its principal place of administration outside this State unless:

(1) all appropriate parties could not be bound by litigation in the courts of the other State or country; or

(2) the interests of justice would be seriously impaired by the failure of the court to entertain proceedings.

(b) The court may require a party to consent to the jurisdiction of another court as a condition for a stay or dismissal of a proceeding described in subsection (a).

Comment

This section is designed to centralize litigation involving the administration of a trust at the place of principal administration, but several exceptions are recognized. First, the court in a location other than the place of principal administration may exercise jurisdiction if doing so would prevent a substantial injustice. Second, the court may entertain the case if all appropriate parties would not be bound by a judgment of a court of the principal place of administration. Finally, actions to determine the existence or nonexistence of a trust are not subject to this section, because such actions concern whether there is even a trust to administer, not how the trustee is conducting the administration of an already existing trust. Also excluded are actions by or against third parties, such as debtors or creditors of a trust or an action by a creditor of a beneficiary. The jurisdiction of the court in such cases is to be determined under generally applicable rules of civil procedure.

The Act does not attempt to list the types of judicial proceedings involving trust administration that might be brought by a trustee or beneficiary. But such an effort is made in California Probate Code § 17200. Excluding matters not germane to the Uniform Trust Act, the California statute lists the following as items relating to the "internal affairs" of a trust:

(1) Determining questions of construction;

(2) Determining the existence or nonexistence of any immunity, power, privilege, duty, or right;

(3) Determining the validity of a trust provision;

(4) Ascertaining beneficiaries and determining to whom property will pass upon final or partial termination of the trust;

(5) Settling accounts and passing upon the acts of a trustee, including the exercise of discretionary powers;

(6) Instructing the trustee;

(7) Compelling the trustee to report information about the trust or account to the beneficiary;

(8) Granting powers to the trustee;

(9) Fixing or allowing payment of the trustee's compensation or reviewing the reasonableness of the compensation;

(10) Appointing or removing a trustee;

(11) Accepting the resignation of a trustee;

(12) Compelling redress of a breach of trust by any available remedy;

(13) Approving or directing the modification or termination of a trust;

(14) Approving or directing the combination or division of trusts; and

(15) Authorizing or directing transfer of a trust or trust property to or from another jurisdiction.

To make certain that a court in the place of principal administration or elsewhere may issue a binding order, subsection (b) allows the court to require a party to consent to the jurisdiction of another court as a condition for a stay or dismissal of proceedings brought under this section.

SECTION 205. TRANSFER OF JURISDICTION.

(a) A trustee may change a trust's principal place of administration to another State or country or transfer some or all of the trust property to a different trustee outside this State:

(1) by substantially complying with a method specified in the terms of the trust; or

(2) if the terms of the trust do not specify a method;

(A) with the consent of all of the qualified beneficiaries; or

(B) with the approval of the court, subject to such terms and conditions as the court may order.

(b) The court may approve the transfer of a trust's principal place of administration to or from this State, or of the transfer of trust property to or from this State to a new trustee, if it finds that:

(1) the transfer will promote the best interest of the trust and of its beneficiaries, taking into account the economical and convenient administration of the trust and the views of the beneficiaries;

(2) any new trustee to whom the trust property would be transferred is willing and able to administer the trust or trust property under the terms of the trust; and

(3) if approval of the transfer by the other court is required under the law of the other State or country, the proper court in the other State or country has approved the transfer.

(c) If the court approves a transfer of a trust or of trust property to another State or country, the court may require that a successor trustee be substituted in any litigation pending in this State. Delivery of property to a successor trustee in accordance with the order of the court is a full discharge of the transferring trustee with respect to all property covered by the order.

(d) If the court approves a transfer of a trust or of trust property to this State, the court may require bond as provided in Section 702.

(e) Except as to its validity and the construction of its beneficial provisions, a trust transferred to this State must be administered in the same manner as a trust created in this State.

Comment

This section creates a procedure for changing the principal place of administration. Such a change may be desirable to secure a lower state income tax rate. Other reasons may include the relocation of the trustee or beneficiaries, the appointment of a new trustee, or a change in the location of the trust investments. This section is not limited to transfers of jurisdiction to or from other States of the United States, but may include a transfer of jurisdiction to or from a different country.

This section does not preclude the acquisition of a new principal place of administration by other means, such as would occur upon the trustee's removal to another State and the carrying on of the day-to-day activity of the trust in the new place. Pursuant to Section 203, the new location will become a new principal place of administration, and under Section 204, the trustee will have consented to the jurisdiction of the court in the new place. But without complying with this section, the trustee, following the move, may also remain subject to the jurisdiction of the courts in the former place, particularly if the former place is where the beneficiaries are located.

This section validates the practice of specifying in the terms of the trust the procedure for changing the principal place of administration to another place. Subsection (a)(1) authorizes a trustee to change the principal place of administration to another State or country, or transfer some or all of the trust property to a different trustee outside of the State by substantially complying with a method specified in the terms of the trust. For other examples where substantial and not literal compliance with a procedure specified in the terms is permitted, see Sections 602 (revocation or modification of revocable trust), and 701 (acceptance or rejection of trusteeship).

If the terms of the trust do not transfer of jurisdiction, subsection (a)(2)(A) permits the trustee to change the place of administration upon approval of the qualified beneficiaries. For the definition of qualified beneficiaries, see Section 105(11). Resort to the courts for approval of a transfer of jurisdiction is not encouraged but is allowed under subsection (a)(2)(B). Per subsection (b), the court must conclude that the transfer is in the best interest of the trust and its beneficiaries, taking into account the economical and convenient administration of the trust and the views of the beneficiaries. If appropriate to facilitate transfer of the trust property or the place of administration of a trust to this State, the court may issue a conditional order appointing a trustee to administer the trust in this State and indicating that transfer to this State will be accepted if transfer is approved by the proper court of the other jurisdiction. A trust that was subject to judicial supervision in another State will not be subject to continuing court jurisdiction in this State unless the terms of the trust so require or the court so determines in the order accepting transfer to this State.

While transfer of the principal place of administration will normally change the governing law with respect to administrative matters, subsection (e) clarifies that such a change does not alter the controlling law with respect to the validity of the trust and the construction of its beneficial provisions.

[SECTION 206. SUBJECT MATTER JURISDICTION.

(a) The [designate] court has exclusive jurisdiction of proceedings brought by a trustee or beneficiary concerning the administration of a trust.

(b) The [designate] court has concurrent jurisdiction with other courts of this State of proceedings to determine the existence of a trust, proceedings by or against creditors or debtors of trusts, and other judicial proceedings involving trustees, beneficiaries, and third persons.]

Comment

This section provides a means for distinguishing the jurisdiction of the court with primary jurisdiction for trust matters from the jurisdiction of other courts, whether that court is denominated the probate court, chancery court, or by some other name. The section has been placed in brackets because subject-matter jurisdiction may already be addressed by other statute or court rule and may be unnecessary to address in States having unified court systems.

For an explanation of what types of matters are included in the phrase "proceedings brought by a trustee or beneficiary concerning the administration of a trust," see the Comment to Section 204. Subsection (a) of this section is derived from Section 7-201(a) of the Uniform Probate Code. Subsection (b) is based on Section 7-204 of the Uniform Probate Code.

[**SECTION 207. VENUE.**

(a) A judicial proceeding concerning a trust may be commenced in the [county] in which the trust's principal place of administration is or is to be located and, if the trust is created by will, in the [county] in which the decedent's estate is administered.

(b) If a trust created other than by will has no trustee, a judicial proceeding for the appointment of a trustee must be commenced in the [county] in which a beneficiary resides or the trust property, or some portion of the trust property, is located.

(c) A judicial proceeding other than those described in subsections (a) and (b) must be commenced in accordance with the rules of venue applicable to civil actions generally.]

Comment

This optional, bracketed section is based on Section 17005 of the California Probate Code and is made available for States which conclude that venue for a judicial proceeding involving a trust is not adequately addressed in the State's rules of civil procedure.

Subsection (b) applies only to appointment of a trustee for a trust not created by will. Judicial proceedings to appoint a trustee for a trust created by will that has no trustee are commenced in the county where the decedent's estate is administered. See subsection (a).

Subsection (c) provides venue rules applicable in cases not covered by subsections (a) and (b). This would include proceedings where jurisdiction over a trust, trust property, or parties to a trust is based on a factor other than that the principal place of administration is in this State. When the principal place of administration of a trust is in another State, but jurisdiction is proper in this State, the general rules governing venue apply.

ARTICLE 3

REPRESENTATION OF BENEFICIARIES AND SETTLEMENT AGREEMENTS

General Comment

This article deals with the important topic of representation of beneficiaries, both representation by fiduciaries (personal representatives, guardians and conservators), and what is known as virtual representation. Virtual representation is a doctrine which allows binding representation by others of beneficiaries who are unborn or unascertained, and under more modern versions, beneficiaries who may be alive and known but who are legally incapacitated.

Section 301 is the general and introductory section, laying out the scope of the article. The representation principles of this article have numerous applications under this Act. The representation principles of the article apply for purposes of settlement of disputes, whether by a court or nonjudicially. They apply for the giving of required notices. They apply for the giving of consents to certain actions. The representation principles of this article may be used to facilitate:

(1) Approval of a transfer of jurisdiction by the qualified beneficiaries (Section 205);

(2) Modification or termination of a trust upon the consent of the beneficiaries, with or without the consent of the settlor (Section 408);

(3) Notice to qualified beneficiaries of a proposed trust combination or division (Section 413);

(4) Notice to qualified beneficiary of emergency assumption of duties without accepting trusteeship (Section 701(c));

(5) Notice to qualified beneficiaries of resignation of trustee (Section 705);

(6) Appointment of successor trustee upon agreement of qualified beneficiaries (Section 708(b)(2));

(7) Notice of trustee's report (Section 814);

(8) Nonliability of trustee upon consent, release, or affirmance of beneficiary (Section 1106).

Section 302 addresses settlement agreements, both judicial and nonjudicial. While the judicial settlement procedures may be used in all court proceedings relating to the trust, the nonjudicial settlement procedures will not always be available. First, the terms of the trust may direct that the procedures not be used, or settlors may negate or modify them by specifying their own methods for obtaining consents. Second, a nonjudicial settlement may not be used to approve actions that would otherwise be illegal, such as to improperly terminate a trust. Only such matters as a court could properly approve may be made the subject of a nonjudicial settlement.

Section 303 deals with the effect of a consent, whether by actual or virtual representation. A consent bars a later objection by the person represented, but a consent is not binding if the person represented raises an objection prior to the date the consent would otherwise become effective. The possibility that a beneficiary might object to a consent given on the beneficiary's behalf will not be germane in many cases because the person represented will be unborn or unascertained. But there are situations where the representation principles of this article can apply to adult and competent beneficiaries. For example, while the trustee of a revocable trust entitled to a pourover devise has authority under Section 305 to approve the personal representative's account on behalf of the trust beneficiaries, such consent would not be binding on a trust beneficiary who registers an objection.

Section 304 deals with the effect of a consent by the holder of a general testamentary powers of appointment. (Revocable trusts and presently exercisable general powers of appointment are covered by Section 603, which grant the settlor or holder of the power all rights of the beneficiaries or persons whose interests are subject to the power). Absent a conflict of interest, the holder of a testamentary general power of appointment may bind those whose interests are subject to the power.

Section 305 provides that a fiduciary, absent conflict of interest, may represent and bind the beneficiary or beneficiaries of the respective fiduciary relationship, whether of an estate, trust, conservatorship, or guardianship. Drawing from Section 1-403 of the Uniform Probate Code, the section also allows a parent without a conflict of interest to represent and bind a minor child. A typical example of conflict of interest is a trustee who seeks the approval of an accounting for an estate of which the trustee is acting as personal representative.

Section 306 is the virtual representation provision. It provides for representation of and the giving of a binding consent on behalf of a minor, incapacitated, unborn, or unascertained person by another beneficiary with a substantially identical interest with respect to the particular issue. Also, the minor, incapacitated, unborn, or unascertained beneficiary is bound only to the extent (1) the other beneficiary adequately represents the person's interest, (2) the person is not otherwise represented under one of the other sections of this part, and (3) there is no conflict of interest between the representative and the person represented.

Section 307 specifies the persons who must be notified to bind a beneficiary represented under this article in connection with a judicial settlement.

Sections 308 and 309 authorize the court to appoint persons to represent the interests of beneficiaries not otherwise able to represent themselves. Such appointments may be made whether or not the person might otherwise be represented as provided in this article. Section 308 authorizes the appointment of a guardian ad litem at any point in a judicial proceeding but to encourage such appointments only when really needed, the court must first find that representation of the beneficiary might otherwise be inadequate. Also, to encourage some flexibility in how the guardian ad litem approaches the job, the guardian ad litem, in approving a settlement, may consider general family benefit. Section 309 authorizes the court, in connection with a nonjudicial settlement, to appoint a special representative to represent the interests of one or more beneficiaries. The distinction between a guardian ad litem and a special representative has more to do with the nature of the proceeding than the function served.

SECTION 301. REPRESENTATION OF BENEFICIARIES.

(a) Whenever under this [Act] a notice may be given to a beneficiary, notice to a person who may represent and bind the beneficiary under this [Article] is notice to the beneficiary.

(b) Whenever under this [Act] a consent may be given by a beneficiary, the consent of a person who may represent and bind the beneficiary under this [Article] is the consent of the beneficiary.

SECTION 302. SETTLEMENT AGREEMENTS.

(a) Except to the extent that the terms of a trust indicate that the procedures specified in this [Article] do not apply, persons interested in a trust may be represented and bound as provided in this [Article], whether or not the settlement is approved by the court.

(b) Nonjudicial settlements may include only terms and conditions a court could properly approve.

(c) Settlement agreements may extend to any question or dispute involving a trust, including:

(1) the determination of the persons interested in the trust;

(2) the interpretation or construction of the terms of the trust;

(3) the direction to a trustee to refrain from performing a particular act or the grant to the trustee of any necessary or desirable power;

(4) a change of trustee or determination of a trustee's compensation;

(5) a change in the principal place of administration of a trust; and

(6) the modification of the trust to comply with federal and State statutes and regulations to achieve qualification for deductions, elections, or other tax provisions.

SECTION 303. EFFECT OF CONSENT. The consent of a person who may represent another under this [Article] is binding on the person represented unless the person represented objects to the representation prior to the date the consent would otherwise have become effective.

SECTION 304. GENERAL TESTAMENTARY POWER OF APPOINTMENT. To the extent there is no conflict of interest between the holder of a general testamentary power of appointment and the persons represented with respect to the particular question or dispute, the holder may represent and bind the persons whose interests, as objects, takers in default, or otherwise, are subject to the power.

SECTION 305. REPRESENTATION BY FIDUCIARIES AND PARENTS. To the extent there is no conflict of interest between the representative and the person represented with respect to the particular question or dispute:

(1) a conservator may represent and bind the person whose estate the conservator controls;

(2) a guardian may represent and bind the ward if a conservator of the ward's estate has not been appointed;

(3) an agent with authority may represent and bind the principal;

(4) a trustee may represent and bind the beneficiaries of the trust;

(5) a personal representative of a decedent's estate may represent and bind the persons interested in the estate; and

(6) if a conservator or guardian has not been appointed, a parent may represent and bind a minor child.

SECTION 306. REPRESENTATION BY PERSON HAVING SUBSTANTIALLY IDENTICAL INTEREST. Unless otherwise represented, a minor or an incapacitated, unborn, or unascertained person may be represented by and bound by another having a substantially identical interest with respect to the particular question or dispute, but only to the extent that:

(1) the person's interest is adequately represented; and

(2) there is no conflict of interest between the representative and those represented.

SECTION 307. NOTICE OF JUDICIAL SETTLEMENT.

(a) Notice of a proposed judicial settlement to a person who may be represented and bound under Section 304 or 305 must be given either directly to the person or to one who may bind the person.

(b) Notice is given to minor, incapacitated, unborn, or unascertained persons who are not represented under Section 304 or 305, and who may be bound under Section 306, by giving notice to all persons whose interests in the judicial proceedings are substantially identical and whose identities are actually known.

SECTION 308. APPOINTMENT OF GUARDIAN AD LITEM. Even if there is representation under Section 304, 305, or 306, at any point in a judicial proceeding, if the court determines that representation of the interest might otherwise be inadequate, the court may appoint a guardian ad litem to represent the interest of and approve a judicial settlement on behalf of a minor, incapacitated, unborn, or unascertained person, or a person whose identity or address is not actually known. If not precluded by conflict of interest, a guardian ad litem may be appointed to represent several persons or interests. In approving a judicially supervised settlement, a guardian ad litem may consider general family benefit.

SECTION 309. APPOINTMENT OF SPECIAL REPRESENTATIVE. Even if there is representation under Section 304, 305, or 306, the court may appoint a special representative to represent the interests of and approve a nonjudicial settlement on behalf of designated persons. If not precluded by conflict of interest, a special representative may be appointed to represent several persons or interests. In approving the settlement, a special representative may consider general family benefit.

ARTICLE 4

CREATION, VALIDITY, MODIFICATION, AND TERMINATION OF TRUST

General Comment

Sections 401 through 406 specify the requirements for the creation of a trust. Most of the requirements track traditional doctrine. These sections develop a three-part classification system for trusts. Noncharitable trusts ordinarily require an ascertainable beneficiary, charitable trusts by their very nature are created to benefit the public at large. Honorary trusts are trusts for noncharitable purposes which are valid despite the absence of an ascertainable (i.e., human) beneficiary. These include trusts for the care of an animal and trusts for other noncharitable purposes such as the maintenance of a cemetery lot.

Section 401 specifies the methods by which trusts are created, such as by transfer of property, self-declaration or exercise of a power of appointment. Section 402 lists the requirements for creation of a trust whatever method may have been employed. The requirements include intention, capacity and, if applicable, the necessity for an ascertainable beneficiary. Section 403 validates oral trusts, Section 404 enumerates the permitted purposes for which a trust may be created. The remaining sections address honorary trusts; Section 405 the trust for the care of an animal, and Section 406 the trust created for another noncharitable purpose.

Sections 407 through 415 provide a series of interrelated rules on when a trust may be terminated or modified other than by its express terms. The overall objective of these sections is to liberalize the common law rules but without losing sight of the principle that preserving the settlor's intent is paramount. Termination or modification may be allowed upon beneficiary consent if the trust no longer serves a material purpose or if the settlor concurs (Section 408), by the court in response to unanticipated circumstances (Section 409), or if continued administration under the trust's existing terms would be uneconomical (Section 410). Trusts may be reformed to correct a mistake of law or fact (Section 411), or modified to achieve the settlor's tax objectives (Section 412). Trusts may be combined or divided (Section 413). Charitable trusts may be modified or terminated under cy pres to better fulfill the settlor's charitable purpose (Section 414). A settlor, trustee, or beneficiary has standing to petition the court with respect to a proposed termination or modification (Section 415).

SECTION 401. METHODS OF CREATING TRUST.

(a) A trust may be created by:

(1) transfer of property to another person as trustee during the settlor's lifetime or by will or other disposition taking effect upon the settlor's death;

(2) declaration by the owner of property that the owner holds identifiable property as trustee; or

(3) exercise of a power of appointment in favor of another person as trustee.

(b) Property subject to a declaration of trust may be identified in the terms of the trust.

(c) Property may be transferred by the terms of a trust, which may function as a deed of conveyance.

Comment

Subsection (a) follows Restatement (Second) of Trusts § 17 (1959) and Restatement (Third) of Trusts § 10 (Tentative Draft No. 1, 1996). Under all three methods specified in this section for creating a trust, the trust is not created until it receives property. For what constitutes an adequate property interest, see Restatement (Third) of Trusts §§ 40- 41 (Preliminary Draft No. 4, 1998). See also Restatement (Second) of Trusts §§ 74-86 (1959). The property interest necessary to fund and create a trust need not be substantial. A revocable designation of the trustee as beneficiary of a life insurance policy or employee benefit plan is a property interest sufficient to create a trust. See Section 105(10) ("property" defined). Furthermore, the property interest need not be transferred contemporaneously with the signing of the trust instrument. A trust created by means of an instrument signed during the settlor's lifetime is not invalid simply because the trustee does not receive property until a later date, including by will or contract at or after the settlor's death. A pourover devise to such a trust is also valid. See Uniform Probate Code § 2-511 (pourover devise to trust valid regardless of existence, size, or character of trust corpus).

While a trust created by will may come into existence immediately at the testator's death and not necessarily only upon the later transfer of title from the personal representative, the nominated trustee does not have a duty to act until there is an acceptance of the trusteeship, express or implied. See Section 701 (acceptance or rejection of trusteeship). To avoid an implied acceptance, a nominated testamentary trustee who is monitoring the actions of the personal representative but who has not yet made a final decision on acceptance should inform the beneficiaries that it has assumed only a limited role. The failure to so inform the beneficiaries could result in liability if the misleading conduct by the nominated trustee causes harm to the trust beneficiaries. See Restatement (Third) of Trusts § 35 cmt.b (Preliminary Draft No. 4, 1998). See also Restatement (Second) of Trusts § 102 cmt. c (1959).

Consideration is not ordinarily required to create a trust, but a promise to create a trust in the future is enforceable only if the requirements for a contract are satisfied. See Restatement (Third) of Trusts § 15 (Tentative Draft No. 1, 1996). See also Restatement (Second) of Trusts §§ 28-30 (1959). If the right to enforce the contract is held by the trustee, however, the chose in action thus created in the trustee is itself a property interest sufficient to create a present trust. Otherwise, the enforceable right, if held by another, does not create a present trust but may give rise to an action for breach of contract. A trust created by means of a promise enforceable by the trustee is valid notwithstanding that the trustee may resign or die before the promise is fulfilled. Unless expressly made personal, the promise can be enforced by a successor trustee. For examples of trusts created by means of promises enforceable by the trustee, see Restatement (Third) of Trusts § 10 cmt. g (Tentative Draft No. 1, 1996).

While this section recognizes the established principle that a trust may be created by means of the exercise of a power of appointment (see subsection (a)(3)), this Act does not attempt to legislate comprehensively on the subject of powers of appointment but addresses only selected issues. See Sections 505(b) (creditor claims against holder of power to withdraw), 603(b) (rights of holder of power of withdrawal), and 304 (representation by holder of general testamentary power of appointment of persons subject to power). For the law on powers of appointment generally, see Restatement (Second) of Property: Donative Transfers §§ 11.1-24.4 (1986).

While trusts are usually created by a transfer of property by the settlor or by a self-declaration, trusts may also be created by the courts or by special statute. See., e.g., Unif. Probate Code § 2-212 (elective share of incapacitated surviving spouse to be held in trust on terms specified in statute); Unif. Probate Code § 5-407 (conservator may create trust with court approval); Restatement (Second) of Trusts § 17 cmt. i (1959) (trusts created by statutory right to bring wrongful death action); Restatement (Third) of Trusts § 10 cmt. b (Tentative Draft No. 1, 1996).

Subsection (b) addresses some of the practical funding concerns that arise with respect to self-declarations of trust. The very nature of the self-declaration of trust negates a requirement that title to trust assets be reregistered and retransferred into the name of the settlor as trustee. See, e.g., *In re Estate of Heggstad*, 20 Cal. Rptr. 2d 43 (Ct. App. 1993) (citing relevant sections from Restatement (Second) of Trusts). See also Restatement (Second) of Trusts § 17 cmt. a (1959); Restatement (Third) of Trusts § 10 cmt. e (Preliminary Draft No. 3, 1997). This subsection validates the practice of merely attaching a schedule listing the assets that are to be subject to the trust without executing separate instruments of transfer. To avoid possible later problems with third party transferees and to better protect the interests of the beneficiaries, it is recommended that settlors not rely on this subsection but instead perfect title to the trust assets by executing separate instruments of transfer.

Subsection (c) applies a similar rule to trusts in which someone other than the settlor is named as trustee. While the execution of separate instruments of transfer for each asset is recommended, this section recognizes that the trust instrument may itself contain language effectively conveying assets to the trustee.

SECTION 402. REQUIREMENTS FOR CREATION.

(a) A trust is created only if:

(1) the settlor has capacity and indicates an intention to create a trust;

(2) the same person is not the sole trustee and sole beneficiary; and

(3) the trust has a definite beneficiary, or is a charitable trust or a trust for the care of an animal or other valid noncharitable purpose.

(b) A beneficiary is definite if the beneficiary may be validly ascertained now or in the future. A power or direction to a trustee to select a beneficiary from an indefinite class is valid.

Comment

Subsection (a) codifies the basic requirements for the creation of a trust. To create a valid trust, the settlor must indicate an intention to create a trust. Restatement (Second) of Trusts § 23 (1959); Restatement (Third) of Trusts § 13 (Tentative Draft No. 1, 1996). But only such manifestations of intent as are admissible as proof in a judicial proceeding may be considered. See Section 105(15) ("terms of a trust" defined).

To create a trust, a settlor must have the requisite mental capacity. To create a revocable or testamentary trust, the settlor must have the capacity to make a will. To create an irrevocable trust, the settlor must have capacity during lifetime to transfer the property free of trust. See Section 601 (capacity of settlor to create revocable trust), and see generally Restatement (Third) of Trusts § 11 (Tentative Draft No. 1, 1996).

Subsection (a)(2) addresses what is known as the doctrine of merger. Under this doctrine, a trust is not created if the settlor is the sole trustee unless there are one or more beneficiaries other than the settlor. The doctrine of merger has been inappropriately applied by the courts in some jurisdictions to invalidate self-declarations of trust in which the settlor is the sole life beneficiary but other persons are designated as beneficiaries of the remainder. The doctrine of merger, however, is properly applicable only if all beneficial interests, both life interests and remainders, are vested in the same person, whether in the settlor or someone else. Under the Act, a beneficiary of a trust includes any person who has a present or future interest, vested or contingent. See Section 105(1) ("beneficiary" defined). On the doctrine of merger generally, see Restatement (Second) of Trusts § 341 (1959).

Subsection (a)(3) requires that a trust, other than a charitable trust, a trust for the care of an animal, or a trust for another valid noncharitable purpose, have a definite or definitely ascertainable beneficiary. While the beneficiary will often be definitely ascertained as of the trust's creation, the beneficiary may also be ascertained in the future. But a trust is not created if the beneficiary can only be ascertained beyond the applicable perpetuities period. The definite beneficiary requirement does not mean that a settlor cannot make a disposition in favor of a class of persons, a designation which by its very nature is usually to a group whose membership may change. Class designations are valid as long as the membership of the class will be finally determined within the applicable perpetuities period. For background on the definite beneficiary requirement, see Restatement (Second) of Trusts §§ 112-115, 120-121 (1959); Restatement (Third) of Trusts §§ 44-45 (Preliminary Draft No. 4, 1998).

Subsection (b) allows a settlor to empower the trustee to select the beneficiaries even if the class from whom the selection may be made is indefinite. Such a provision would fail under traditional doctrine; it is an imperative power with no designated beneficiary capable of enforcement. But such a provision is valid under both this Act and the Restatement. If the power is not exercised within a reasonable time, the power will fail and the property will pass by resulting trust. See Restatement (Second) of Trusts § 122 (1959); Restatement (Second) of Property: Donative Transfers § 12.1 cmt. e (1986).

SECTION 403. EVIDENCE OF ORAL TRUST. Except as otherwise required by a statute other than this [Act], a trust need not be evidenced by a writing, but the creation of an oral trust may be established only by clear and convincing evidence.

Comment

While it is always advisable for a settlor to reduce a trust to writing, the Act validates oral trusts. Absent some specific statutory provision, such as a provision requiring that transfers of real property be in writing, a writing is not required to evidence a trust. States with statutes of frauds or other provisions requiring that the creation of certain trusts must be evidenced by a writing may wish to specifically cite such provisions.

For the Statute of Frauds generally, see Restatement (Second) of Trusts §§ 40-52. For a description of what the writing must contain, assuming that a writing is required, see Restatement (Third) of Trusts § 22 (Tentative Draft No. 1, 1996). For a discussion of when the writing must be signed, see Restatement (Third) of Trusts § 23 (Tentative Draft No. 1, 1996). For a discussion of the law on oral trusts, see Sarajane Love, Imperfect Gifts as Declarations of Trust: An Unapologetic Anomaly, 67 Ky. L. J. 309 (1979).

SECTION 404. TRUST PURPOSE.

(a) A trust may be created only if its purpose is lawful, does not violate public policy, and is possible to fulfill.

(b) A charitable trust may be created for the relief of poverty, the advancement of education or religion, the promotion of health, or any other purpose the accomplishment of which is beneficial to the community. If the terms of a trust do not indicate a particular charitable purpose or designate beneficiaries, the trustee may select one or more charitable purposes or beneficiaries.

(c) Except as otherwise provided in Section 405 or 406, the purpose of a noncharitable trust must be to benefit its beneficiaries.

Comment

For an explication of the requirement that a trust must have a purpose that is not unlawful or against public policy, see Restatement (Second) of Trusts §§ 60-65; Restatement (Third) of Trusts §§ 27-30 (Preliminary Draft No. 4, 1998). A trust with a purpose that is unlawful or against public policy is invalid. Depending on when the violation occurred, the trust may be invalid at its inception or the invalidity may occur at a later date. The invalidity may also be limited to particular provisions. Generally, a trust has a purpose which is illegal or against public policy if: (1) its performance involves the commission of a criminal or tortious act by the trustee; (2) its enforcement would otherwise be against public policy even though not criminal or tortious; (3) the settlor's purpose in creating the trust was to defraud creditors or others; or (4) the consideration for the creation of the trust was illegal. See Restatement (Second) of Trusts § 60 cmt. a (1959); Restatement (Third) of Trusts § 28 cmt. a (Preliminary Draft No. 3, 1997).

The required purpose for a charitable trust restates the well-established categories of charitable purposes listed in Restatement (Second) of Trusts § 368 and ultimately derived from the Statute of Charitable Uses, 43 Eliz. I, c.4 (1601).

Subsection (b) also restates an established estate planning technique under which the trustee is permitted to select the charitable beneficiary or purposes for which distributions are to be made. See Restatement (Second) of Trusts § 396 (1959).

For the requirement that a trust must have a purpose which is for the benefit of its beneficiaries, both in its terms and in how it is administered, see Restatement (Third) of Trusts § 27(2) and cmt. b (Preliminary Draft No. 4, 1998). Although the settlor is granted considerable latitude in defining the purpose of the trust, the requirement that a trust have a purpose which is for the benefit of its beneficiaries preclude purposes that are capricious and which largely reflect personal whim. Individuals may deal without restraint with their own property but not when impressed with a trust for the benefit of others. See Restatement (Second) of Trusts § 124 cmt. g (1959). Thus, attempts to impose unreasonable restrictions on the use of trust property, such as a provision in a noncharitable trust severely impairing the use of real property, will fail. See, e.g., *Colonial Trust v. Brown*, 135 A. 555 (Conn. 1926).

Trusts authorized by Sections 405 and 406, because they need not have ascertainable beneficiaries, are exempt from the requirement that they have a purpose which is of benefit to the beneficiaries. However, such trusts are subject to the requirement that there purpose not be capricious. See, e.g., *McCaig v. University of Glasgow*, Sess. Cases 231 (Scotland 1907), which invalidated a provision requiring the trustee to erect statues of the settlor and members of his family.

For a provision which may allow reformation of trusts which fail to comply with this section, see Section 411.

SECTION 405. TRUST FOR CARE OF ANIMAL.

(a) A trust for the care of an animal living at the settlor's death is valid. The trust terminates upon the death of all animals covered by the terms of the trust. A settlor's expressions of intent must be liberally construed to bring the transfer within this subsection and to presume against a merely precatory disposition.

(b) Property of a trust authorized by this section may not be applied to a use other than its intended use except to the extent the court determines that the value of the trust property exceeds the amount required for the intended use. Except as otherwise directed by the terms of the trust, property not required for the intended use must be distributed to those who would take the trust property if the trust had terminated on the date of the distribution.

(c) The intended use of a trust authorized by this section may be enforced by a person designated for that purpose in the terms of the trust or, if none, by a person appointed by the court. A person with a demonstrated interest in the welfare of the animal may petition for an order appointing or removing the person designated to enforce the trust.

Comment

This section and the next section of the Act validate so-called honorary trusts. Unlike honorary trusts created pursuant to the common law of trusts, which are arguably no more than unenforceable powers of appointment, the trusts created by this and the next section are valid and enforceable and not dependent on whether the trustee decides to honor the settlor's wishes. For a discussion of the common law doctrine, see Restatement (Second) of Trusts § 124 (1959); Restatement (Third) of Trusts § 48 (Preliminary Draft No. 3, 1997).

This section addresses a particular type of honorary trust, the trust for the care of an animal. Section 406 specifies the requirements for trusts created for other noncharitable purposes. A trust for the care of an animal may last for the life of the animal. While the animal will ordinarily be alive on the date the trust is created, an animal may be added as a beneficiary after that date as long as the addition is made prior to the settlor's death. Animals in gestation but not yet born at the time of the trust's creation may also be covered by its terms.

Subsection (b) addresses the problem of excess funds. Should the court determine that the trust property exceeds the amount needed for the intended purpose, the excess must be distributed to those who would take the trust property if the trust were to terminate on the date of the distribution. If the terms of the trust do not direct disposition upon termination, a resulting trust is ordinarily created in the settlor. See Restatement (Third) of Trusts § 47 (Preliminary Draft No. 4, 1998). The settlor may also anticipate the problem of excess funds by directing their disposition in the terms of the trust. Absent the presence of excess funds, no portion of a trust authorized by this or the next section may be applied other than for its intended use.

Subsection (c) addresses enforcement. Noncharitable trusts ordinarily may be enforced by their beneficiaries. Charitable trusts may be enforced by the state attorney general or by a person deemed to have a special interest. See Restatement (Second) of Trusts § 391 (1959). But at common law, trusts for the care of an animal or a trust without an ascertainable beneficiary created for another noncharitable purpose were unenforceable because there was no person authorized to enforce the trustee's obligations.

This section and the next section close this gap. The intended use of a trust authorized by either section may be enforced by a person designated for that purpose in the terms of the trust or, if none, by a person appointed by the court. Should the trust be created for the care of an animal, persons with a demonstrated interest in the welfare of the animal have standing to petition for such an appointment, either of themselves or of others. The person appointed by the court to enforce the trust should also be a person who has exhibited such a demonstrated interest. The concept of granting standing to a person with a demonstrated interest in the animal's welfare is derived from the Uniform Guardianship and Protective Proceedings Act (1997), which allows a person interested in the welfare of a ward or protected person to file petitions on the ward's or protected person's behalf.

This section and the next section are originally derived from Section 2-907 of the Uniform Probate Code but much of this and the following section is new.

SECTION 406. TRUST FOR VALID NONCHARITABLE PURPOSE.

(a) A trust for a noncharitable purpose without a definite or definitely ascertainable beneficiary or for a noncharitable purpose to be selected by the trustee is valid. The trust may not be enforced for more than 21 years.

(b) Property of a trust authorized by this section may not be applied to a use other than its intended use except to the extent the court determines that the value of the trust property exceeds the amount required for the intended use. Except as otherwise directed by the terms of the trust, property not required for the intended use must be distributed to those who would take the trust property if the trust were to terminate on the date of the distribution.

(c) The intended use of a trust authorized by this section may be enforced by a person designated for that purpose in the terms of the trust or, if none, by a person appointed by the court.

Comment

This section authorizes two types of trusts without ascertainable beneficiaries; trusts for general but noncharitable purposes, and trusts for a specific noncharitable purpose other than the care of an animal, which is covered by Section 405. Examples of trusts for general noncharitable purposes would include a bequest of money to be distributed to such objects of benevolence as the trustee might select. At common law, such a trust was honorary but under this section such a trust is enforceable for a period of up to 21 years, the maximum period allowed under the rule against perpetuities for a disposition without lives in being.

The most common example of a trust for a specific noncharitable purpose is a trust for the care of a cemetery plot. Trusts and other funding devices for the perpetual care of cemetery plots is a topic frequently addressed by separate legislation. Such legislation will typically endeavor to provide for truly perpetual care as opposed to care limited for 21 years.

For the requirement that a trust, particularly the type of trust authorized by this section, must have a purpose that is not capricious, see Section 404 Comment. For examples of the types of trusts authorized by this section, see Restatement (Second) of Trusts § 124 (1959); Restatement (Third) of Trusts § 47 (Preliminary Draft No. 4, 1998).

This section is similar to Section 405, although less detailed. Much of the Comment to Section 405 also applies to this section.

SECTION 407. TERMINATION OF TRUST. In addition to the methods specified in Sections 408 through 410, a trust terminates if the trust is revoked or expires pursuant to its terms or if the purpose of the trust is fulfilled or becomes unlawful, impossible to fulfill, or violative of public policy.

Comment

This section lists the various methods and grounds by which trusts typically terminate. In addition to other powers granted under this Act or by the terms of the trust, upon termination of a trust a trustee has the powers appropriate to complete the trust's administration. See Section 817(24).

For the requirement that a trust must have a purpose that is not illegal, impossible to fulfill, or violative of public policy, see Section 404 and Comment.

SECTION 408. MODIFICATION OR TERMINATION OF IRREVOCABLE TRUST BY CONSENT.

(a) An irrevocable trust may be modified or terminated with consent of all of the beneficiaries if continuance of the trust on its existing terms is not necessary to further a material purpose of the settlor. The inclusion of a spendthrift provision in the terms of the trust is not presumed to constitute a material purpose of the settlor.

(b) Whether or not continuance of the trust on its existing terms is necessary to further a material purpose of the settlor, an irrevocable trust may be modified or terminated upon consent of the settlor and all beneficiaries.

(c) Upon termination of a trust pursuant to subsection (a) or (b), the trustee shall distribute the trust property as agreed by the beneficiaries.

(d) If a beneficiary other than a qualified beneficiary does not consent to a proposed modification or termination of a trust by the other beneficiaries or by the settlor and other beneficiaries, the court may approve the proposed modification or termination only if the court is satisfied that:

(1) if all beneficiaries had consented, the trust could have been terminated or modified under this section; and

(2) the rights of a beneficiary who does not consent will be adequately protected.

Comment

This section describes the circumstances under which an irrevocable trust may be terminated or modified by the beneficiaries, with or without the concurrence of the settlor. For provisions governing modification or termination of trusts without the need to seek beneficiary consent, see Sections 409 (modification or termination because of unanticipated circumstances) and 410 (termination or modification of uneconomic trust). If the trust is revocable by the settlor, the method of revocation specified in Section 602 applies.

Subsection (a) states the test for termination or modification by unanimous consent without the concurrence of the settlor. Subsection (b) states the test for termination or modification by the beneficiaries with the concurrence of the settlor. Subsection (c) directs how the trust property is to be distributed following a termination under either subsection (a) or (b). Subsection (d) creates a procedure for judicial approval of a proposed termination or modification when the consent of less than all of the beneficiaries is available.

A trust may be modified or terminated pursuant to this section over a trustee's objection and, except as provided in subsection (d), without court approval. However, the court is available to indicate its approval or disapproval of a proposed termination or modification upon petition of the settlor, beneficiary, or trustee. See Section 415.

Subsection (a) of this section is based on Section 337 of the Restatement (Second) of Trusts (1959), except that this subsection, unlike the Restatement, deals expressly with the effect of a spendthrift provision. While the inquiry on whether continuation of a trust is necessary to further a material purpose should focus on the material purpose or purposes of the particular settlor, the courts have tended to preclude termination based on whether the trust contains particular language without examining its context. For the case law, see Austin W. Scott & William F. Fratcher, The Law of Trusts § 337 (4th ed. 1988). The insertion of a spendthrift provision, which is often added to instruments with little thought, has been a particular problem. Subsection (a) does not negate the possibility that continuation to assure spendthrift protection might be a material purpose of the particular settlor. It instead calls attention to the issue by negating the inference that inserting a spendthrift provision is always a bar to termination or modification.

Subsection (b), which is based on Restatement (Second) of Trusts § 338 (1959), permits termination upon the joint action of the settlor and beneficiaries. While the beneficiaries alone cannot terminate a trust unless continuation of the trust will no longer further the settlor's material purposes in creating the trust, such a finding is not required if the settlor also consents. No finding is required because all parties with a possible interest in the trust's continuation, both the settlor and beneficiaries, are agreed there is no further need for the trust.

The provisions of Article 3 on representation, virtual representation and the appointment and approval of guardians ad litem and special representatives apply for purposes of determining whether all beneficiaries have signified consent under this section. The authority to consent on behalf of another person, however, does not include the authority to consent over the other person's objection. See Section 303.. For a listing of who may consent on behalf of a beneficiary, see Sections 304, 305, and 306. A consent obtained by virtual representation is valid only if there is no conflict of interest between the representative and the person represented. Given this limitation, virtual representation will rarely be available in a trust termination case, although its use will be frequent in cases involving trust modification, such as a grant to the trustee of additional powers. If virtual representation is unavailable, Sections 308 and 309 of the Act permit the court to appoint either a guardian ad litem or special representative who may give the necessary consent to the proposed modification or termination on behalf of the minor, incapacitated, unborn, or unascertained beneficiary.

Subsection (c) recognizes that the power to terminate the trust includes the right to direct how the trust property is to be distributed. While subsection (b) requires the settlor's consent to terminate an irrevocable trust, such required consent does not extend to the subsequent distribution of the trust property. Once a termination has been approved, how the trust property is to be distributed is solely for the beneficiaries to decide.

Subsection (d) addresses situations in which a termination or modification is requested by less than all of the beneficiaries, either because a beneficiary objects, the consent of a beneficiary cannot be obtained, or virtual representation is either unavailable or its application uncertain. Subsection (d) allows the court to fashion an appropriate order protecting the interests of the nonconsenting beneficiaries while at the same time permitting the remainder of the trust property to be distributed without restriction. The order of protection for the nonconsenting beneficiaries might include continuation of the trust, the purchase of an annuity, or the valuation and cashout of the interest.

SECTION 409. MODIFICATION OR TERMINATION BECAUSE OF UNANTICIPATED CIRCUMSTANCES.

(a) The court shall modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not anticipated by the settlor, modification or termination will substantially further the settlor's purpose in creating the trust.

(b) Upon termination of a trust under this section, the trust property must be distributed in accordance with the settlor's probable intention.

Comment

This section permits modification or termination of a trust when there are circumstances not anticipated by the settlor. This may include circumstances in existence at the time of the trust's creation which were known to but not considered by the settlor. Unlike Restatement (Second) of Trusts §§ 167 and 336 (1959), upon which this section is partially based, this section allows a court to modify or terminate a trust with respect to its beneficial provisions, not merely its administrative terms. For example, modification of the beneficial provisions to increase support of a beneficiary might be appropriate if the beneficiary has become unable to provide for support due to poor health or serious injury.

While it is necessary there be circumstances not anticipated by the settlor before the court may grant relief under this section, it is not essential that circumstances have changed. The circumstances not anticipated by the settlor may have been in existence when the trust was created. This section thus complements Section 411, which allows for reformation of a trust based on mistake of fact or law at the creation of the trust.

Relief under this section should not be lightly granted. Reasonable minds can often disagree on the purpose of a trust and on whether the settlor chose the appropriate means of implementation. For this reason, the petitioner must demonstrate that the proposed termination or modification will substantially further the settlor's objectives in creating the trust.

Upon termination under this section, subsection (b) requires that the trust be distributed in accordance with the settlor's probable intent. This requirement, which is similar to the doctrine of cy pres, will require an examination of what the settlor probably would have done had the settlor been aware of the unanticipated circumstances. Typically, such terminating distributions will be made to the qualified beneficiaries, perhaps in proportion to the actuarial value of their interests, although the section does not so prescribe. For the definition of qualified beneficiaries, see Section 105(11).

SECTION 410. UNECONOMIC TRUST.

(a) Except as otherwise provided by the terms of the trust, if the value of the property of a trust is less than [$50,000], the trustee may terminate the trust.

(b) Notwithstanding a term of the trust to the contrary, the court may modify or terminate a noncharitable trust or remove the trustee and appoint a different trustee if it determines that the value of the trust property is insufficient to justify the cost of administration.

(c) Upon termination of a trust under this section, the trustee shall distribute the trust property of a noncharitable trust in accordance with the settlor's probable intention, and shall distribute the trust property of a charitable trust in a manner consistent with the settlor's charitable purpose.

Comment

Subsection (a) assumes that a trust with a value of $50,000 or less is inherently uneconomical and may be terminated without the expense of a judicial termination proceeding.. This provision is a default rule. While the creation of small charitable trusts is not encouraged, this subsection does not interfere with the right of a settlor to do so. The settlor is free to set a higher or lower figure or to specify different procedures or to prohibit termination without a court order.

Subsection (b) allows a trust to be modified or terminated if the costs of administration would otherwise be excessive. The court may terminate a trust under this section even if a settlor has forbid such action. A court termination procedure may be utilized for a trust of any size but most cases will involve smaller trusts although ones greater than $50,000 in value.

Compliance with this section is within the discretion of the trustee or, if court approval is required, within the discretion of the court. When considering whether to terminate a noncharitable trust under this section, the trustee or court should consider the protective function the trust is designed to serve. Termination under this section is not always wise. Even if administrative costs may seem expensive in relation to the size of the trust, protection of the asset base may indicate that the trust be continued.

While this section is not principally directed a honorary trusts, it may be so applied. See Sections 405, 406.

In order to reduce administrative costs in relation to the size of the trust, the court, instead of terminating the trust, may appoint a new trustee. Upon termination of the trust, the trust property is to be distributed, in the case of a noncharitable trust, in accordance with the settlor's probable intention, or in the case of a charitable trust, pursuant to the cy pres principles articulated in Section 414.

SECTION 411. REFORMATION TO CORRECT MISTAKES.

(a) The court may reform the terms of a trust, even if unambiguous, to conform to the settlor's intention if the failure to conform was due to a mistake of fact or law, whether in expression or inducement, and the settlor's intent can be established by clear and convincing evidence.

(b) In determining the settlor's intent for purposes of this section or any other purpose, direct evidence contradicting the plain meaning of the text as well as other evidence may be considered.

Comment

Reformation of inter vivos instruments to correct for a mistake of law or fact is a long-established remedy. The purpose of Restatement (Third) of Property: Donative Transfers § 12.1 (Tentative Draft No. 1, 1995), upon which this section is based, is to clarify that this doctrine also applies to wills.

This section applies whether the mistake is one of expression or one of inducement. A mistake of expression occurs when the terms of the trust misstate the settlor's intention, fails to include a term that was intended to be included, or includes a term that was not intended to be excluded. A mistake in the inducement occurs when the terms of the trust accurately reflect what the settlor intended to be included or excluded but this intention was based on a mistake of fact or law. Restatement (Third) of Property: Donative Transfers § 12.1 cmt. i (Tentative Draft No. 1, 1995).

Reformation is different than clarification of an ambiguity. Clarification of an ambiguity involves the interpretation of a term already in the trust. Reformation, on the other hand, involves the addition of a term not originally in the trust, or the deletion of a term originally included by mistake. Because reformation involves the addition of a term to the instrument, or deletion of a term in an instrument that may appear clear on its face, reliance on extrinsic evidence is essential. To guard against the possibility of unreliable or contrived evidence in such circumstance, the higher standard of clear and convincing proof is required. See Restatement (Third) of Property: Donative Transfers § 12.1 cmt. e (Tentative Draft No. 1, 1995).

This section disapproves of the "plain meaning" rule, a meaning which is often plain only in the eye of the beholder. For this reason, evidence contradicting the so-called plain meaning of the text is admissible. The objective of the plain meaning rule, to protect against fraudulent testimony, is satisfied by requiring the presentation of clear and convincing evidence before a requested reformation may be granted. See Restatement (Third) of Property: Donative Transfers § 12.1 cmt. d (Tentative Draft No. 1. 1995).

SECTION 412. ACHIEVING SETTLOR'S TAX OBJECTIVES.

(a) The terms of a trust must be construed to achieve the settlor's tax objectives.

(b) To achieve the settlor's tax objectives, the court may modify the terms of a trust in a manner that does not violate the settlor's probable intention. The court may make the modification retroactive.

Comment

Subsection (a) is intended to function as what is normally termed a tax savings clause. The effect of such a provision is to construe terms of a trust that might be interpreted differently in a way to achieve the desired tax objective. A tax provision alone cannot create the essential terms of a tax-qualified trust. There must already be language in the terms susceptible of the necessary interpretation. Examples of tax provisions the meaning of which are sometimes in doubt include the effect of administrative provisions on qualification for the federal estate tax marital deduction, and whether a standard of distribution is sufficiently narrow to negate what would otherwise be a taxable general power of appointment.

Subsection (a) is consistent with the Revised Uniform Principal and Income Act (1997), which denies the trustee a power to equitably adjust the allocation of income and principal receipts and disbursements if to do would endanger intended tax benefits. See Section 10-104(c).

While subsection (a) is intended to function similar to a tax savings clause, it is better practice to expressly include such a tax savings provision in the terms of the trust. That way, there will be no doubt as to the settlor's intent.

Subsection (b) is based on Restatement (Third) of Property § 12.2 (Tentative Draft No. 1, 1995). "Modification" under this section is to be distinguished from the "reformation" authorized by Section 411. Reformation under Section 411 is available when the terms of a trust fail to reflect the donor's original, particularized intention. The mistaken terms are then reformed to match this specific intent. The modification authorized here is more general, allowing documents to be changed to meet the settlor's tax-saving objective as long as the resulting terms, particularly the beneficial provisions, are not inconsistent with the settlor's probable intent. The modification allowed by this subsection is similar in concept to the cy pres doctrine for charitable trusts (see Section 414), and the deviation doctrine for unanticipated circumstances (see Section 409).

Whether a modification made by the court under subsection (b) will be recognized for purposes of federal tax law is a matter of federal law, not this Act. Among the modifications recognized under federal law have been the revision of split-interest trusts to qualify for the charitable deduction, modification of a trust for a noncitizen spouse to become eligible as a qualified domestic trust, and the splitting of a trust to better utilize the exemption from generation-skipping tax.

Before proceeding to modify a trust under subsection (b), the advisor is encouraged to determine whether modification utilizing some other section of this article would assure a more certain federal tax result.

For further discussion of the issues raised by a desire to modify a trust to achieve the settlor's tax objectives, see the Comments and Reporter's Notes to Restatement (Third) of Property § 12.2 (Tentative Draft No. 1, 1995).

SECTION 413. COMBINATION AND DIVISION OF TRUSTS. Except as otherwise provided by the terms of a trust, on written notice to the qualified beneficiaries, the trustee may combine two or more trusts into a single trust or divide a trust into two or more separate trusts, if the combination or division does not impair the rights of any beneficiary or adversely affect the accomplishment of the trust purpose.

Comment

This section, which authorizes the combination or division of trusts, applies only in the absence of an express provision in the terms of the trust. Many trust instruments and standardized estate planning forms include comprehensive provisions permitting these steps.

This section allows a trustee to combine two or more trusts even though their terms are not identical, although typically the trusts to be combined will have been created by different members of the same family and vary on only insignificant details, such as the presence of different perpetuities savings periods. The more the beneficial provisions of the trusts to be combined differ from each other the more likely it is that a combination will result in the reduction of some beneficiary's interest and the less likely it is that the settlor's purpose will be accomplished and the combination can be approved. Combining trusts may prompt more efficient trust administration and is sometimes an alternative to simply terminating the trusts as permitted by Section 410. Administrative economies promoted by combining trusts include a potential reduction in trustee's fees, particularly if the trustee charges a minimum fee per trust, the ability to file one trust income tax return instead of multiple returns, and the ability to invest more efficiently because of a larger pool of available capital.

Division of trusts is often beneficial and, in certain circumstances, almost routine. Division of trusts is frequently undertaken due to a desire to obtain maximum advantage of exemptions available under the federal generation-skipping tax. While the terms of the trusts which result from such a division are identical, the division will permit differing investment objectives to be pursued and allow for discretionary distributions to be made from one trust and not the other.

This section authorizes a trustee to divide a trust even if the trusts that result are dissimilar. Conflicts among beneficiaries, including differing investment objectives, often invite such a division, although as in the case with a proposed combination of trusts, the farther away the terms of the divided trusts are from the original plan the less likely it is that the settlor's purpose will be achieved and the division can be approved.

This section does not require that a combination or division be approved by either the court or beneficiaries. Prudence may dictate, however, that court approval under Section 415 be sought and beneficiary consent obtained whenever the terms of the trusts to be combined or the trusts that will result from a division differ substantially one from the other. For the provisions relating to beneficiary consent or ratification of a transaction, or release of trustee from liability, see Section 1106.

While the consent of the beneficiaries is not necessary before a trustee may combine or divide trusts under this section, advance notice to the qualified beneficiaries of the proposed combination or division is required. This is consistent with Section 814, which requires that the trustee keep the beneficiaries reasonably informed of trust administration, including the giving of advance notice to the qualified beneficiaries of several specified actions that may have a major impact on their interests.

For a list of statutes authorizing division of trusts, either by the trustee or court order, see Restatement (Third) Property: Donative Transfers § 12.2 statutory note (Tentative Draft No. 1, 1995). For a provision authorizing a trustee, in distributing the assets of the divided trust, to make non-pro-rata distributions, see Section 817(20).

SECTION 414. APPLICATION OF CY PRES.

(a) Unless the terms of a charitable trust provide to the contrary, if a particular charitable purpose becomes unlawful, impracticable, unlawful, impossible to fulfill, or wasteful:

(1) the trust does not fail, in whole or in part;

(2) the property of the trust does not revert to the settlor; and

(3) the court shall modify or terminate the trust and direct that the trust property be applied or distributed, in whole or in part, in a manner most closely approximating the settlor's charitable purpose.

(b) If a term of a charitable trust impairs the effective administration of the trust, the court may modify the term.

Comment

This section broadens substantially the authority of courts and trustees to make charitable gifts more effective. Many of the concepts implemented in this section have long been advocated by commentators. See, e.g., Roger G. Sisson, Relaxing the Dead Hand's Grip: Charitable Efficiency and the Doctrine of Cy Pres, 74 Va. L. Rev. 635 (1988); Report, Cy Pres and Deviation: Current Trends and Application, 8 Real Prop. Prob. & Trust J. 391 (1971); Joseph A. DiClerico, Jr., Cy Pres: A Proposal for Change, 47 B.U.L. Rev. 153 (1967); Kenneth L. Karst, The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility, 73 Harv. L. Rev. 433 (1960). This broadening of the ability of a court to apply cy pres is also reflected in a number of the state statutes, with the reforms in Wisconsin being the most notable. See Wis. Stat. § 701.10.

This section codifies the court's inherent authority to apply cy pres. The power may be applied to modify an administrative or beneficial term. The court may order the trust terminated and distributed to other charitable entities. Partial termination may also be ordered if the trust property is more than sufficient to satisfy the trust's current purpose. Cy pres under the Act is a default rule. The court's authority is subject to the settlor's right to specify an alternate disposition.

This section modifies the doctrine of cy pres by presuming that the settlor had a general charitable intent. Under traditional doctrine, if a specific charitable purpose becomes impossible to fulfill, the courts then determine whether the settlor had a general charitable intent. If so, the trust property is diverted to other charitable purposes. If not, the charitable trust fails. In the great majority of cases the settlor would prefer that the gift not fail but be used for other charitable purposes. Upon failure of a particular charitable purpose, courts rarely divert the trust property to a noncharitable use. Courts are almost always able to find a general charitable purpose to which to apply the property, no matter how vaguely such purpose may have been expressed by the settlor. Consequently, this section preserves the property for charity. Unless the terms of the trust provide to the contrary, a charitable trust does not fail in whole or in part if the particular purpose for which the trust was created becomes impracticable, unlawful, impossible to fulfill, or wasteful. The court must instead either modify the terms of the trust or direct that the property of the trust be distributed in whole or in part in a manner best meeting the settlor's charitable purpose.

The application of cy pres requires a balancing of the needs of society against an assessment of the settlor's probable intent. In determining the settlor's probable intent, the court may wish to consider the current and future community needs in the general field of charity for which the trust was created, the settlor's other charitable interests, and the value of the available trust property.

The doctrine of cy pres is also applied in the law applicable to other types of charitable dispositions, including charitable corporations. This section, because it is part of a Uniform Trust Act, does not control charitable dispositions made in nontrust form. However, in formulating the rules for such dispositions the courts commonly refer to the principles governing charitable trusts.

SECTION 415. PETITION FOR APPROVAL OR DISAPPROVAL; REPRESENTATION OF SETTLOR.

(a) A petition to approve or disapprove a proposed action under Sections 408 through 414 may be filed by a settlor, trustee, or beneficiary.

(b) A settlor may maintain an action to enforce or modify a charitable trust.

(c) A settlor's powers under this section may be exercised by:

(1) an agent under a power of attorney to the extent the power of attorney or terms of the trust so authorize; or

(2) a conservator if approved by the court supervising the conservatorship.

Comment

Subsection (a) clarifies that petitions for approval or disapproval of proposed actions under this Sections 408 through 414 may be filed by the settlor, a trustee, or a beneficiary. The effect of this subsection is to make clear that a settlor is an interested person with respect to any proposed action under this part, a considerably broader role than that recognized under common law. A second effect of this subsection is to make clear that court approval or disapproval may be sought for an action which can be accomplished without court permission. This would include petitions to approve or disapprove modification or termination by beneficiary consent (Section 408), a petition questioning the trustee's distribution upon termination of a trust under $50,000 (Section 410), and a petition for approval or disapproval of a proposed trust division or consolidation (Section 413).

Subsection (b), unlike Restatement (Second) of Trusts § 391 (1959), authorizes the settlor to maintain an action to enforce or modify a charitable trust. This is consistent with subsection (a), which grants a settlor standing to participate in actions relating to termination or modification of a trust, and with Section 706, which authorizes a settlor to petition for removal of a trustee.

Subsection (c) addresses the authority of an agent or conservator to act on a settlor's behalf. Consistent with Section 602 on revocation or modification of a revocable trust, the section assumes that a settlor, in granting an agent general authority, did not intend for the agent to have authority to consent to the termination or modification of a trust and possibly undo the settlor's estate plan. In order for an agent to validly consent to a termination or modification, such authority must be expressly conveyed either in the power or in the terms of the trust.

Similarly, subsection (c) assumes that the termination or modification of the settlor's trust is a sufficiently important transaction that a conservator should not be allowed to consent without first consulting with and obtaining the approval of the court supervising the conservatorship. Many conservatorship statutes, in fact, expressly require that the conservator obtain court approval to create, amend or revoke a trust. See, e.g., Unif. Probate Code § 5-407.

ARTICLE 5

SPENDTHRIFT PROVISIONS; CREDITOR CLAIMS

General Comment

This part addresses the validity of a spendthrift provision and the rights of creditors, both of the settlor and beneficiaries, to reach a trust to collect a debt. Section 501 specifies the requirements for a valid spendthrift provision and, if valid, its effect. For trusts without valid spendthrift provisions, Section 502 describes the circumstances under which a beneficiary's creditors may reach the beneficiary's interest. Section 503 lists the categories of creditors whose claims are not subject to a spendthrift bar, and the extent to which such a creditor may reach the trust. Sections 504 through 506 address special categories where the rights of a beneficiary's creditors may not depend on whether or not the trust contains a spendthrift provision. Section 504 deals with discretionary trusts and trusts for which distributions are subject to a standard. Section 505 covers creditor claims against a settlor, whether the trust is revocable or irrevocable, and if revocable, whether the claim is made during the settlor's lifetime or incident to the settlor's death. Section 506 provides a creditor with a remedy if a trustee fails to make a required distribution within a reasonable time.

SECTION 501. SPENDTHRIFT PROVISION: GENERAL.

(a) A spendthrift provision is valid only if it provides for restraint of both voluntary and involuntary transfer of a beneficiary's interest.

(b) A beneficiary may not transfer an interest in a trust protected by a valid spendthrift provision, and, except as otherwise provided in this [Article], a creditor or assignee of the beneficiary may not attach the interest or a distribution by the trustee, before its receipt by the beneficiary.

Comment

Under this section, a settlor has the power to restrain the transfer of a beneficiary's interest, regardless of whether the beneficiary has an interest in income, in principal, or both. Unless one of the exceptions under this article applies, a creditor of the beneficiary is prohibited from attaching a protected interest and may only attempt to collect directly from the beneficiary after payment is made. This section is similar to Restatement (Second) of Trusts §§ 152-153 (1959), and Restatement (Third) of Trusts § 58 (Preliminary Draft No. 4, 1998). For the definition of spendthrift provision, see Section 105(13).

For a spendthrift provision to be effective under the Act, the provision must prohibit *both* the voluntary and involuntary transfer of the beneficiary's interest, that is, the Act does not permit a settlor to provide that a beneficiary may not assign but creditors may collect, and vice versa.

A disclaimer, because it is a refusal to accept ownership of an interest and not a transfer of an interest already owned, is not affected by the presence or absence of a spendthrift provision. Also, most disclaimer statutes expressly provide that the validity of a disclaimer is not affected by a spendthrift protection. See, e.g., Unif. Probate Code § 2-801.

While a valid spendthrift provision makes it impossible for a beneficiary to make a legally binding transfer, a trustee is not penalized for voluntarily honoring the assignment. A voluntary assignment by a beneficiary as to periodic payments otherwise due the beneficiary may be honored by a trustee but is revocable by the beneficiary at any time.

SECTION 502. CLAIM OF BENEFICIARY'S CREDITOR AGAINST TRUST WITHOUT SPENDTHRIFT PROVISION. To the extent a beneficiary's interest is not protected by a spendthrift provision, a creditor or assignee of a beneficiary may reach the beneficiary's interest in an appropriate judicial proceeding, including obtaining an order attaching present or future distributions to or for the benefit of the beneficiary.

Comment

Absent a valid spendthrift provision, the interest of a beneficiary may be reached the same as any other of the beneficiary's assets. This section does not attempt to prescribe the procedures for reaching a beneficiary's interest, preferring instead to leave that issue to the enacting State's laws on creditor rights. Consequently, the section provides that a creditor or assignee may pursue collection in "an appropriate judicial proceeding." The section does clarify, however, that an order obtained against the trustee, whatever state procedure may have been used, may extend to future distributions whether made directly to the beneficiary or to others for the beneficiary's benefit. By allowing an order to extend to future payments, the need for the creditor to periodically return to court will be reduced.

While this section does not prescribe creditor procedure, the creditor typically will serve an order on the trustee attaching the beneficiary's interest, although the particular State's law may use other terms, such as garnishment or creditor bill. Assuming the validity of the order cannot be contested, the trustee will then pay to the creditor instead of to the beneficiary any payments the trustee would otherwise be required to make to the beneficiary, such as a required payment of income, as well as payments the trustee might otherwise decide to make, such as a discretionary distribution of principal. The creditor may also, in theory, force a judicial sale of a beneficiary's interest.

A creditor's attachment of a beneficiary's interest may not result in the creditor receiving all distributions that would otherwise be made to the beneficiary. State creditor law may limit the creditor to a specified percentage of a distribution. See, e.g., Cal. Prob. Code § 15306.5.

SECTION 503. EXCEPTIONS TO SPENDTHRIFT PROVISION.

(a) Even if a trust contains a spendthrift provision, a beneficiary's child or current or former spouse may obtain, in an appropriate judicial proceeding, an order attaching present or future distributions to or for the benefit of the beneficiary.

(b) A spendthrift provision is unenforceable against a State or the United States to the extent a statute of the State or federal law so provides.

Comment

For trusts with spendthrift provisions, the effect of this section is to enable certain creditors to bypass a spendthrift restriction but only with respect to their particular claims. Under this section, exceptions are recognized for court orders for the support of a child or a current or former spouse and for certain governmental claims.

The exception in subsection (a) for orders to support a beneficiary's child or current or former spouse is in accord with Restatement (Second) of Trusts § 157 (1959), Restatement (Third) of Trusts § 59 (Preliminary Draft No. 4, 1998), and numerous state statutes. It is also consistent with federal bankruptcy law, which exempts such support orders from discharge. The effect of this exception is to permit the claimant for unpaid support to attach present or future distributions that would otherwise be made to the beneficiary. Distributions subject to attachment include distributions required by the express terms of the trust, such as mandatory payments of income, and distributions the trustee has otherwise decided to make, such as through the exercise of discretion. Subsection (a), unlike Section 504, does not authorize the spousal or child claimant to force a sale of the beneficiary's interest. For the right of a spouse or child claimant to force a distribution if the trustee has abused discretion or failed to comply with a standard for distribution, see Section 504.

Subsection (b), which is similar to Restatement (Third) of Trusts § 59 (Preliminary Draft No. 4, 1998), exempts certain governmental claims from a spendthrift bar. Federal preemption guarantees that certain federal claims, such as claims by the Internal Revenue Service, may bypass a spendthrift provision no matter what this Act might say. The case law and relevant Internal Revenue Code provisions on the exception for federal tax claims are collected in 2A Austin W. Scott & William F. Fratcher, The Law of Trusts § 157.4 (4th ed. 1987). As to claims by state governments, this subsection recognizes that States take a variety of approaches with respect to collection, depending on whether the claim is for unpaid taxes, for care provided at an institution, or for other charges. Acknowledging this diversity, subsection (b) does not prescribe a definite rule, but instead refers to other statutes of the State on whether a particular claim would be barred or exempted from a spendthrift provision. The other state statute might be a statute of the forum jurisdiction or the statute of another State.

Unlike Restatement (Second) of Trusts § 157 (1959), and Restatement (Third) of Trusts § 59 (Preliminary Draft No. 4, 1998), this Act does not provide that a spendthrift provision is unenforceable against creditors who have furnished necessary services or supplies to the beneficiary, or creditors who have furnished services or materials which have preserved or supposedly enhanced the beneficiary's interest. For a discussion of these other exceptions to the spendthrift bar, recognized in some States, see 2A Austin W. Scott & William F. Fratcher, The Law of Trusts §§ 157-157.5 (4th ed. 1987).

SECTION 504. DISCRETIONARY TRUSTS AND TRUSTS SUBJECT TO STANDARD.

(a) Except as otherwise provided in subsection (b), whether or not the trust contains a spendthrift provision, if the terms of a trust provide that the trustee shall pay to or for the benefit of a beneficiary income or principal of the trust subject to a standard or in the discretion of the trustee, a creditor of a beneficiary may not compel a distribution from the trust, even if the trustee has failed to comply with the standard or abused the discretion.

(b) To the extent a trustee has failed to comply with a standard or abused a discretion, a distribution may be compelled in an appropriate judicial proceeding by a spouse, former spouse, or child who has a judgment against the beneficiary for support. The court shall direct the trustee to pay the spouse or child such amount as is equitable under the circumstances but not in excess of the amount the trustee was otherwise required to distribute to or for the benefit of the beneficiary.

(c) This section does not limit the right of a beneficiary to maintain a judicial proceeding against a trustee for an abuse of discretion or failure to comply with a standard for distribution.

Comment

Pursuant to Section 501, the effect of a valid spendthrift provision, where applicable, is to prohibit a creditor from collecting on a distribution prior to its receipt by the beneficiary. If the trust is not protected by a spendthrift provision, or should the creditor fit within one of the exceptions created by Section 503, the creditor may attach a distribution the trustee is required to or has otherwise decided to make to the beneficiary. If the trust does not contain a spendthrift provision, the creditor may also conceivably force a sale of the beneficiary's interest. See Section 502. But the mere power to attach an interest does not mean that a creditor can force a trustee to exercise discretion or make a distribution based on a standard.

Subsection (a), which establishes the general rule, forbids a creditor from compelling a distribution from the trust, even if the trustee has failed to comply with the standard of distribution or has abused a discretion. Per subsection (c), the power to force a distribution due to an abuse of discretion or failure to comply with a standard belongs solely to the beneficiary. Under Section 815, a trustee must always exercise a discretionary power in good faith and with regard to the purpose of the trust and the interest of the beneficiaries.

Subsection (b) creates an exception for support claims of a spouse, former spouse, or child. While a creditor of a beneficiary may not in general assert that a trustee has abused discretion or failed to comply with a standard of distribution, such a claim may be asserted by the beneficiary's spouse, former spouse, or child, but only if made in an appropriate judicial proceeding. The court must direct the trustee to pay the spouse or child such amount as is equitable under the circumstances but not in excess of the amount the trustee was otherwise required to distribute to or for the benefit of the beneficiary. Before fixing this amount, the court with jurisdiction over the trust should consider that in setting the respective support award, an obligation on which the beneficiary has now defaulted, the family court has already considered the respective needs and assets of the family. The Act does not attempt to prescribe the particular procedural method for enforcing a support judgment against the trust, leaving that matter to local collection law. For an example, see Cal. Prob. Code § 15305.

SECTION 505. CREDITOR'S CLAIM AGAINST SETTLOR.

(a) Whether or not the terms of a trust contain a spendthrift provision, the following rules apply:

(1) A creditor or assignee of the settlor may reach the maximum amount that the trustee could pay to or for the settlor's benefit. If a trust has more than one settlor, the amount the creditor or assignee of a particular settlor may reach may not exceed the settlor's discretionary interest in the portion of the trust attributable to that settlor's contribution.

(2) During the lifetime of the settlor, the property of a revocable trust is subject to the claims of the settlor's creditors.

(3) After the death of a settlor, and subject to the settlor's right to direct the source from which liabilities will be paid, the property of a revocable trust which was subject to the settlor's power of revocation at the time of death is subject to claims of the settlor's creditors, costs of administration of the settlor's estate, the expenses of

the settlor's funeral, and statutory allowances to a surviving spouse and children to the extent the settlor's probate estate is inadequate to satisfy those claims, costs, expenses and allowances.

(b) For purposes of this section, to the extent of the property subject to the power, the holder of a presently exercisable power of withdrawal is treated in the same manner as the settlor of a revocable trust.

Comment

Subsection (a)(1), which is based on Section 156 of the Restatement (Second) of Trusts (1959), and Restatement (Third) of Trusts § 58(2) & cmt. e (Preliminary Draft No. 4, 1998), follows traditional doctrine in providing that a settlor who is also a beneficiary may not use the trust as a shield against the settlor's creditors. Whether the trust contains a spendthrift provision or not, a creditor of the settlor may reach the maximum amount that the trustee could have paid to the settlor-beneficiary. Should the trustee have discretion to distribute the entire income and principal to the settlor, the effect of this subsection is to place the settlor's creditors in the same position as if the trust had not been created. For the definition of "settlor," see Section 105(12).

This section does not address possible rights against a settlor should the settlor have been insolvent at the time of the trust's creation or was rendered insolvent by the transfer of property to the trust. This subject is instead left to the State's law on fraudulent conveyances. A transfer to the trust by an insolvent settlor may also constitute a voidable preference under federal bankruptcy law.

Subsection (a)(2) states what is now a well accepted conclusion, that a revocable trust is subject to the settlor's creditors while the settlor is living. Such claims were not allowed at common law, however. See Restatement (Second) of Trusts § 330, cmt. o (1959). Because a settlor usually also retains a beneficial interest which a creditor may reach under subsection(a)(1), the common law rule is normally of little significance. See Restatement (Second) of Trusts § 156(2) (1959).

Subsection (a)(3) recognizes that a revocable trust is usually employed as a will substitute. As such, the trust assets, following the death of the settlor, should be subject to the settlor's debts and other charges. However, in accordance with traditional doctrine, the assets of the settlor's probate estate must normally first be exhausted before the assets of the revocable trust can be reached.

This section does not attempt to address the procedural issues raised by the need to first exhaust the decedent's probate estate to reach the assets of the revocable trust. Nor does this section address the priority of the creditor claims or the possible liability of the decedent's other nonprobate assets for the decedent's debts and other charges. Subsection (a)(3), however, does ratify the typical pourover will, revocable trust plan. Such a plan will usually shift a portion if not all of the death-related liabilities from the probate estate to the revocable trust. As long as the rights of the creditor or family member claiming a statutory allowance are not impaired, the settlor is free to shift liability from the probate estate to the revocable trust.

This section does not cover all creditor issues that may arise in connection with revocable trusts, in particular the possible liability of other nonprobate assets for unpaid claims. These issues, which extend well beyond the law of trusts, are addressed in Section 6-102 of the Uniform Probate Code, which was approved at the Commissioners' 1998 Annual Meeting.

Subsection (b) treats a presently exercisable general power of appointment as the functional equivalent of a power of revocation. Should the power be unlimited, the property subject to the power will be fully subject to the claims of the power holder's creditors, the same as the power holder's other assets. Should the power holder retain the power until death, the property subject to the power may be liable for claims and statutory allowances to the extent the power holder's probate estate is insufficient to satisfy those claims and allowances. For powers limited either in time or amount, such as a right to withdraw a $10,000 annual exclusion contribution within 30 days, this subsection would limit the creditor to the $10,000 contribution and require the creditor to take action prior to the expiration of the 30-day period. However, subsection (b) does not negate the possibility that upon the lapse of the power, the power holder would be deemed to have become the settlor and thereby subject the contribution to creditor claims under subsection (a)(1). For the definition of settlor and its possible interpretation, see Section 105(12) and Comment.

This Act does not address creditor issues with respect to property subject to a special power of appointment or testamentary general power of appointment. For creditor rights against such interests, see Restatement (Property) Second: Donative Transfers §§ 13.1-13.7 (1986).

SECTION 506. LATE DISTRIBUTION. Whether or not a trust contains a spendthrift provision, a creditor or assignee of a beneficiary may attach a distribution directed to be made to the beneficiary by the terms of the trust if the trustee has failed to make the distribution within a reasonable time.

Comment

The effect of a spendthrift provision is generally to totally insulate a beneficiary's interest until a distribution is made and has been received by the beneficiary. See Section 501. But this section, along with several other sections in this article, recognize exceptions to this general rule. Whether a trust contains a spendthrift provision or not, a trustee should not be able to avoid creditor claims against a beneficiary by refusing to make a distribution required to be made by the express terms of the trust. On the other hand, a spendthrift provision would become largely a nullity were a beneficiary's creditors able to attach all required payments as soon as they became due. This section reflects a compromise between these two competing principles. A creditor can reach a distribution required to be made to the beneficiary by the express terms of the trust only if the trustee has failed to make the payment within a reasonable time after the required distribution date. Following this reasonable period, payments required to be made by the express terms of the trust are in effect being held by the trustee as agent for the beneficiary and should be treated the same as any other of the beneficiary's personal assets.

ARTICLE 6

REVOCABLE TRUSTS

General Comment

Because of the widespread use in recent years of the revocable trust as an alternative to a will, this short article is one of the more important articles of the Act. Each section of this article deals with issues of significance not totally settled under current law. A general theme of this article and of the other parts of this Act is to treat the revocable trust as the functional equivalent of a will. Section 601 provides that the capacity standard for wills is to apply in determining whether the settlor had capacity to create a revocable trust. Section 602, after providing that a trust is presumed revocable unless stated otherwise, prescribes the procedure for revocation or modification, whether the trust contains one or multiple settlors. Section 603 provides that while a trust is revocable and the settlor has capacity, the settlor has all rights that would otherwise be granted to the beneficiaries. Section 604 prescribes a statute of limitations on contest of a trust that was revocable at death.

SECTION 601. CAPACITY OF SETTLOR TO CREATE REVOCABLE TRUST. An individual who has capacity to make a will has capacity to create a revocable trust.

Comment

The purpose of this section, which is patterned after Restatement (Third) of Trusts § 11 (Tentative Draft No. 1, 1996), is to provide some certainty to what has become a major issue in the law of trusts due to the recent and widespread use of the revocable trust as an alternative to a will.

This section recognizes that the revocable trust is used primarily as a will substitute, with its key provision being the determination of the persons to receive the trust property upon the settlor's death. To solidify the use of the revocable trust as a device for transferring property at death, the settlor usually also executes a pourover will under which the property not transferred to the trust during life will, following the settlor's death, be combined with the trust property which the settlor did manage to convey. Given this primary use of the revocable trust as a device for disposing of property at death, the capacity standard for wills, and not for lifetime gifts, should apply. If lifetime management issues implicating the standard of capacity arise, they may be dealt with by reformation or other appropriate remedies that will not jeopardize the overall plan of disposition by making the standard for the trust different or higher than that for making a will. Restatement (Third) of Trusts § 11 cmt. b (Tentative Draft No. 1, 1996).

The application of the capacity standard for wills does not mean that the revocable trust must be executed with the formalities of a will. There are no execution requirements under this Act for a trust not created by will, and a trust, at least one containing personal property, may be created by an oral statement. See Section 403 and Comment. Nor does the application of the capacity standard for wills, and the fact that most States prohibit a guardian or conservator from making a will for the ward or protected person, mean that a guardian or conservator cannot create a trust, if allowed under local guardianship or conservatorship law.

The Act does not explicitly spell out the standard of capacity necessary to create other types of trusts, although Section 402 does require that the settlor have capacity. This section expressly states a capacity standard for the creation of revocable trusts because of the lack of clarity in the case law and the importance of the issue in modern estate planning. No such uncertainty exists with respect to the capacity standard for other types of trusts. To create a testamentary trust, the settlor must have the capacity to make a will. To create an irrevocable trust, the settlor must have the capacity during lifetime to transfer the property free of trust. See generally Restatement (Third) of Trusts § 11 (Tentative Draft No. 1, 1996).

SECTION 602. REVOCATION OR MODIFICATION OF REVOCABLE TRUST.

(a) Unless the terms of a trust expressly provide that the trust is irrevocable, the settlor may revoke or modify the trust. This subsection does not affect trusts created under instruments executed before [the effective date of this [Act]].

(b) Except as otherwise provided by the terms of a trust, if the trust is created or funded by more than one settlor:

(1) to the extent the trust consists of community property, the trust may be revoked by either spouse acting alone but may be modified only by joint action of both spouses;

(2) to the extent the trust consists of other property, each settlor may revoke or modify the trust as to the portion of the trust property contributed by that settlor.

(c) A trust that is revocable by the settlor may be revoked or modified:

(1) by substantially complying with the method specified by the terms of the trust; or

(2) unless the terms of the trust expressly make the specified method exclusive, by any other method manifesting clear and convincing evidence of the settlor's intent.

(d) Upon revocation of a revocable trust, the trustee shall distribute the trust property as the settlor directs.

(e) A settlor's powers with respect to revocation or modification may be exercised by an agent under a power of attorney only to the extent the terms of the trust or the power of attorney expressly so authorizes.

(f) Except to the extent prohibited by the terms of the trust, a conservator may revoke or modify a revocable trust with the approval of the court supervising the conservatorship.

Comment

Subsection (a), which provides that a settlor may revoke or modify a trust unless the terms of the trust expressly state that the trust is irrevocable, is contrary to the common law of trusts. The common law presumes that a trust is irrevocable absent evidence of contrary intent. See Restatement (Second) of Trusts § 330 (1959). This subsection does not govern trusts created in another State whose validity, under choice of law rules, is governed by the law of a State following the common law rule. In addition, this subsection does not prevent a trust from being reformed to make it irrevocable if the settlor was proceeding under a mistake of law at the time of its creation. See Section 411 (reformation of trust). But far easier than relying on this statute, choice of law rules, or reformation is for the drafter to simply express in the terms of the trust whether the trust is revocable or irrevocable.

A power of revocation includes the power to modify. See Restatement (Second) of Trusts § 331 cmt. g (1959). An unrestricted power to modify may also include the power to revoke a trust. See Restatement (Second) of Trusts § 331 cmt. h.

Subsection (b) provides default rules for revocation or modification of a trust with multiple settlors. The settlor's authority to revoke or modify the trust varies depending on the extent to which the trust consists of community property. To the extent the trust consists of community property, the trust may be revoked by either spouse acting alone but may be modified only by joint action of both spouses. The purpose of this provision, and the reason for the use of joint trusts in community property States, is to preserve the community character of property transferred to the trust. While community property does not prevail in a majority of States, contributions of community property to joint trusts created in noncommunity property States does occur. This is due to the mobility of settlors, and the fact that community property retains its community character when a couple move from a community to a noncommunity property State. For this reason, subsection (b), and its provision on contributions of community property, should be enacted in all States, whether community or noncommunity.

With respect to separate property contributed to the trust, or all property of the trust if none of the trust property consists of community property, each settlor may revoke or modify the trust as to the portion of the trust contributed by that settlor. The inclusion of a rule for contributions of separate property does not mean that the drafters of this Act concluded that the use of joint trusts should be encouraged. The rule is included because of the widespread use of joint trusts in noncommunity property States in recent years. Due to the desire to preserve the community character of trust property, joint trusts are a necessity in community property States. Unless community property will be contributed to the trust, no such motivating reason exists for their creation in a noncommunity property State.

This section does not explicitly require that the other settlor or settlors be notified if a joint trust is revoked by less than all of the settlors, but such notice would be required under Section 814(f). While the trust is revocable and the settlor has capacity, Section 814(f) provides that the duty to keep the beneficiaries reasonably informed of developments is owed exclusively to the settlor. To avoid an issue as to how this duty applies to a trust with multiple settlors, subsection (f) further provides that in the case of a trust with multiple settlors, this duty to keep the *settlor* informed extends to *all* of the settlors. Notifying the other settlor of settlors of the revocation or modification will place them in a better position to protect their interests. If the revocation or modification by less than all of the settlors breaches an implied agreement not to revoke or modify the trust, those harmed by the action could sue for breach of contract. If the trustee fails to notify the other settlor or settlors of the revocation, the parties aggrieved by the trustee's failure could sue the trustee for breach of trust.

Under subsection (c), the settlor may revoke a revocable trust by substantially complying with the method specified in the terms of the trust or by any other method manifesting clear and convincing evidence of the settlor's intent to revoke. Only if the method specified in the terms of the trust is exclusive are use of the other methods prohibited. Even then, a failure to comply with a technical requirement, such as required notarization, may be excused as long as compliance with the method specified in the terms of the trust is otherwise substantial.

While revocation of a trust is ordinarily accomplished by signing and delivering a written document to the trustee, other methods, such as by oral statement or by physical act coupled with a withdrawal of the property, may also demonstrate the necessary intent. These less formal methods, because they provide less reliable indicia of intent, are not to be encouraged.

Subsection (c) does not require that a trustee concur in a revocation or modification of a trust. Such a concurrence would be necessary only if expressly required by the terms of the trust. If the trustee concludes that a modification unacceptably changes the trustee's duties, the trustee is free to resign. See Section 705.

Subsection (d), providing that upon revocation the trust property is to be distributed as the settlor directs, codifies a provision commonly included in revocable trust instruments.

Subsection (e) allows an agent under a power of attorney to revoke or modify a revocable trust but only to the extent the terms of the trust or power of attorney expressly so permit. An express provision is required because most settlors usually intend the revocable trust, and not the power of attorney, to function as the settlor's principal property management device. The power of attorney is usually intended as a backup for assets not transferred to the revocable trust or to address specific topics, such as the power to sign tax returns or apply for certain government benefits, which are questionably beyond the authority of a trustee or which are not customarily granted to a trustee.

Many States allow a conservator to exercise the settlor's power of revocation with the prior approval of the court supervising the conservatorship. See, e.g., Unif. Prob. Code § 5-407. Subsection (f) allows a settlor to direct in the terms of the trust that this other law not apply. The fact that a conservator may be prohibited from revoking the trust does not mean that the conservator is prohibited from taking appropriate action to protect the settlor's interest if the settlor, now under conservatorship, is also a beneficiary of the trust. For example, the conservator could petition for removal of the trustee. See Section 706. The conservator, acting on the settlor-beneficiary's behalf, could also bring an action to enforce the trust according to its terms. Pursuant to Section 305, a conservator may act on behalf of the beneficiary whose estate the conservator controls whenever a consent or other action by the beneficiary is required or may be given under the Act.

The settlor's power to revoke the trust under this section does not preclude termination of the trust under another section.

SECTION 603. OTHER RIGHTS OF SETTLOR; PRESENTLY EXERCISABLE POWERS OF WITHDRAWAL.

(a) Except as otherwise provided by the terms of a trust, while the trust is revocable and the settlor has capacity to revoke the trust:

(1) rights of the beneficiaries are held by, and the duties of the trustee are owed exclusively to the settlor; the rights to be held by and owed to the beneficiaries only upon the settlor's death or incapacity; and

(2) the trustee may follow a written direction of the settlor, even if contrary to the terms of the trust.

(b) The holder of a presently exercisable power of withdrawal has the rights of a settlor of a revocable trust under this section to the extent of the property subject to the power.

Comment

This section has the effect of postponing the enjoyment of rights of beneficiaries of revocable trusts until the death or incapacity of the settlor or other person holding the power to revoke the trust. This section thus recognizes that the settlor of a revocable trust is in control of the trust and should have the right to enforce the trust. Because of this degree of control, the trustee may also rely on a written direction of the settlor, even if contrary to the terms of the trust. Alternatively, the written direction of the settlor might be regarded as a modification of the trust.

Under this section, the duty to inform and report to beneficiaries is owed to the settlor of a revocable trust as long as the settlor has capacity. See also Section 814 (trustee's duty to inform and report to beneficiaries). The introductory clause of this section recognizes that the terms of a trust may grant rights to the beneficiaries which would otherwise be held by the holder of the power to revoke.

This section no longer applies should the settlor lose capacity. In that event, the beneficiaries are granted all rights normally afforded the beneficiaries of irrevocable trusts, subject to a possible right of a conservator or agent to revoke or modify the trust. See Section 602(e)-(f).

Subsection (b) makes clear that a holder of a presently exercisable power of withdrawal has the same powers over the trust as the settlor of a revocable trust. Equal treatment is warranted due to the holder's equivalent power to control the trust.

SECTION 604. LIMITATION ON ACTION CONTESTING VALIDITY OF REVOCABLE TRUST.

(a) A judicial proceeding to contest the validity of a trust which, immediately prior to the settlor's death, was revocable by the settlor must be commenced not later than three years after the death of the settlor, unless barred earlier by adjudication, consent, or other limitation.

(b) After the death of the settlor, the trustee of a trust which was revocable by the settlor at the settlor's death may assume that the trust is valid absent actual knowledge of a pending judicial proceeding contesting the validity of the trust or that a colorable claim for contesting the trust exists.

Comment

The purpose of this section is to provide finality to when a contest of a revocable trust may be brought and to encourage the expeditious distribution of the trust property following the death of the settlor. Subsection (a), which requires that a contest be brought no later than three years following the death of the settlor, is consistent with the Uniform Probate Code, which places a three-year limit on the probate or contest of a will if not earlier barred. The time limit applies not only to contests to invalidate the trust in its entirety but also to contests to invalidate a trust in part.

Subsection (b), which protects a trustee in making distributions absent actual knowledge of a contest or colorable claim, does not discharge the distributees from potential liability for what may later turn out to have been an inappropriate distribution. Should a successful contest later be brought, the contestants may also reach any trust property still in the trustee's possession.

This section does not address possible liability for the debts of the deceased settlor nor possible liability to creditors for distributing trust assets. For possible liability of the trust, see Section 505(a)(3) and Comment. Whether a trustee can be held liable for creditor claims following distribution of trust assets is addressed in proposed Uniform Probate Code § 6-102, which was approved by the Commissioners at its 1998 Annual Meeting.

ARTICLE 7

OFFICE OF TRUSTEE

General Comment

This article contains a series of default rules dealing with the office of trustee, all of which may be superseded by the terms of the trust. Sections 701 and 702 address the process for getting a trustee into office, including the procedures for indicating an acceptance and whether bond will be required. Section 703 address cotrustees, permitting the cotrustees to act by majority action and specifying the extent to which one trustee may delegate to another. Sections 704 through 708 address changes in the office of trustee, specifying the circumstances when a vacancy must be filled, the procedure for resignation, the grounds for removal, and the process for appointing a successor. Sections 709 and 710 prescibe the standard for determining trustee compensation and reimbursement for expenses advanced.

SECTION 701. ACCEPTANCE OR REJECTION OF TRUSTEESHIP.

(a) Except as otherwise provided in subsection (c), a person designated as trustee accepts the trusteeship by:

(1) substantially complying with a method specified in the terms of the trust; or

(2) unless the terms of the trust make the specified method exclusive, accepting delivery of the trust property, exercising powers or performing duties as trustee, or otherwise indicating an intention to accept the trusteeship.

(b) A person designated as trustee who has not yet accepted the trusteeship may reject the trusteeship. A failure to accept the trusteeship within a reasonable time after the person knows of the appointment is a rejection of the trusteeship.

(c) If there is an immediate risk of loss to the trust property, the person designated as trustee may act to preserve the trust property without accepting the trusteeship, if within a reasonable time after acting the person delivers a written rejection of the trusteeship to the settlor or, if the settlor is dead or lacks capacity, to a qualified beneficiary.

Comment

This section, specifying the requirements for a valid acceptance of the trusteeship, implicates many of the same issues as arise in determining whether a trust has been revoked. Consequently, the two provisions track each other closely. Compare Section 602(c) (procedure for revoking or modifying trust). Procedures specified in the terms of the trust are recognized, but only substantial, not literal compliance is required. A failure to meet technical requirements, such as notarization of the trustee's signature, does not result in nonacceptance. Ordinarily, the trustee will indicate an acceptance by signing the trust instrument or signing a separate written instrument. However, this section recognizes any other method indicating the necessary intent, such as an acceptance by oral statement or knowingly exercising trustee powers, unless the terms of the trust make a specified method exclusive. This section also does not preclude an acceptance by estoppel or damages for an unreasonable delay in signifying a decision as to an acceptance or rejection. For general background on issues relating to trustee acceptance and rejection, see Restatement (Second) of Trusts § 102 (1959); Restatement (Third) of Trusts § 35 (Preliminary Draft No. 4, 1998). Consistent with Section 201, which encourages a court to intervene only when called upon by an interested party or in other special circumstance, there is no requirement that a trustee qualify in court.

To avoid the inaction that can result if the person designated as trustee fails to communicate a decision to either accept or reject the trusteeship, subsection (b) provides that a failure to accept within a reasonable time constitutes a rejection of the trusteeship. A trustee's rejection of a trust normally precludes a later acceptance of the trust but does not cause the trust to fail. See Restatement (Third) of Trusts § 35 cmt. c (Preliminary Draft No. 4, 1998). As to filling vacancies in the event of a rejection, see Section 708.

While a person designated as trustee who decides not to accept the trusteeship need not provide a formal rejection, a clear and early communication is recommended. The appropriate recipient of the written rejection depends upon the particular circumstances. Ordinarily, it would be appropriate to give the rejection to the person who informs the person of the proposed trusteeship. If judicial proceedings involving the trust are pending, the rejection could be filed with the court. In the case of a person named as trustee of a revocable trust, it would be appropriate to give the rejection to the settlor. In any event it would be best to give notice of rejection to a beneficiary with a significant interest in the trust because that beneficiary might be more motivated than others to seek appointment of a new trustee.

Subsection (c) makes clear that the authority to act in an emergency does not impose a duty to act. The person named as trustee may act in an emergency without being considered to have accepted the trusteeship but upon conclusion of the emergency the nominated trustee must clearly indicate to the settlor, if living and competent, otherwise to the qualified beneficiaries entitled to approve a trustee's report, that the person rejects the trusteeship.

SECTION 702. TRUSTEE'S BOND.

(a) A trustee must give a bond to secure performance of the trustee's duties only if the court finds that a bond is needed to protect the interest of beneficiaries or a bond is required by the terms of the trust and the court has not dispensed with the requirement.

(b) If required, a bond must be in such amount and with such sureties and liabilities as the court may specify. The court, by requiring bond, is not precluded from later modifying or dispensing with the bond.

(c) Except as otherwise provided by the terms of trust or ordered by the court, the cost of a bond is charged to the trust.

Comment

This provision is consistent with the Restatement and with the bonding provisions of the Uniform Probate Code. See Restatement (Third) of Trusts § 34 cmt. a (Preliminary Draft No. 4, 1998); Unif. Probate Code §§ 3-604 (personal representatives), 5-410 (conservators), and 7-304 (trustees). Because a bond is required only if the terms of the trust require bond or a bond is found by the court to be necessary to protect the interests of beneficiaries, bond should rarely be required under the Act. This section does not specifically excuse bond for financial-service institutions with trust powers, preferring instead to leave that topic to separate legislation.

The amount of a bond otherwise required may be reduced by the value of trust property deposited in a manner that prevents its unauthorized disposition, and by the value of real property which the trustee, by express limitation of power, lacks power to convey without court authorization.

The court may excuse or otherwise modify a requirement of a bond, reduce or increase the amount of a bond, release a surety, or permit the substitution of another bond with the same or different sureties.

SECTION 703. COTRUSTEES.

(a) Except as otherwise provided by the terms of a trust:

(1) a power held by cotrustees may be exercised by majority action;

(2) if a vacancy occurs in a cotrusteeship, the remaining cotrustees may act for the trust; and

(3) if a cotrustee is unavailable to perform duties because of absence, illness, or other temporary incapacity, and prompt action is necessary to accomplish the purpose of the trust or to avoid injury to the trust property, the remaining cotrustees may act for the trust as if they were the only trustees.

(b) If a trust has more than one trustee, each trustee shall:

(1) participate in the administration of the trust and not delegate to a cotrustee the performance of a function that the settlor reasonably expected the trustees to perform jointly; and

(2) take reasonable steps to prevent a cotrustee from committing a breach of trust and to compel a cotrustee to redress a breach of trust.

(c) A trustee who complies with subsection (b) is not liable for a cotrustee's action or failure to act.

Comment

Subsection (a)(1) is in accord with Restatement (Third) of Trusts § 39 (Preliminary Draft No. 4, 1998), which rejects earlier Restatement formulations requiring unanimity among the trustees of a private trust. See Restatement (Second) of Trusts § 194 (1959). This section, consistent with the prior Restatement rule limited to charitable trusts, allows action by a majority of the trustees, whatever type of trust may be involved. See Restatement (Second) of Trusts § 383 (1959). However, the rule of this section is subject to contrary provision in the terms of the trust, as noted in the introductory clause. Should a cotrustee resign or a vacancy occur by some other means, only a majority of the remaining trustees need be counted, even though the number of trustees constituting a majority would then be less than before the vacancy occurred.

Under subsection (a)(2), a vacancy in a cotrusteeship is disregarded if there is at least one trustee remaining in office. This is consistent with Section 708, which provides that unless the terms of the trust so require, a vacancy in a cotrusteeship need be filled only if there is no cotrustee remaining in office.

By permitting the trustees to act by a majority, subsection (a) contemplates that there may be a trustee or trustees who might dissent. A trustee who dissents is not liable to a third party for failing to join in the majority's exercise of a power. However, should the action by the majority constitute a breach of trust, the dissenting trustee may be held liable under subsection (b) for failing to take action to rectify the improper acts of the other cotrustees. The responsibility to monitor the actions of the other cotrustees imposed by subsection (b) codifies the substance of Sections 184 and 224 of the Restatement (Second) of Trusts (1959).

Subsection (b) also addresses the extent to which a trustee may delegate the performance of functions to a cotrustee. A trustee may not delegate to a cotrustee the performance of functions that the settlor expected the trustee to personally perform. This is consistent with Restatement (Second) of Trusts § 171, although that Restatement provision applied to all delegation, both to agents and to cotrustees. For the provision of this Act on delegation to agents, see Section 808. The exact extent to which a trustee may delegate functions to another trustee in a particular case will vary depending on the reasons the settlor decided to appoint cotrustees. The better practice is to address the division of functions in the terms of the trust, as allowed by Section 801.

A cotrustee's assumption of duties due to a trustee's inability to perform the trusteeship is not a delegation. Under subsection (a)(3), a cotrustee may assume some or all of the functions of another trustee who is unavailable to perform duties because of absence, illness, or other temporary incapacity.

SECTION 704. VACANCY IN TRUSTEESHIP. A vacancy in a trusteeship occurs if:

(1) a person designated as trustee rejects the trusteeship;

(2) a person named as trustee cannot be identified or does not exist;

(3) a trustee resigns;

(4) a trustee is disqualified or removed;

(5) a trustee dies; or

(6) a guardian or conservator is appointed for an individual serving or eligible to serve as trustee.

Comment

This section lists the typical ways in which a trusteeship becomes vacant. For the rules on filling a vacancy, see Section 708. See also Sections 701 (acceptance or rejection of trusteeship), 705 (resignation of trustee), and 706 (removal of trustee).

SECTION 705. RESIGNATION OF TRUSTEE.

(a) A trustee may resign by any of the following methods:

(1) as provided by the terms of the trust;

(2) in the case of a revocable trust, upon at least 30 days' written notice to:

(A) the settlor if the settlor has capacity;

(B) the settlor's conservator, guardian, or agent if the settlor lacks capacity but is represented by a conservator, guardian, or agent; or

(C) the qualified beneficiaries if the settlor lacks capacity and is not represented by a conservator, guardian, or agent;

(3) in the case of an irrevocable trust, upon at least 30 days' written notice to the qualified beneficiaries; or

(4) with the approval of the court.

(b) A qualified beneficiary, by a written consent, may waive a notice otherwise required under this section.

(c) In approving a resignation, the court may impose orders and conditions reasonably necessary for the protection of the trust property, including the appointment of a receiver or temporary trustee.

(d) The liability for acts or failures to act of a resigning trustee or of any sureties on the trustee's bond is not released or affected by the trustee's resignation.

Comment

This section provides several alternative methods by which a trustee may resign. As provided in subsection (a)(1), a trustee may always resign as provided in the terms of the trust. If the terms of the trust do not provide a method for resignation or if the method for whatever reason is not followed, a trustee may resign by giving notice as provided in subsection (a)(2)-(3). Under subsection (a)(4), court approval of a resignation is required only if none of the other alternatives are available.

The persons to whom notice of a resignation must be given are generally the same as those who must approve the appointment of a successor trustee to fill a vacancy. See Section 708. For a revocable trust, notice to the settlor will ordinarily be required, but should the settlor be incapacitated, subsection (a)(2) makes provision for a substitute consent. For an irrevocable trust, subsection (a)(3) requires that notice be given to the qualified beneficiaries.

Section 814 requires a trustee's report whenever there is a change of trustees. See also Restatement (Second) of Trusts § 106 cmt. b, and Restatement (Third) of Trusts § 36 cmt. d (Preliminary Draft No. 4, 1998), which, like subsection (d), provides that resignation does not release the resigning trustee from potential liabilities.

SECTION 706. REMOVAL OF TRUSTEE.

(a) A trustee may be removed in accordance with the terms of the trust or by the court on its own initiative or on petition of a settlor, cotrustee, or beneficiary.

(b) The court may remove a trustee or order other appropriate relief as specified in Section 1102:

(1) if the trustee has committed a material breach of trust;

(2) if the trustee is unfit or unable to administer the trust;

(3) if lack of cooperation among cotrustees substantially impairs the administration of the trust;

(4) if the investment decisions of the trustee, although not constituting a breach of trust, have resulted in investment performance persistently and substantially below those of comparable trusts;

(5) if, because of changed circumstances, removal of the trustee would substantially further the settlor's purpose in creating the trust; or

(6) for other good cause shown.

(c) Pending a final decision on the petition to remove the trustee, the court may order such appropriate relief under Section 1102 as may be necessary to protect the trust property or the interests of the beneficiaries.

Comment

Subsection (a), unlike the Restatement, grants the settlor of an irrevocable trust the right to petition for removal of a trustee. See Restatement (Second) of Trusts § 107 (1959); Restatement (Third) of Trusts § 37 (Preliminary Draft No. 4, 1998). The right to petition for removal does not give the settlor of an irrevocable trust any other rights, such as the right to an annual report or to receive other information concerning administration of the trust. The right of a beneficiary to petition for removal does not apply to a revocable trust while the settlor has capacity. While the trust is revocable and the settlor has capacity, the settlor holds all rights that would otherwise be granted to the beneficiaries. See Section 603.

While removal is ordinarily ordered by a court, the topic may also be addressed in the terms of the trust, as subsection (a) recognizes. In fashioning a removal provision for an irrevocable trust, the drafter should remain cognizant of the potential inclusion of the trust in the settlor's federal gross estate if the settlor retains the power to be appointed as trustee.

The statement of grounds for removal by the court in subsection (b) is taken in part from the Texas Trust Code and in part from the Restatement. See Tex. Prop. Code Ann. § 113.082(a). See also Restatement (Second) of Trusts § 109 cmt. b (1959); Restatement (Third) of Trusts § 38 cmt. e (Preliminary Draft No. 3, 1997). If a trustee is removed, another may be appointed to fill the vacancy as provided in Section 708.

Subsection (b) allows removal for untoward action on the part of a trustee, such as a material breach of trust, but the section is not so limited. The grounds listed in subsection (b)(1)-(6) allow for removal under a variety of circumstances where the trustee is not acting in the best interests of the beneficiaries or in line with the expectations of the settlor.

Because of its importance to the long-term value of the beneficiaries' interests, subsection (b)(4) specifically allows a trustee to be removed if the investment decisions of the trustee, although not constituting a breach of trust, have resulted in investment performance persistently and substantially below those of comparable trusts.

To honor the settlor's reasonable expectations, subsection (b)(5) allows a trustee to be removed because of changed circumstances. Changed circumstances justifying removal of a trustee might include a substantial change in the character of the trustee which has occurred between the date of the trust's creation and the date the removal petition is filed.

Subsection (b)(6), instead of trying to catalog yet more grounds for removal, allows for removal whenever there is good cause. Friction between cotrustees, inability of the trustee and beneficiaries to get along through fault of the trustee, indifference on the part of the trustee, and mediocre service may all justify removal if in the best interests of the beneficiaries and not inconsistent with the purpose of the trust.

A particularly appropriate circumstance justifying removal is the failure of a trustee to keep the beneficiaries reasonably informed of the administration of the trust or to comply with a beneficiary's request for information as required by Section 814. Failure to comply with this duty may make it impossible for the beneficiaries to protect their interests. It may also mask more serious violations by the trustee. The failure to comply with the duties prescribed by Section 814 may justify removal under subsection (b)(1), if it constitutes a material breach of trust, or under subsection (b)(6), when determined to constitute good cause.

While the failure of a trustee to act in the beneficiaries' best interest is an important factor in determining whether removal is appropriate, the settlor's purpose in creating the trust should not be ignored. Complying with the beneficiaries' wishes to the detriment of the settlor's purpose may also constitute good cause for removal, justifying replacement with a trustee who will comply with the fundamental responsibility to administer a trust in accordance with its terms.

SECTION 707. DELIVERY OF PROPERTY BY FORMER TRUSTEE.

Unless a cotrustee remains in office or the court otherwise orders, and until the trust property is delivered to a successor trustee or to a person appointed by the court to receive the property:

(1) a trustee who has resigned or been removed has the duties and powers of the trusteeship; and

(2) a former trustee's personal representative, if the former trustee's appointment terminated because of death, or a former trustee's conservator or guardian, if the appointment terminated because of the former trustee's incapacity, is responsible for and has the powers necessary to protect the trust property and administer the trust.

Comment

This section addresses the continuing authority of a former trustee. Subject to the power of the court to make other arrangements, a former trustee has continuing authority until the property is delivered to a successor. However, if a cotrustee remains in office, there is no reason to grant such continuing authority, and none is granted. If the trustee has resigned or been removed, the continuing authority is granted to the former trustee; if the former trustee has died, to the former trustee's personal representative; if the former trustee has been adjudicated incapacitated, to the former trustee's guardian or conservator. Whether a former trustee remains in office or not, the former trustee remains liable for actions or omissions during the trustee's term of office until liability is barred.

Section 814 requires a trustee's report whenever there is a change of trustees. Section 1108(c) protects third persons who deal in good faith with a former trustee without knowledge that the person is no longer a trustee. See also Section 1102(4) (appointment of receiver or temporary trustee upon breach of trust).

SECTION 708. FILLING VACANCY.

(a) A trustee must be appointed to fill a vacancy in a trusteeship if the trust has no remaining trustee or the terms of the trust require a vacancy in the trusteeship to be filled.

(b) A vacancy in a trusteeship required to be filled must be filled:

(1) by the person named in or nominated pursuant to the method specified by the terms of the trust; or

(2) if the terms of the trust do not name a person or specify a method for filling the vacancy, or the person named or nominated pursuant to the method specified does not accept, by a person designated by the unanimous agreement of the qualified beneficiaries, or appointed by the court.

Comment

This section addresses only circumstances when a vacancy in the trusteeship *must* be filled. The court, exercising its inherent equity authority, may always appoint additional trustees if the appointment would promote better administration of the trust. See Restatement (Second) of Trusts § 108 cmt. e (1959); Restatement (Third) of Trusts § 34 cmt. e (Preliminary Draft No. 4, 1998).

Good drafting practice suggests that the terms of the trust deal expressly with the problem of vacancies, naming successors and addressing the procedure for filling a vacancy in the absence of a named successor. For this reason, subsection (b)(1) provides that the first choice for filling the vacancy is the person named in or nominated pursuant to the method specified in the terms of the trust. Furthermore, subsection (a) clarifies that a vacancy in the cotrusteeship need be filled only if the trust so requires. If a vacancy in the cotrusteeship is not filled, Section 703 authorizes the remaining cotrustees to continue to administer the trust. For a listing of the circumstances when a vacancy in a cotrusteeship may occur, see Section 704.

Absent an effective provision in the terms of the trust, subsection (b)(2)(A) permits a vacancy in the trusteeship to be filled, without the need for court approval, by a person selected by unanimous agreement of the qualified beneficiaries, who, per Section 705(a)(3), may also receive the trustee's resignation. If a trustee resigns pursuant to Section 705(a)(3), the trust may be transferred to a successor appointed pursuant to subsection (b)(2)(A), all without court involvement.

Subsection (b)(2)(B) authorizes the court to fill a vacancy if the trust does not name a successor who is willing to accept the trust or if the trust does not provide another method of appointment. The appointment of a successor by the court is an alternative to an appointment by the beneficiaries under subsection (b)(2)(A). The petition may be brought by any beneficiary of the trust. Per Section 706, a beneficiary without authority to join in a beneficiary appointment may petition the court for removal of the trustee appointed by the qualified beneficiaries. For a list of factors for the court to consider in making its selection, see Restatement (Second) of Trusts § 108 cmt. d (1959); Restatement (Third) of Trusts § 34 cmt. f (Preliminary Draft No. 4, 1998).

In the case of a revocable trust, the appointment of a successor will normally be made directly by the settlor. As to the duties of a successor trustee, see Section 813.

SECTION 709. COMPENSATION OF TRUSTEE.

(a) If the terms of a trust do not specify the trustee's compensation, a trustee is entitled to compensation that is reasonable under the circumstances.

(b) If the terms of a trust specify the trustee's compensation, the trustee is entitled to be compensated as provided, but the court may allow more or less compensation:

(1) if the duties of the trustee are substantially different from those contemplated when the trust was created;

(2) if the compensation specified by the terms of the trust would be unreasonably low or high; or

(3) in extraordinary circumstances calling for equitable relief.

Comment

Subsection (a) establishes a standard of reasonable compensation. For a list of factors relevant in determining reasonable compensation, see Restatement (Second) of Trusts § 242 cmt. b (1959); Restatement (Third) of Trusts § 38 cmt. c (Preliminary Draft No. 4, 1998). In setting compensation, the services actually performed and responsibilities assumed by the trustee should be closely examined. For example, an adjustment in compensation may be appropriate if the trustee has delegated significant duties, such as the delegation of investment authority, to outside managers. See Section 808 (delegation by trustee), and Section 909 Comment (delegation of investment and management authority under Uniform Prudent Investor Act). On the other hand, a trustee with special skills, such as those of a real estate agent, may be entitled to extra compensation for performing services that would ordinarily be delegated. See Restatement (Second) of Trusts § 242 cmt. d (1959); Restatement (Third) of Trusts § 38 cmt. d (Preliminary Draft No. 4, 1998).

Subsection (b) permits the reasonable compensation standard to be overridden or clarified by the terms of the trust, subject to the court's inherent equity power to make adjustments downward or upward in appropriate circumstances. Whether a provision in the terms of the trust setting the amount of the trustee's compensation is binding on a successor trustee is a matter for interpretation. Also a question for interpretation is whether a beneficial provision for the trustee in the terms of the trust is in addition to or in lieu of the trustee's regular compensation. Another possible uncertainty is whether the discharge of the beneficial provision is conditional on the person performing services as trustee. See Restatement (Second) of Trusts § 242 cmt. f (1959); Restatement (Third) of Trusts § 39 cmt. e (Preliminary Draft No.4, 1998).

Compensation may be set by agreement. A trustee may enter into an agreement with the beneficiaries for lesser or increased compensation, although an agreement increasing compensation is not binding on a nonconsenting beneficiary. A trustee may agree to waive compensation and should do so prior to rendering significant services if concerned about possible gift and income tax liability on the compensation accrued prior to the waiver. See Rev. Rul. 66-167, 1966-1 C.B. 20. See also

Restatement (Second) of Trusts § 242 cmt. i (1959); Restatement (Third) of Trusts § 38 cmt. f (Preliminary Draft No. 4, 1998).

The standard of reasonable compensation also applies to a trust with multiple trustees. The mere fact that a trust has more than one trustee does not mean that the trustees together are entitled to more compensation than had either acted alone. Nor does the appointment of multiple trustees mean that the trustees are eligible to receive the compensation in equal shares. The total amount of the compensation to be paid and how it will be divided depend on the totality of the circumstances. Factors to be considered include the settlor's reasons for naming multiple trustees and the level of responsibility assumed and exact services performed by each trustee.

Section 817(15) grants the trustee authority to fix and pay its compensation without the necessity of prior court review, but without precluding the right of a beneficiary to object to the compensation in a later judicial proceeding. Allowing the trustee to pay its compensation without prior court approval promotes efficient trust administration but does place a significant burden on a beneficiary who believes the compensation is unreasonable. To provide a beneficiary with time to take action, if the beneficiary believes that action is appropriate, and because of the importance of trustee's fees to the beneficiaries' interests, Section 814(b)(4) requires a trustee to provide the qualified beneficiaries with advance notice of any change in the method or rate of the trustee's compensation. Failure to provide such advance notice constitutes a breach of trust, possibly justifying removal under Section 706.

SECTION 710. REPAYMENT OF EXPENDITURES. A trustee is entitled to be reimbursed out of the trust property, with interest as appropriate, for:

(1) expenditures that were properly incurred in the administration of the trust; and

(2) to the extent necessary to prevent unjust enrichment of the trust, expenditures that were not properly incurred in the administration of the trust.

Comment

A trustee has the authority to expend trust funds as necessary in the administration of the trust, including expenses incurred in the hiring of agents. See Sections 808 (delegation by trustee) and 817(15) (trustee to pay expenses of administration from trust).

Paragraph (1) clarifies that a trustee is entitled to reimbursement from the trust for incurring expenses within the trustee's authority. The trustee may also withhold appropriate reimbursement for expenses before making distributions to the beneficiaries. Restatement (Second) of Trusts § 244 cmt. b (1959); Restatement (Third) of Trusts § 38 cmt. b (Preliminary Draft No. 4, 1998). But a trustee is ordinarily not entitled to reimbursement for incurring unauthorized expenses. Such expenses are normally the personal responsibility of the trustee.

As provided in paragraph (2), a trustee is entitled to reimbursement for unauthorized expenses only if the unauthorized expenditures benefitted the trust The purpose of paragraph (2), which is derived from Restatement (Second) of Trusts § 245, is not to ratify the unauthorized conduct of the trustee, but to prevent the unjust enrichment of the trust. Given this purpose, a court, on appropriate grounds, may delay or even deny reimbursement for expenses which benefitted the trust. For a list of factors which the court may wish to take into consider in making this determination, see Restatement (Second) of Trusts § 245 cmt. g (1959).

Reimbursement under this section may include attorney's fees and expenses incurred by the trustee in defending an action. However, a trustee is not ordinarily entitled to attorney's fees and expenses if it is determined that the trustee breached the trust. See, e.g., *In re Estate of Gilmaker*, 38 Cal. Rptr. 270 (Ct. App. 1964); *In re Estate of Vokal*, 263 P.2d 64 (Cal. Ct. App. 1953).

ARTICLE 8

FIDUCIARY ADMINISTRATION

General Comment

This part states the fundamental duties of a trustee and lists the trustee's powers. The duties listed are not new, but how the particular duties are formulated and applied has changed over the years. This part was drafted where possible to conform with the 1994 Uniform Prudent Investor Act, which has been enacted in over half the States. The Uniform Prudent Investor Act prescribes a trustee's responsibilities with respect to the management and investment of trust property. This Act also addresses a trustee's duties with respect to distribution to beneficiaries.

Because of the widespread adoption of the Uniform Prudent Investor Act, no effort has been made to interweave the Prudent Investor Act into this part of the Act. Instead, the Prudent Investor Act is reproduced separately as Article 9. States adopting this Act which have previously enacted the Prudent Investor Act are encouraged to recodify their version of the Prudent Investor Act by reenacting it as Article 9 instead of leaving it elsewhere in their codes. Where the two Acts overlap, States should enact the provisions of this part and not the duplicative provisions of the Prudent Investor Act. To facilitate this process, the Uniform Prudent Investor Act is reproduced in full in Article 9 but provisions of that Act which duplicate provisions of this article are placed in brackets. Sections of this part which overlap with the Prudent Investor Act are Sections 803 (duty of loyalty), 804 (impartiality), 806 (costs of administration), trustee's skills (807), and delegation (808). For a list of the sections of the Prudent Investor Act which have been placed in brackets, see the General Comment to Article 9.

SECTION 801. MODIFICATION OF STATUTORY DUTIES AND POWERS. In the terms of the trust the settlor may expand, restrict, eliminate, or otherwise alter the duties prescribed by and powers provided in this [article], but the settlor may not authorize a trustee to act other than in good faith and with regard to the purpose of the trust and the interest of the beneficiaries. The trustee may reasonably rely on the terms of a trust as so altered.

Comment

A settlor is free to vary the duties prescribed by and powers listed in this part but not without limit. A trustee must always act in good faith and in accordance with the purpose of the trust and the interests of the beneficiaries. The obligation to act in good faith and in light of fiduciary principles is a fundamental concept that applies throughout this Act. See Sections 815 (duties with regard to discretionary power), 1105 (exculpation of trustee). See also Sections 803 (duty of loyalty), and 805 (duty to act with prudence). The trustee is not required to perform a duty prescribed by the terms of the trust if performance would be impossible, invalid, illegal or violative of public policy. See Section 404 (purposes for which trust can be created).

While a trustee generally must administer a trust in accordance with its terms and purpose, the purpose and particular terms of the trust will on occasion conflict. Should such a conflict occur because of circumstances not anticipated by the settlor, it may be appropriate for the trustee to petition under Section 409 to modify or terminate the trust.

Section 2(b) of the Uniform Prudent Investor Act, codified at Section 901(b), is similar, although unlike this section it places no express limit on the ability of a settlor to vary the terms of the trust. However, a requirement that the trustee must always act in good faith and with regard to the purpose of the trust and the interests of the beneficiaries would seem to be implied.

SECTION 802. DUTY TO ADMINISTER TRUST. Upon acceptance of a trusteeship, the trustee shall administer the trust in good faith, according to its terms and purpose and, except to the extent the terms of the trust otherwise provide, according to this [Act].

Comment

This section confirms that the primary duty of a trustee, above all others, is to follow the terms and purpose of the trust. Only if the terms of a trust are silent or for some reason invalid on a particular issue are the trustee's duties derived exclusively from this Act. This section also confirms that a trustee does not have a duty to act until the trustee has accepted the trusteeship. See Section 701 and Comment (acceptance or rejection of trusteeship).

For background on the trustee's duty to administer the trust, see Restatement (Second) of Trusts §§ 164-169 (1959). For the provision of the Uniform Prudent Investor Act protecting a trustee in relying on the terms of the trust, see Section 901(b).

SECTION 803. DUTY OF LOYALTY.

(a) A trustee shall administer the trust solely in the interest of the beneficiaries.

(b) A transaction involving the trust property which is affected by a substantial conflict between the trustee's fiduciary and personal interests is voidable by a beneficiary affected by the transaction unless the transaction was authorized by the terms of the trust or approved by the court, or the beneficiary has consented to the trustee's conduct, ratified the transaction, or released the trustee as provided in Section 1106.

(c) A transaction is presumed to involve a substantial conflict between personal and fiduciary interests if it involves a sale, encumbrance, or other transaction concerning the trust property entered into by the trustee with the spouse, descendants, siblings, parents, agent, or attorney of a trustee, or with a corporation or other enterprise in which the trustee has a substantial beneficial interest.

(d) A transaction between a trustee and a beneficiary which occurs during the existence of the trust or while the trustee retains significant influence over the beneficiary and from which the trustee obtains an advantage is voidable unless the trustee establishes that the transaction was fair to the beneficiary.

(e) A trustee may invest in securities of an investment company or trust to which the trustee, or its affiliates, provides services, and receive compensation from the trust for those services, if the decision to invest satisfies the prudent investor rule of [Article] 9 and the trustee discloses at least annually to the persons entitled under

Section 814 to receive a copy of the trustee's annual report the rate and method by which the compensation was determined.

(f) This section does not restrict the following transactions, if fair to the beneficiaries:

(1) an agreement relating to the appointment of the trustee;

(2) the payment of reasonable compensation to the trustee, whether by agreement, the terms of the trust, or this [Act]; and

(3) a transaction between a trust and another trust, decedent's estate, or conservatorship of which the trustee is a fiduciary or in which a beneficiary has an interest.

Comment

This section addresses the duty of loyalty, perhaps the most fundamental duty of the trustee. Subsection (a) states the general principle. A trustee owes a duty of loyalty to the beneficiaries, a principle which is sometimes expressed as the obligation by the trustee not to place the trustee's own interests over those of the beneficiaries. Most but not all violations of the duty of loyalty concern transactions involving the trust property, but breaches of the duty can take a myriad of other forms. For a discussion of the different types of violations, see 2A Austin W. Scott § William F. Fratcher, The Law of Trusts §§ 170-170.24 (4th ed. 1987).

Subsection (b) states the general rule with respect to transactions involving trust property. A transaction involving the trust property which is affected by a substantial conflict between the trustee's fiduciary and personal interests is voidable by a beneficiary affected by the transaction. Transactions involving trust property entered into by a trustee for the trustee's own account are voidable without further proof under the "no further inquiry" rule. Such transactions are irrebuttably presumed to involve a substantial conflict between personal and fiduciary interests. The appropriate result is less clear with respect to transactions entered into with persons who have close business or personal ties to the trustee. Subsection (c) resolves the issue by requiring the trustee to prove the propriety of such transactions. Transactions between a trustee and certain relatives, business associates, or enterprises in which the trustee has a substantial beneficial interest are presumptively voidable. Transactions involving trust property with parties not on the list are not necessarily valid, however.

While a presumption does not apply, a transaction may still be voided if the beneficiary proves that a substantial conflict between personal and fiduciary interests exists and that the transaction was affected by the conflict.

The right of a beneficiary to void a transaction involving a substantial conflict of interest is elective. Should the transaction prove unprofitable to the trustee, the beneficiary will likely allow the transaction to stand. Also, as provided in subsection (b), the beneficiary may be precluded from acting if the transaction was expressly authorized by the terms of the trust or approved by the court. In addition, a beneficiary may be precluded from acting by statute of limitations or laches, or by choosing to ratify the transaction, either prior to or subsequent to its occurrence. See Sections 1104, 1106. In determining whether a beneficiary has consented to a transaction, the principles of fiduciary and virtual representation from Article 3 may be applied.

Subsection (d) creates a presumption that certain transactions between a trustee and beneficiary outside of trust are an abuse by the trustee of a confidential relationship with the beneficiary. This section has a limited scope. If the trust has terminated, there must be proof that the trustee's influence with the beneficiary remains. Furthermore, whether or not the trust has terminated, there must be proof that the trustee obtained an advantage from the relationship. The fact the trustee profited is insufficient to show an abuse if a third party would have similarly profited in an arm's length transaction.

Subsection (e) creates a special exception for a "proprietary fund," a mutual fund investment offered to customers of a financial-service institution trustee. Under such an arrangement, the mutual fund company will typically pay an annual fee based on a percentage of the fund's value to the financial-service institution trustee for providing investment advice, custody, transfer agent, distribution, or shareholder services that would otherwise be provided by agents of the fund. Subsection (e) provides that it is not a violation of the duty of loyalty for a trustee, or its affiliates, to receive compensation for providing such services as long as the trustee discloses at least annually to the beneficiaries entitled to receive a copy of the trustee's annual report the rate and method by which the compensation was determined. However, the mutual fund investment selected must be prudent in accordance with the applicable prudent investor law of the jurisdiction and the selection of a mutual fund, and the resulting delegation of certain of the trustee's functions, may be taken into account in setting the trustee's regular compensation. See Section 709 (trustee's compensation), and Article 9 (Uniform Prudent Investor Act). Provisions similar to subsection (e) are in force in a substantial majority of states.

Subsection (f) contains several exceptions to the general duty of loyalty, which apply if the transaction was fair to the beneficiaries. A trustee is allowed to negotiate in freedom about the terms of appointment and rate of compensation. Consistent with Restatement (Second) of Trusts § 170 cmt. r (1959), a trustee may also engage in a transaction involving another trust of which the trustee is also trustee, or a transaction with a decedent's or conservatorship estate of which the trustee is personal representative or conservator. With respect to a transaction involving another fiduciary role, the trustee need not give advance notice of the transaction to the beneficiaries unless required by some other provision. See, e.g., Section 814(b)(5).

Because it overlaps with subsection (a) of this section, Section 905, the section of the Uniform Prudent Investor Act pertaining to the duty of loyalty, has been placed in brackets.

SECTION 804. IMPARTIALITY. If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust property, taking into account any differing interests of the beneficiaries.

Comment

The duty of impartiality is an important aspect of the duty of loyalty. This section is identical to Section 6 of the Uniform Prudent Investor Act, codified at Section 906, except that this section also applies to decisions by the trustee with respect to distributions. The Prudent Investor Act is limited to duties with respect to the investment and management of trust property. The differing beneficial interests for which the trustee must act impartially include those of the current beneficiaries versus those holding interests in the remainder, and among those currently eligible for distributions, the interests of those entitled or eligible to receive distributions of income versus those eligible to receive distributions of principal. In effectuating the duty to act impartially, the trustee should be particularly sensitive to allocation of receipts and disbursements between income and principal and should consider, in an appropriate case, a reallocation of income to the principal account and vice versa, if allowable under local law. For an example of such a provision, taken from the Uniform Principal and Income Act (1997), see Section 1004.

Placed in brackets is Section 906, the portion of the Uniform Prudent Investor Act which overlaps with this section.

SECTION 805. PRUDENT ADMINISTRATION. A trustee shall administer the trust as a prudent person would, by considering the purpose, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

Comment

The duty to administer a trust with prudence is a fundamental duty of the trustee. This duty is not affected by whether the trustee receives compensation but may be altered by the terms of the trust. See Section 801 (modification of trustee duties and powers by settlor). For a more detailed statement of the duty of prudence with respect to trustee investment, including a list of factors to be taken into account in determining whether the standard has been met, see Section 2 of the Uniform Prudent Investor Act, codified at Section 902 (prudent investor rule).

SECTION 806. COSTS OF ADMINISTRATION. In administering the trust, a trustee may only incur costs that are reasonable in relation to the trust property, the purpose of the trust, and the skills of the trustee.

Comment

This section is consistent with the rules concerning costs in Section 227(c)(3) of the Restatement (Third) of Trusts: Prudent Investor Rule (1992). For related rules concerning compensation and reimbursement of trustees, see Sections 709 and 710. The duty to minimize costs applies to delegation to agents as well as to other aspects of trust administration. In deciding whether and how to delegate, the trustee must be alert to balancing projected benefits against the likely costs. The trustee must also be alert to adjusting compensation for functions which the trustee has delegated to others in order to protect the beneficiary against "double dipping." The obligation to incur only necessary costs of administration has long been part of the common law and of the Restatement. See Restatement (Second) of Trusts § 188 (1959).

Placed in brackets is Section 907, the portion of the Uniform Prudent Investor Act which overlaps with this section.

SECTION 807. TRUSTEE'S SKILLS.

(a) A trustee shall apply the full extent of the trustee's skills.

(b) A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.

Comment

This section requires a trustee to apply the full extent of the trustee's skills, whether the trustee actually possesses those skills or incorrectly represents such competence. In other words, a skilled trustee who makes representation of minimal competence is subject to the standard of a skilled trustee as is a trustee of modest abilities who makes representations of great competence. This section is similar to Section 7-302 of the Uniform Probate Code and Restatement (Second) of Trusts § 174 (1959).

Placed in brackets is Section 902(f), the portion of the Uniform Prudent Investor Act which overlaps with subsection (b) of this section.

SECTION 808. DELEGATION BY TRUSTEE.

(a) A trustee may delegate duties and powers 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 purpose 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 subsection (a) is not liable to the beneficiaries or to the trust for a decision or action of the agent to whom the function was delegated.

(d) By accepting a delegation of powers or duties 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, which is similar to Section 9 of the Uniform Prudent Investor Act, codified at Section 909, eliminates the traditional emphasis against delegation by a trustee and the often futile attempt to distinguish specified ministerial functions, which were delegable, from discretionary functions, which the trustee was required personally to perform. See Section 909 Comment; and John H. Langbein, Reversing the Nondelegation Rule of Trust-Investment Law, 59 Mo. L. Rev. 105 (1994).

Under this section, the emphasis is placed instead on encouraging and protecting the trustee in making delegations appropriate to the facts and circumstances of the particular trust. Whether particular functions of the trustee are delegable is based on whether it is a function that a prudent trustee might delegate under similar circumstances. For example, delegation of trust administration and reporting duties might be prudent for a family trustee but improper for a corporate trustee which holds itself out as having expertise in and which is being compensated for this activity.

This section does not mandate delegation or hold a trustee liable for failing to delegate. However, such liability may result under some other section if the trustee, due to a failure to delegate, is unable to perform in accordance with standards of prudence required of a trustee. See, e.g., Sections 805 (trustee's standard of prudence in performing duties), 901 (prudent investor rule).

This section applies only to delegation to agents and not to delegation to a cotrustee. For the provision authorizing but at the same time limiting the ability to delegate to a cotrustee, see Section 703(b)(1).

Under subsection (a)(3), the duty to review the agent's performance includes the periodic evaluation of the continued need for and appropriateness of the delegation of authority. In particular circumstances, the trustee may need to terminate the delegation to comply with the duty under subsection (a)(1) (duty to use reasonable care, skill, and caution in selecting agent).

Placed in brackets is Section 909, the portion of the Uniform Prudent Investor Act which overlaps with this section.

SECTION 809. POWERS TO DIRECT.

(a) If the terms of a trust grant a person other than the trustee power to direct certain actions of the trustee, the trustee shall act in accordance with the exercise of the power unless an attempted exercise manifestly violates the terms of the trust or the trustee knows that the attempted exercise violates a fiduciary duty that the person holding the power owes the beneficiaries of the trust.

(b) The holder of a power to direct is presumptively a fiduciary who, as such, is required to act in good faith, with regard to the purpose of the trust and the interest of the beneficiaries, and is liable for any loss that results from breach of a fiduciary duty.

Comment

This section is derived from Restatement (Second) of Trusts § 185 (1959). Powers to direct in the terms of a trust usually relate either to choice of investment or management of closely-held business interests. A power to direct must be distinguished from a veto power. A power to direct involves action initiated and within the control of a third party. The trustee usually has no responsibility other than to carry out the direction when made. But if a third party holds a veto power, the trustee is responsible for initiating the decision, subject to the third party's approval. A trustee who administers a trust subject to a veto power occupies a position akin to that of a cotrustee and is responsible for taking appropriate action if the third party's refusal to consent would result in a breach of trust. See Restatement (Second) of Trusts § 185 cmt. g (1959); Section 703(b)(2)(duties of cotrustees).

Powers to direct take a variety of forms. Frequently, the person holding the power is directing the investment of the holder's own beneficial interest. Such self-directed accounts are particularly prevalent among trusts holding interests in employee benefit plans or individual retirement accounts. But for the type of donative trust which is the primary focus of this Act, the holder of the power to direct is frequently acting on behalf of others and may not even be a beneficiary of the trust. In that event, the holder, as provided in subsection (b), is presumptively acting in a fiduciary capacity and can be held liable should the power holder's conduct constitute a breach of trust.

Powers to direct are most effective when the trustee is not deterred from honoring the exercise of the power due to concerns about possible liability. On the other hand, the trustee does bear overall responsibility for seeing that the terms of the trust are honored. For this reason, subsection (a) provides that the trustee need not honor an attempted exercise of a power to direct if the attempted exercise manifestly violates the terms of the trust or the trustee knows the attempted exercise violates a fiduciary duty that the holder of the power owes to the beneficiaries of the trust. For the definition of "know," see Section 105(7).

SECTION 810. CONTROL AND SAFEGUARDING OF TRUST PROPERTY. A trustee shall take steps reasonable under the circumstances to take control of and to safeguard the trust property.

Comment

This section codifies the substance of Sections 175 and 176 of the Restatement (Second) of Trusts (1959). The duty to take control of and safeguard trust property is an aspect of the trustee's duty to act with prudence. See Section 805. See also Sections 817(1) (power to collect trust property), 817(11) (power to insure trust property), and 817(12) (power to abandon trust property), This section, like the other sections in this part, is subject to limitation in the terms of the trust. For example, the settlor may provide that the spouse or other beneficiary may occupy the settlor's former residence rent free, in which event the trustee will be specifically precluded by the terms of the trust from taking complete control.

SECTION 811. SEPARATION AND IDENTIFICATION OF TRUST PROPERTY.

(a) A trustee shall keep trust property separate from property of the trustee.

(b) Unless a trustee is a regulated financial-service institution, the trustee shall cause the trust property to be designated so that the interest of the trust, to the extent feasible, clearly appears in records maintained by a third party.

Comment

The duty to earmark trust assets and the duty of a trustee not to mingle the assets of the trust with the trustee's own are closely related. Subsection (a), which addresses the duty not to mingle, is derived from Section 179 of the Restatement (Second) of Trusts (1959). Subsection (b), which addresses earmarking, however, broadens the standard of Restatement Second by attempting to make more precise what is meant by the phrase "the interest of the trust clearly appears." Except for a regulated financial-service institution, whose trust records are subject to regular state or federal audit, the interest of the trust must clearly appear in the records of a third party, such as a bank or brokerage firm. Because of the serious risk of mistake or misappropriation even if disclosure is made to the beneficiaries, a noninstitutional trustee is not allowed to show the interest of the trust solely in the trustee's own internal records. Section 817(7), which allows a trustee to hold securities in nominee form, is not inconsistent with this requirement. While securities held in nominee form are not specifically registered in the name of the trustee, they are properly earmarked because the trustee's holdings are indicated in the records maintained by a third party, such as in an account at a brokerage firm.

Earmarking is not practical for all types of assets. With respect to assets not subject to registration, such as tangible personal property and bearer bonds, arranging for the trust's ownership interest to be reflected on the records of a third-party custodian would be impracticable. For this reason, subsection (b) waives separate recordkeeping for these types of assets. Under subsection (a), however, the duty of the trustee not to mingle these or any other trust assets with the trustee's own remains absolute.

SECTION 812. ENFORCEMENT AND DEFENSE OF CLAIMS. A trustee shall take reasonable steps to enforce claims of the trust and to defend against claims against the trust.

Comment

This section codifies the substance of Sections 177 and 178 of the Restatement (Second) of Trusts (1959). Under this section, it may not be reasonable to enforce a claim depending upon the likelihood of recovery and the cost of suit and enforcement. It might also be reasonable to settle an action or suffer a default rather than to defend an action. See also Section 817(14) (power to pay, contest, settle or release claims).

SECTION 813. FORMER FIDUCIARIES. A trustee shall take reasonable steps to compel a former trustee or other fiduciary to deliver trust property to the trustee and to discover and redress a breach of trust committed by the former trustee or other fiduciary.

Comment

This section is based on Restatement (Second) of Trusts § 223 (1959). Unlike the Restatement, however, this section applies not only to duties with respect to predecessor trustees, but also to a personal representative or conservator from whom the trustee receives trust property.

This section is a specific application of Section 812 on the duty to enforce claims, which could include a claim against a predecessor trustee for breach of trust. In certain circumstances it may not be reasonable to enforce a claim against a predecessor trustee or other fiduciary, depending upon the likelihood of recovery and the cost of suit and enforcement.

As authorized by Section 1106, the beneficiaries may relieve the trustee form potential liability for acts of a predecessor trustee or other fiduciary.

SECTION 814. DUTY TO INFORM AND REPORT.

(a) A trustee shall keep the beneficiaries of the trust reasonably informed about the administration of the trust and, unless unreasonable under the circumstances, promptly respond to a beneficiary's request for information.

(b) A trustee shall:

(1) upon request of a beneficiary, promptly provide the beneficiary with a copy of the trust instrument;

(2) within 30 days after accepting a trusteeship, inform the beneficiaries of the acceptance;

(3) within 30 days after the death of the settlor of a revocable trust, inform the beneficiaries of their respective interests in the trust;

(4) inform the beneficiaries in advance of any change in the method or rate of the trustee's compensation; and

(5) inform the beneficiaries in advance of a transaction affecting trust property that comprises a significant portion of the value of the trust property and whose fair market value is not readily ascertainable.

(c) A trustee shall prepare and send to the beneficiaries at least annually, at the termination of the trust, and upon a change of trustee, a report of the trust property, liabilities, receipts, and disbursements, including the source and amount of the trustee's compensation. A report of a former trustee must be prepared by the former trustee or, if the trusteeship terminated by reason of death or incapacity, by the former trustee's personal representative, conservator, or guardian.

(d) Copies of a trustee's report and other information required to be provided under subsections (b) and (c) must be sent to:

(1) the qualified beneficiaries; and

(2) each beneficiary who has delivered to the trustee or other fiduciary a written request for a copy of the report or other information.

(e) A beneficiary, by a written consent, may waive the right to a trustee's report or other information otherwise required to be provided under this section. The terms of a trust may not dispense with the requirements of this section except as to a trustee's report or other information required to be furnished to a beneficiary who is also a settlor.

(f) Except as otherwise provided by the terms of a trust, while the trust is revocable and the settlor has capacity to revoke the trust, the duties of the trustee under this section are owed exclusively to the settlor; the duties are owed to the beneficiaries only upon the settlor's death or incapacity. If a trust has more than one settlor, the duties under this section are owed to all settlors.

Comment

The duty to keep the beneficiaries informed of the administration of the trust is one of the fundamental duties of a trustee. The trustee is under a duty to communicate to the beneficiary information about the administration of the trust that is reasonably necessary to enable the beneficiary to enforce the beneficiary's rights under the trust or to prevent or redress a breach of trust. See Restatement (Second) of Trusts § 173 cmt. c (1959). Ordinarily, the trustee is not under a duty to furnish information to the beneficiary in the absence of a specific request for the information. See *id.* cmt. d. Thus, the general duty provided in subsection (a) is ordinarily satisfied by complying with the annual report mandated by subsection (c) unless there are special circumstances requiring particular information to be reported to beneficiaries. However, if the trustee is dealing with the beneficiary on the trustee's own account, the trustee has a duty to communicate material facts relating to the transaction that the trustee knows or should know. See *id.*

The standard is different if the beneficiary makes a specific request for information. In that event, subsection (a) requires the trustee to promptly comply with the beneficiary's request unless unreasonable under the circumstances. Further supporting the principle that a beneficiary should be allowed to make an independent assessment of what information is relevant to protecting the beneficiary's interest, subsection (b)(1) requires the trustee to on request furnish a beneficiary with a complete copy of the trust instrument.

Subsections (a) and (b)(1) and the other provisions of this section have only limited application to revocable trusts. Subsection (f) provides that during the time that a trust is revocable and the settlor has capacity, the right to request information or a copy of the trust instrument pursuant to this section belongs exclusively to the settlor. In the case of a trust with multiple settlors, subsection (f) clarifies that the beneficiaries' right to information extends to all of the settlors. Should less than all of the settlor revoke or modify the trust, the trustee must notify the other settlor or settlors of this fact. See Section 602 Comment.

To effectively protect their interests, it is essential that the beneficiaries at least know the identity of the trustee. Subsection (b)(2) requires that a trustee inform the beneficiaries of the trustee's assumption of office within 30 days of acceptance. Similar to the obligation imposed on a personal representative following admission of the will to probate, subsection (b)(3) requires the trustee of a revocable trust to inform the beneficiaries, within 30 days after the settlor's death, of their respective interests in the trust. These two duties can overlap. If the death of the settlor happens to also be the occasion for the appointment of a successor trustee, the new trustee of the now formerly revocable trust would need to inform the beneficiaries both of the trustee's acceptance and of the beneficiaries' respective interests.

Subsection (b)(4) deals with the sensitive issue of changes, usually increases, in trustee compensation. Consistent with the requirement that the beneficiaries receive advance notice of major transactions affecting their interests, subsection (b)(4) requires that the beneficiaries be told in advance of changes in the method or rate of the trustee's compensation. This might include a change in a periodic base fee, rate of percentage compensation, hourly rate, termination fee or transaction charge. For the standard for setting trustee compensation, see Section 4-109 Comment.

Absent a specific request by a beneficiary for information, the duty to keep the beneficiaries reasonably informed is ordinarily satisfied by providing the beneficiaries with a copy of the trustee's annual report, but subsection (b)(5) requires that the beneficiaries be given advance notice of certain proposed transactions. This subsection, which is based on a provision drawn from South Dakota law, is designed to codify but make more precise the fiduciary duty delineated in such cases as *Allard v. Pacific National Bank*, 663 P.2d 104 (Wash. 1983), in which the court surcharged a trustee for failing to give the beneficiaries advance notice of the proposed sale of a parcel of real estate that was the sole asset of the trust. Cases subsequent to *Allard* have extended this duty to the sale of an interest in a closely-held business, and this subsection extends the duty to sales of tangible personal property.

Subsection (c) requires the trustee to furnish the beneficiaries with a copy of a trustee's report at least annually, at the termination of the trust, and upon a change of trustee. The term "report" instead of "accounting" is used to negate the inference that the report must be prepared in any particular format. The key factor is not the format chosen but whether the report provides the beneficiaries with the information necessary to protect their interests. Subsection (c) also addresses the responsibility for the preparation of the report upon a trustee's death or incapacity. Consistent with Section 707, the report must be prepared by the trustee's personal representative, in the event of the trustee's death, or the trustee's conservator or guardian, in the event of the trustee's incapacity.

The principle that the trustee must keep the beneficiaries reasonably informed is well established. Less certain is who among the many different types of beneficiaries must be given the required notices. Subsection (d) provides that required notices under subsections (b)-(c) be given to the qualified beneficiaries as well as other beneficiaries who have requested a copy of the report or other information. For the definition of qualified beneficiaries, see Section 105(11). The result of this limitation is that the information need not be furnished to beneficiaries with remote remainder interests unless they have filed a specific request with the trustee.

Subsection (e), which allows trustee reports and other required information to be waived upon written consent, is derived from South Dakota law. However, a waiver of a trustee's report or other information is not a waiver of the trustee's accountability and potential liability for items that the report or other information would have disclosed. Subsection (e) also authorizes the creation of a "blind" trust. While the terms of the trust may not prohibit the trustee from furnishing the beneficiaries with the information required under this section, such a prohibition is valid with respect to a beneficiary who is also a settlor.

SECTION 815. DUTY WITH REGARD TO DISCRETIONARY POWER.

Notwithstanding the breadth of discretion granted to a trustee, including the use of such terms as "absolute", "sole", or "uncontrolled", the trustee shall exercise a discretionary power in good faith and with regard to the purpose of the trust and the interest of the beneficiaries.

Comment

Despite the breadth of discretion purportedly granted by the wording of a trust, a grant of discretion to a trustee, whether with respect to management of distribution, is never absolute. A grant of discretion establishes a range within which the trustee may act. The greater the grant of discretion, the broader the range. A trustee's action must always be in good faith, with regard to the purpose of the trust and the interest of the beneficiaries, and in accordance with the trustee's other duties, including the obligation to exercise reasonable skill, care and caution. See Sections 404 (noncharitable trust must have purpose of benefit to beneficiaries), 801 (modification of duties and powers by settlor), 802 (duty to administer trust), and 805 (duty to act with prudence). See also Edward C. Halbach, Jr., Problems of Discretion in

Discretionary Trusts, 61 Colum. L. Rev. 1425 (1961); Restatement (Second) of Trusts § 187 (1959).

The standard of this section applies only to powers which are to be exercised in a fiduciary capacity. A power held in a nonfiduciary capacity, such as a power to appoint among the settlor's descendants at termination of the trust, is not subject to this section even though the power holder may coincidentally be acting as trustee.

SECTION 816. GENERAL POWERS OF TRUSTEE.

(a) A trustee, without authorization by the court, may exercise:

(1) powers conferred by the terms of a trust;

(2) except as limited by the terms of a trust:

(A) all powers over the trust property which an unmarried competent owner has over individually owned property;

(B) any other powers appropriate to accomplish the proper management, investment, and distribution of the trust property; and

(C) any other powers conferred by this [Act].

(b) Except as modified by the terms of a trust, the exercise of a power is subject to fiduciary duties as prescribed by this [article].

Comment

This section is intended to grant trustees the broadest possible powers, but to be exercised always in accordance with the terms of the trust and duties of the trustee. The powers conferred elsewhere in this Act which are subsumed by this section include all of the specific powers listed in Section 817 as well as others listed in the Comment to that section. The powers conferred by this Act may be exercised without court approval. Should court approval of the exercise of a power be desired, a petition for court approval may be filed.

A power differs from a duty. A duty imposes either a mandatory obligation or mandatory prohibition. A power, on the other hand, is a discretion, the exercise of which is not obligatory. The existence of a power, however created or granted, does not speak to the question of whether it is prudent under the circumstances to exercise the power.

SECTION 817. SPECIFIC POWERS OF TRUSTEE. Without limiting the authority conferred by Section 816, a trustee may:

(1) collect trust property and receive additions to the trust property from a settlor or any other person;

(2) acquire property for the trust, for cash or on credit;

(3) sell property, for cash or on credit, at public or private sale, or exchange property;

(4) deposit trust funds in an account in a financial-service institution, including an institution operated by the trustee;

(5) borrow money, with or without security, and mortgage or pledge trust property for a period within or extending beyond the term of the trust;

(6) advance money for the protection of the trust, for which advances the trustee has a lien on the trust property as against a beneficiary;

(7) with respect to an interest in a proprietorship, partnership, limited liability company, business trust, corporation or other form of business or enterprise, continue the business or enterprise and take any action that may be taken by shareholders, members, or property owners, including changing the form of business organization, voting, or giving proxies to vote, shares of stock or membership interests, and holding a security in the name of a nominee or in other form without disclosure of the trust so that title may pass by delivery;

(8) with respect to an interest in real property, make ordinary or extraordinary repairs, alterations, or improvements in buildings or other structures, demolish improvements, raze existing or erect new party walls or buildings, subdivide or develop land, dedicate land or easements to public use, and make or vacate plats and adjust boundaries;

(9) enter into a lease for any purpose as lessor or lessee, including a lease or other arrangement for exploration and removal of natural resources, with or without the option to purchase or renew, for a period within or extending beyond the term of the trust;

(10) grant an option involving a sale, lease, or other disposition of trust property or take an option for the acquisition of property, including an option exercisable beyond the term of the trust;

(11) insure the property of the trust against damage or loss and insure the trustee, the trustee’s agents, and beneficiaries against liability to third persons arising from the administration of the trust;

(12) abandon or decline to administer property which the trustee reasonably believes is of little or no value;

(13) inspect or investigate property the trustee holds or has been asked to hold, or property owned or operated by an entity in which the trustee holds or has been asked to hold an interest, for the purpose of determining the application of environmental law with respect to the property; take action to prevent, abate, or otherwise remedy any actual or potential violation of any environmental law affecting

property held directly or indirectly by the trustee; and decline to accept property into trust or to disclaim any power with respect to property that has or may have environmental liability attached;

(14) pay or contest any claim, settle a claim by or against the trust by compromise, arbitration, or otherwise, and release, in whole or in part, a claim belonging to the trust;

(15) pay taxes, assessments, compensation of the trustee and of employees and agents of the trust, and other expenses incurred in the administration of the trust;

(16) exercise elections with respect to federal, state, and local taxes;

(17) select a mode of payment under any employee benefit or retirement plan, annuity, or life insurance payable to the trustee, exercise rights thereunder, and take appropriate action to collect the proceeds, including exercise of the right to indemnification against expenses and liabilities;

(18) make loans out of trust property, including loans to a beneficiary on terms and conditions the trustee considers to be fair and reasonable under the circumstances, and guarantee loans to the beneficiary by encumbrances on trust property;

(19) pay an amount distributable to a beneficiary under a legal disability or who the trustee otherwise believes is incapacitated, by applying it directly for the beneficiary's benefit, or by paying the amount to:

(A) the beneficiary's conservator or, if the beneficiary does not have a conservator, the beneficiary's guardian;

(B) the beneficiary's custodian under [the Uniform Transfers to Minors Act] or custodial trustee under [the Uniform Custodial Trust Act]; or

(C) if there is no conservator, guardian, custodian, or custodial trustee, a relative or other person having physical custody of the beneficiary;

(20) make a distribution of property and money in divided or undivided interests, pro rata or non-pro-rata, and adjust resulting differences in valuation;

(21) resolve a dispute concerning the interpretation of the trust or its administration by mediation, arbitration, or other procedure for alternative dispute resolution;

(22) prosecute or defend an action, claim, or judicial proceeding in any jurisdiction to protect trust property and the trustee in the performance of the trustee's duties;

(23) sign and deliver instruments that are useful to accomplish or facilitate the exercise of the trustee's powers; and

(24) on termination of the trust, exercise the powers appropriate to complete the administration of the trust and distribute the trust property to those entitled to it.

Comment

Most of the powers listed in this section are similar to the powers listed in Section 3 of the Uniform Trustees' Powers Act (1964). Several of the paragraphs are new, however, and other provisions of the Trustees' Powers Act have been modified.

Certain specific powers of a trustee which may be exercised without court approval are contained in other sections. See Sections 205 (transfer of jurisdiction), 410 (termination of trust with value less than $50,000), 413 (combination and division of trusts), 703 (delegation to cotrustee), 808 (delegation of powers and duties), 901 *et seq.* (Uniform Prudent Investor Act), and 10-104 (power to equitably adjust principal and income allocation).

The powers listed here add little of substance not already granted by Section 816 and powers conferred elsewhere in the Act. While the Committee drafting this Act discussed excluding a list of specific powers, it concluded that the demand of third parties to see language expressly authorizing a specific transaction required that a detailed list be retained.

Paragraph (3) authorizes a trustee to dispose of property, for cash or on credit, at public or private sale, or by exchange. Under the Restatement, a trustee may sell on credit only if security is given. Restatement (Second) of Trusts § 190 cmt. j (1959).

Paragraph (7) authorizes the trustee to continue, incorporate or otherwise change the form of a business. Any such decision by the trustee must be made in light of the standards of prudent investment stated in Part 2 of this article. The authority under this paragraph is broader than that granted under Section 3(c)(3) of the Uniform Trustees' Powers Act. Under the Trustees' Powers Act, a trustee may continue a business only if authorized by the terms of the trust or court order.

Paragraph (13), which addresses possible liability for violations of environmental law, is drawn primarily from the Texas Trust Code. See Tex. Prop. Code § 113.025.

Paragraph (14) authorizes a trustee to release claims. The determination of when to release a claim depends upon the duties imposed on the trustee. As a general matter, the trustee should be able to release a claim not only when it is uncollectible, but also when collection would be uneconomical. See also Section 812 (duty to enforce claims and defend actions).

Paragraph (15) authorizes a trustee to pay compensation without prior court approval. For the standard for setting the compensation, see Section 709. See also Section 710 (repayment for expenses).

Paragraph (18) allows a trustee to make loans to or guarantee loans of a beneficiary upon such terms and conditions the trustee considers fair and reasonable. The determination of what is fair and reasonable must be made in light of the fiduciary duties of the trustee and purpose of the trust. If the trustee requires security for the loan to the beneficiary, adequate security under this paragraph may consist of a charge on the beneficiary's interest in the trust. See Restatement (Second) of Trusts § 255 (1959). The interest of a beneficiary that is subject to a spendthrift restraint may not be used for security for a loan under this paragraph. See Article 5 (spendthrift protection and claims of creditors).

Paragraph (19) allows a trustee to make payments to another person for the use or benefit of the beneficiary, including to a custodian under the Uniform Transfers to Minor Act.

Paragraph (20) allows a trustee to make non-pro-rata distributions and distribute undivided interests. The trustee also has the power to sell property in order to make the distribution. This paragraph recognizes the authority to take gains and losses into account for tax purposes when making distributions. This power provides needed flexibility and lessens the risk that the non-pro-rata distribution will be treated as a taxable sale.

Paragraph (22) authorizes a trustee to prosecute or defend an action. As to the propriety of reimbursement for attorney's fees and other expenses of an action or judicial proceeding, see Section 710 and Comment. See also Section 812 (duty to defend actions).

Paragraph (24), which is similar to Section 344 of the Restatement (Second) of Trusts (1959), clarifies that even though the trust has terminated, the trustee retains the powers needed to complete the administration of the trust and distribute the remaining trust property. While such terminations should not be delayed, neither should they be hasty or ill-considered. By anticipating the termination prior to the terminating event, many of the problems that typically arise can be avoided.

ARTICLE 9

UNIFORM PRUDENT INVESTOR ACT

General Comment

Reproduced below in its entirety is the Uniform Prudent Investor Act as approved in 1994. The text reproduced below is identical to that of the free-standing Act except for minor revisions to conform terminology. Because of the widespread adoption of the Uniform Prudent Investor Act, no effort has been made to interweave the Prudent Investor Act into this article. States adopting this Act which have previously enacted the Prudent Investor Act are encouraged to recodify their version of the Prudent Investor Act as part of this Act. Enacting the Prudent Investor Act in a unit as a separate part of this Act preserves uniformity with States which have enacted the Prudent Investor Act in its free-standing form..

The Prudent Investor Act prescribes a series of duties relevant to the *investment* and *management* of trust property. The Uniform Trust Act, Article 8 lists the duties and powers of a trustee relevant to the *investment*, *management*, and *distribution* of trust property. Because of this overlap between the two Acts, provisions of the Prudent Investor Act which duplicate Article 8 have been placed in brackets. They should not be enacted but are included here for the sake of completeness and to preserve the Comments. The provisions of the Prudent Investor Act placed in brackets and the corresponding provisions of Article 8 of this Act are as follows:

	Prudent Investor Act	**Article 5, Part 1**
Special skills	902(f)	807
Loyalty	905	803
Impartiality	906	804
Investment costs	907	806
Delegation	909	808

PREFATORY NOTE

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

This Act draws upon the revised standards for prudent trust investment promulgated by the American Law Institute in its Restatement (Third) of Trusts:

Prudent Investor Rule (1992) [hereinafter Restatement of Trusts 3d: Prudent Investor Rule; also referred to as 1992 Restatement].

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

(1) The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the trust setting the term “portfolio” embraces all the trust’s assets. Section 902(b).

(2) The tradeoff in all investing between risk and return is identified as the fiduciary’s central consideration. Section 902(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. Section 902(e).

(4) The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing. Section 903.

(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. Section 909.

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].

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).

SECTION 901. PRUDENT INVESTOR RULE.

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

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

Comment

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

Origins. The prudence standard for trust investing traces back to *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446 (1830). Trustees should "observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested." Id. at 461.

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

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

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

Objective standard. The concept of prudence in the judicial opinions and legislation is essentially relational or comparative. It resembles in this respect the "reasonable person" rule of tort law. A prudent trustee behaves as other trustees similarly situated would behave. The standard is, therefore, objective rather than subjective. Sections 902 through 909 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 902. STANDARD OF CARE; PORTFOLIO STRATEGY; RISK AND RETURN OBJECTIVES.

(a) A trustee shall invest and manage trust property 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 property 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 property.

(e) A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act].

[(f) A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.]

Comment

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

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

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

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

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

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

Duty to investigate. Subsection (d) carries forward the traditional responsibility of the fiduciary investor to examine information likely to bear importantly on the value or the security of an investment for example, audit reports or records of title. E.g., *Estate of Collins*, 72 Cal. App. 3d 663, 139 Cal. Rptr. 644 (1977) (trustees lent on a junior mortgage on unimproved real estate, failed to have land appraised, and accepted an unaudited financial statement; held liable for losses).

Abrogating categoric restrictions. Subsection (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, subsection (e) 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 (e) is that trust beneficiaries are better protected by the emphasis on close attention to risk/return objectives as prescribed in subsection (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 in Section 905. 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) and 1992 Supp. at 48-49.

The UPIA Drafting Committee declined the suggestion that the Act should create an exception to the prudent investor rule (or to the diversification requirement of Section 903 in the case of smaller trusts. The Committee believes that subsections (b) and (c) 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 901(b) 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 a 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 903. DIVERSIFICATION. A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.

Comment

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

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

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

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

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

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

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

Fiduciary investing in mutual funds. Trusts can also achieve diversification by investing in mutual funds. See Restatement of Trusts 3d: Prudent Investor Rule, § 227, Comment *m*, at 99-100 (1992) (endorsing trust investment in mutual funds). ERISA § 401(b)(1), 29 U.S.C. § 1101(b)(1), expressly authorizes pension trusts to invest in mutual funds, identified as securities "issued by an investment company registered under the Investment Company Act of 1940 . . . ."

SECTION 904. DUTIES AT INCEPTION OF TRUSTEESHIP. Within a reasonable time after accepting a trusteeship or receiving trust property, a trustee shall review the trust property 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 [part].

Comment

This section, 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 902 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 905. LOYALTY.** A trustee shall invest and manage the trust property solely in the interest of the beneficiaries.]

Comment

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

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

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

No form of so-called "social investing" is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries – for example, by accepting below-market returns – in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause. See, e.g., John H. Langbein & Richard Posner, Social Investing and the Law of Trusts, 79 Michigan L. Rev. 72, 96-97 (1980) (collecting authority). For pension trust assets, see generally Ian D. Lanoff, The Social Investment of Private Pension Plan Assets: May it Be Done Lawfully under ERISA?, 31 Labor L.J. 387 (1980). Commentators supporting social investing tend to concede the overriding force of the duty of loyalty. They argue instead that particular schemes of social investing may not result in below-market returns. See, e.g., Marcia O'Brien Hylton, "Socially Responsible" Investing: Doing Good Versus Doing Well in an Inefficient Market, 42 American U.L. Rev. 1 (1992). In 1994 the Department of Labor issued an Interpretive Bulletin reviewing its prior analysis of social investing questions and reiterating that pension trust fiduciaries may invest only in conformity with the prudence and loyalty standards of ERISA §§ 403-404. Interpretive Bulletin 94-1, 59 Fed. Regis. 32606 (Jun. 22, 1994), to be codified as 29 CFR § 2509.94-1. The Bulletin reminds fiduciary investors that they are prohibited from "subordinat[ing] the interests of participants and beneficiaries in their retirement income to unrelated objectives."

[**SECTION 906. IMPARTIALITY.** If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust property, 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 907. INVESTMENT COSTS.** In investing and managing trust property, a trustee may only incur costs that are appropriate and reasonable in relation to the property, 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 this section 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 908. REVIEWING COMPLIANCE. Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight.

Comment

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

[**SECTION 909. 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 reverses the much-criticized rule that forbad trustees to delegate investment and management functions. The language of this section is derived from Restatement of Trusts 3d: Prudent Investor Rule § 171 (1992), discussed infra, and from the 1991 Illinois act, 760 ILCS § 5/5.1(b), (c)(1992).

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

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

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

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

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

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

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

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

> professionals manage the portfolio (the largest plans spread their pension investments among dozens of money management firms).

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

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

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

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

Protecting the beneficiary against unreasonable delegation. There is an intrinsic tension in trust law between granting trustees broad powers that facilitate flexible and efficient trust administration, on the one hand, and protecting trust beneficiaries from the misuse of such powers on the other hand. A broad set of trustees' powers, such as those found in most lawyer-drafted instruments and exemplified in the Uniform Trustees' Powers Act, permits the trustee to act vigorously and expeditiously to maximize the interests of the beneficiaries in a variety of transactions and administrative settings. Trust law relies upon the duties of loyalty and prudent administration, and upon procedural safeguards such as periodic reports 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.

This section is designed to strike the appropriate balance between the advantages and the hazards of delegation. This section authorizes delegation under the limitations of subsections (a) and (b). Subsection (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) exonerates the trustee from personal responsibility for the agent's conduct when the delegation satisfies the standards of subsection (a), subsection (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 907 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 910. LANGUAGE INVOKING PRUDENT INVESTOR RULE.

The following terms or comparable language in the terms of the 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.

ARTICLE 10

UNIFORM PRINCIPAL AND INCOME ACT (1997)

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. Article 10, Parts 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 10-201(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 10-401.

(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 10-403.

(5) The allocation of receipts from discount obligations such as zero-coupon bonds. Section 10-406(b).

(6) The allocation of net income from harvesting and selling timber between principal and income. Section 10-412.

(7) The allocation between principal and income of receipts from derivatives, options, and asset-backed securities. Sections 10-414 and 10-415.

(8) Disbursements made because of environmental laws. Section 10-502(a)(7).

(9) Income tax obligations resulting from the ownership of S corporation stock and interests in partnerships. Section 10-505.

(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 10-506.

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 10-303.

(2) Income from a partnership is based on actual distributions from the partnership, in the same manner as corporate distributions. Section 10-401.

(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 10-401(d)(2).

(4) Deferred compensation is dealt with in greater detail in a separate section. Section 10-409.

(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 10-410.

(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 10-411.

(7) The unproductive property rule has been eliminated for trusts other than marital deduction trusts. Section 10-413.

(8) Charging depreciation against income is no longer mandatory, and is left to the discretion of the trustee. Section 10-503.

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 (1991). 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).

PART 1

DEFINITIONS AND FIDUCIARY DUTIES

SECTION 10-101. SHORT TITLE. This [article] may be cited as the Uniform Principal and Income Act (1997).

SECTION 10-102. DEFINITIONS. In this [article]:

(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 [Part] 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 [article] to or from income during the period.

(9) “Principal” means property held in trust for distribution to a remainder beneficiary when the trust terminates.

(10) “Remainder beneficiary” means a person entitled to receive principal when an income interest ends.

(11) “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.

Comment

“Income beneficiary.” The definitions of income beneficiary (Section 10-102(5)) and income interest (Section 10-102(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).

“**Net income.”** The reference to “transfers under this Act to or from income” means transfers made under Sections 10-104(a), 10-412(b), 10-502(b), 10-503(b), 10-504(a), and 10-506.

“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 10-103. 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 [Parts] 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 [article];

(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 [article];

(3) shall administer a trust or estate in accordance with this [article] 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 [article] 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 10-104(a) or a discretionary power of administration regarding a matter within the scope of this [article], whether granted by the terms of a trust, a will, or this [article], 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 [article] 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 10-103(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 10-103(a) states that it also applies to matters within the scope of Articles 2 and 3. Section 10-103(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.*

Questions for which there is no provision. Section 10-103(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 10-103(b), after considering the return from the portfolio as a whole, the trustee may make an appropriate adjustment under Section 10-104(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 10-103(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 10-104. 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 10-103(a), that the trustee is unable to comply with Section 10-103(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;

(6) the net amount allocated to income under the other sections of this [article] 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 surviving 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

Purpose and Scope of Provision. The purpose of Section 10-104 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 10-104(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 10-103(a), that he is unable to comply with Section 10-103(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 10-104(b), but the trustee may not make an adjustment in circumstances described in Section 10-104(c).

Section 10-104 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 10-104(a) is the requirement in Section 10-103(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 10-104 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 10-104 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 10-103(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 10-104(a).

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 a 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 10-104(a) is also to be exercised by considering net income from the portfolio as a whole and not investment by investment. Section 10-413(b) of this Act eliminates the underproductive property rule in all cases other than trusts for which a marital deduction is allowed, and it applies to a marital deduction trust if the trust’s assets “consist substantially of property that does not provide the surviving 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 10-104(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 10-104(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 10-104(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 10-104. 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 903 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 10-104(b)(5); Section 903 Comment; 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 surviving 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 surviving spouse. Subsection (c)(1) applies to a trust that qualifies for the marital deduction because the surviving 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 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 10-104(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 10-104(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 10-104(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 10-104(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 10-104(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 10-104:

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 10-104(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 10-406 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 10-104(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 10-109(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 10-103(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 10-501(3). After considering the return from the trust's portfolio as a whole and other relevant factors described in Section 10-104(b), T may exercise the power to adjust under Section 10-104(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 10-103(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 10-501(1) and the other one-half would have been paid from principal under Section 10-502(a)(1). After considering the total return from the portfolio as a whole and other relevant factors described in Section 10-104(b), T may exercise its power to adjust under Section 10-104(a) by transferring $1,000, or half of the trust's proportionate share of the fee, from principal to income.

PART 2

DECEDENT'S ESTATE OR TERMINATING INCOME INTEREST

SECTION 10-201. 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 [Parts] 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 [Parts] 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 10-202 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 10-501 or 10-502 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.

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 10-201(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 10-201(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 (Supp. 1997).

Administration expenses and interest on death taxes. Under Section 10-201(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 6-201(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.

Under the 1962 Act, Section 13(c)(5) charges interest on estate and inheritance taxes to principal. The 1931 Act has no provision. Section 6-501(3) of this Act provides that, except to the extent provided in Section 10-201(2)(B) or (C), all interest must be paid from income.

SECTION 10-202. DISTRIBUTION TO RESIDUARY AND REMAINDER BENEFICIARIES.

(a) Each beneficiary described in Section 10-201(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 trustee may apply the rules in this section, to the extent that the trustee 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 10-202 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 80 (1984 and Supp. 1997); Thomas H. Cantrill, Fractional or Percentage Residuary Bequests: Allocation of Postmortem Income, Gain and Unrealized Appreciation, 10 Prob. Notes 322, 327 (1985).

PART 3

APPORTIONMENT AT BEGINNING AND END OF INCOME INTEREST

SECTION 10-301. 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 10-302 and 10-303 apply accordingly if the terms of the trust do not contain different provisions.

SECTION 10-302. 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 10-201(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 [Article]. Distributions to shareholders or other owners from an entity to which Section 10-401 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.

Having several different rules that apply to similar transactions is confusing. In order to simplify administration, Section 10-302 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 10-302, 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 10-302(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 10-201(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 10-406.

SECTION 10-303. 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 – accrued periodic payments. The rules in Section 10-302 and Section 10-303 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 10-302(a), the July 20 payment is added to the principal of the successive income interest when received. Under Section 10-302(b), the entire periodic payment of rent that is due on August 20 is income when received by the successive income interest. Under Section 10-303, 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

PART 4

ALLOCATION OF RECEIPTS DURING ADMINISTRATION OF TRUST

SECTION 10-401. 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 10-402 applies, a business or activity to which Section 10-403 applies, or an asset-backed security to which Section 10-415 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.

(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 10-401 applies. The reference to partnerships in Section 10-401(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, but the trustee may determine, after considering the return from the portfolio as a whole, whether an adjustment under Section 10-104 is necessary as a result.

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 10-401 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 10-104(a) to make an adjustment between income and principal, subject to the limitations in Section 10-104(c).

SECTION 10-402. 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 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 10-401 or 10-415 applies to a receipt from the trust.

Comment

Terms of the distributing trust or estate. Under Section 10-103(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 10-415 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 10-403. 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 6-414 applies.

Comment

Purpose and scope. The provisions in Section 10-403 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, 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 10-403 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 10-403 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 10-201.

Separate accounts. A trustee may or may not maintain separate bank accounts for business activities that are accounted for under Section 10-403. 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.

SECTION 10-404. PRINCIPAL RECEIPTS. A trustee shall allocate to principal:

(1) to the extent not allocated to income under this [article], 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 10-502(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 10-405. 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, 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 10-403. This section applies to the extent that the trustee does not account separately under Section 10-403 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 10-405, a transfer from income to reimburse principal may be appropriate under Section 10-504 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 10-104(b) in deciding whether and to what extent to make an adjustment between principal and income under Section 10-104(a) after considering the return from the portfolio as a whole.

SECTION 10-406. 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 10-409, 10-410, 10-411, 10-412, 10-414, or 10-415 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 10-414.

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 10-104. In deciding whether and to what extent to exercise the power to adjust between principal and income granted by Section 10-104(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.

SECTION 10-407. 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 10-403, loss of profits from a business.

(c) This section does not apply to a contract to which Section 10-409 applies.

SECTION 10-408. INSUBSTANTIAL ALLOCATIONS NOT REQUIRED.

If a trustee determines that an allocation between principal and income required by Section 10-409, 10-410, 10-411, 10-412, or 10-415 is insubstantial, the trustee may allocate the entire amount to principal unless one of the circumstances described in Section 10-104(c) applies to the allocation. This power may be exercised by a cotrustee in the circumstances described in Section 10-104(d) and may be released for the reasons and in the manner described in Section 10-104(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 10-411. If the net receipts from the working interest are $35,000, so that the amount allocated to income under Section 10-411 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 10-411 should be made, even though the trustee is still permitted under Section 10-408 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 10-411, by less than 10%. Section 6-408 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 10-104(c) to eliminate claims that the power in this section has adverse tax consequences.

SECTION 10-409. 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.

(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 10-410 applies.

Comment

Scope. Section 10-409 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 10-410 (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 10-409 because of their special characteristics.

Section 10-409 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 10-409(b). Section 10-409(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 10-409(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.

Section 10-409(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 10-409(c).

Allocations Under Section 10-409(c). The focus of Section 10-409, 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 10-409(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 10-409(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 10-409 follows the rule in Section 10-404(2), which provides that money or property received from a change in the form of a principal asset be allocated to principal.

Section 10-409(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 10-409 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 6-104. Section 10-104(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 10-104.

SECTION 10-410. 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 10-409, resources subject to Section 10-411, timber subject to Section 10-412, an activity subject to Section 10-414, an asset subject to Section 10-415, or any asset for which the trustee establishes a reserve for depreciation under Section 10-503.

(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 10-410 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 10-409.

SECTION 10-411. 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 [article] 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 [article] 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 [article].

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 10-411 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 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 10-403 and 10-408. This section applies to the extent that the trustee does not account separately for receipts from minerals and other natural resources under Section 10-403 or allocate all of the receipts to principal under Section 10-408.

Open mine doctrine. The purpose of Section 10-411(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 10-411(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 10-412. 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 [article] applies whether or not a decedent or transferor was harvesting timber from the property before it became subject to the trust.

(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 [article] 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 [article].

Comment

Scope of section. The rules in Section 10-412 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 10-403 and 10-408. 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 10-403 or allocate all of the receipts to principal under Section 10-408. The option to account for net receipts separately under Section 10-403 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 10-413. 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 surviving 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 10-104 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 10-104(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 10-104(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 10-104(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 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 10-104 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 surviving spouse to qualify for a marital deduction if applicable state law is unclear about the surviving 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 10-104 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 10-104(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 10-413, the power under Section 10-104(a) would be exercised to transfer principal to income and not to transfer income to principal.

Section 10-413 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 10-414. 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 accounts for transactions in derivatives pursuant to this section, 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 ãhen 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 10-401 and not Section 10-414. 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 10-403; if a trustee chooses not to account under Section 10-403, Section 10-414(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 derivativefinancial instruments.

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 10-414(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 10-403. 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 10-404(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 10-415. 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 10-401 or 10-409 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 10-402, 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 10-103(a)(4), and the trustee may then consider whether and to what extent to exercise the power to adjust in Section 10-104, taking into account the return from the portfolio as whole and other relevant factors.

PART 5

ALLOCATION OF DISBURSEMENTS DURING ADMINISTRATION OF TRUST

SECTION 10-501. DISBURSEMENTS FROM INCOME. A trustee shall make the following disbursements from income to the extent that they are not disbursements to which Section 10-201(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 10-502(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 10-502. DISBURSEMENTS FROM PRINCIPAL.

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

(1) the remaining one-half of the disbursements described in Section 10-501(1) and (2);

(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 10-501(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 10-504. 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 10-502(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 10-403. 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 10-504(a) and 10-504(b)(5), a trustee who makes or expects to make a principal disbursement for an environmental expense described in Section 10-502(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 10-502(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.

Title proceedings. Disbursements that are made to protect a trust's property, referred to in Section 10-502(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 10-502(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 10-503. 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 6-403 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 10-103(b), and in exercising the power a trustee must comply with Section 10-103(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 10-504(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 10-504. 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;

(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 10-502(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 10-504 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 10-504 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 10-505. 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.

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 10-506 and 10-104 to make adjustments are probably sufficient to enable a trustee to correct inequities that may arise because of technical problems.

SECTION 10-506. 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 10-506(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 10-506(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 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. Settlors 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 11

LIABILITY OF TRUSTEES AND RIGHTS OF THIRD PERSONS

General Comment

Sections 1101 through 1106 lists the remedies for breach of trust, describes how money damages are to be determined, and specifies some potential defenses. The remedies for breach of trust are listed in Section 1102. The remedies provided are both broad and flexible. The method for determining money damages provided in Section 1103 is based on two principles: (1) the trust should be restored to the position it would have been in had the harm not occurred; and (2) the trustee should not be permitted to profit from the trustee's own wrong. Section 1104 through 1106 specify potential defenses. Section 1104 provides a statute of limitations on actions against a trustee, Section 1105 describes the effect of and potential limits on use of an exculpatory clause, and Section 1106 deals with the requirements for beneficiary approval of acts of the trustee that might otherwise constitute a breach of trust.

Sections 1107 through 1109 addresses trustee relations with third parties. The emphasis is on encouraging trustees and third parties to engage in commercial transactions to the same extent as if the property was not held in trust. Section 1107 negates personal liability on contracts entered into by the trustee if the fiduciary relationship or identity of the trust was properly disclosed. The trustee is also relieved from liability for torts committed in the course of administration unless the trustee was personally at fault. Section 1108 protects third persons who deal with a trustee in good faith and without knowledge that the trustee is exceeding a power. Section 1109 permits a trustee to rely on a certification of trust, thereby hopefully reducing requests by third parties for copies of the complete trust instrument.

SECTION 1101. BREACH OF TRUST FOR VIOLATION OF DUTY. A violation by a trustee of a duty the trustee owes a beneficiary is a breach of trust. The remedies of a beneficiary for breach of trust are exclusively equitable.

Comment

This section is drawn from Section 201 of the Restatement (Second) of Trusts (1959). The remedies of a beneficiary are exclusively equitable and, as such, do not include either punitive damages or jury trial. The purpose of equity is to make one whole, not penalize.

For the list of remedies, see Section 1102. For the method for determining money damages, see Section 1103.

SECTION 1102. REMEDIES FOR BREACH OF TRUST. To remedy a breach of trust that has occurred or may occur, the court may:

(1) compel the trustee to perform the trustee's duties;

(2) enjoin the trustee from committing a breach of trust;

(3) compel the trustee to redress a breach of trust by payment of money or otherwise;

(4) appoint a receiver or temporary trustee to take possession of the trust property and administer the trust;

(5) suspend or remove the trustee;

(6) reduce or deny compensation to the trustee;

(7) subject to Section 1108, void an act of the trustee, impose an equitable lien or a constructive trust on trust property, or trace trust property wrongfully disposed of and recover the property or its proceeds; or

(8) grant any other appropriate remedy.

Comment

This section codifies in general terms the equitable remedies available to a beneficiary or cotrustee if a trustee has committed a breach of trust or threatens to do so. This section provides brief statements of the available remedies and does not attempt to set out the refinements and exceptions developed in case law. The availability of a remedy in a particular circumstance is governed by the common law of trusts, including its principles of equity. See Section 103. The petitioner may seek any of the remedies listed appropriate to the particular case.

Paragraph (1) is consistent with Restatement (Second) of Trusts § 199(a) (1959). Paragraph (2) is consistent with Restatement (Second) of Trusts § 199(b) (1959).

The reference to payment of money in paragraph (3) includes liability that might be characterized as damages, restitution, or surcharge. For the measure of liability, see Section 1103. In certain circumstances, rather than ordering the payment of money, it may be appropriate for the court to order the trustee to transfer tangible property as a remedy for breach of trust. See Restatement (Second) of Trusts § 199(c)(1959).

Paragraph (4) makes explicit the court's authority to appoint a receiver. See also Restatement (Second) of Trusts § 199(d) (1959). This paragraph also permits appointment of a temporary trustee if appointment of a receiver would be appropriate. See Section 708 (appointment of trustee to fill vacancy).

As to paragraph (5), see Restatement (Second) of Trusts § 199(e) (1959). For provisions governing disqualifying or removing trustees, see Section 706 (grounds for removal).

Paragraph (6) follows Section 243 of the Restatement (Second) of Trusts (1959).

The authority under paragraph (7) to set aside wrongful acts of the trustee is a corollary of the power to enjoin a threatened breach as provided in paragraph (2). As recognized in the introductory clause, the wrongful acts of the trustee may not be set aside if to do so would impair the rights of bona fide purchasers as provided in Section 1108. See Restatement (Second) of Trusts § 202 (1959). See also G. Bogert, The Law of Trusts and Trustees § 861, at 16-17 (rev. 2d ed. 1982).

A successor trustee may also have standing to sue for a breach of trust. As to standing generally, see Restatement (Second) of Trusts § 200 (1959).

SECTION 1103. DAMAGES AGAINST TRUSTEE FOR BREACH OF TRUST. A beneficiary may charge a trustee who commits a breach of trust with the amount required to restore the value of the trust property and trust distributions to what they would have been had the breach not occurred, or, if greater, the profit that the trustee made by reason of the breach.

Comment

This section is based on Restatement (Third) of Trusts: Prudent Investor Rule § 205 (1992).

If a trustee commits a breach of trust, the beneficiaries may either affirm the transaction or, if a loss has occurred, hold the trustee liable for the amount necessary to fully compensate for the consequences of the breach. This may include lost income, capital gain, or appreciation that would have resulted from proper administration. Even if a loss has not occurred, the trustee may not be allowed to benefit by reason of the trustee's improper action, and is thus accountable for any profit that the trustee may have made by reason of the breach.

For extensive commentary on the determination of damages, with numerous specific applications, see Restatement (Third) of Trusts: Prudent Investor Rule §§ 204-213 (1992).

The court may reduce or excuse damages in circumstances in which it is appropriate to do so. See Restatement (Second) of Trusts § 205 cmt. g (1959).

The remedies provided in this section do not preclude resort to other remedies provided by this Act or available under the common law of trusts. See Sections 103 (common law of trusts) and 1102 (remedies for breach of trust). As to possible defenses of the trustee, see Sections 1104 through 1106.

SECTION 1104. LIMITATION OF ACTION AGAINST TRUSTEE AFTER FINAL REPORT OR OTHER STATEMENT.

(a) Unless previously barred by adjudication, consent, or other limitation, a claim against a trustee for breach of trust is barred as to a beneficiary who has received from the trustee a report or other statement adequately disclosing the existence of the claim unless a judicial proceeding to assert the claim is commenced within two years after the later of the receipt of the report or statement or the termination of the trust relationship between the beneficiary and that particular trustee. A report or statement adequately discloses the existence of a claim if it provides sufficient information so that the beneficiary knows of the claim or reasonably should have inquired into its existence.

(b) For the purpose of subsection (a), a beneficiary is deemed to have received a report or other statement:

(1) in the case of an adult, if it is received by the adult personally, or if the adult lacks capacity, if it is received by the adult's conservator, guardian, or agent with authority; or

(2) in the case of a minor, if it is received by the minor's guardian or conservator or, if the minor does not have a guardian or conservator, if it is received by a parent of the minor who does not have a conflict of interest.

Comment

This section is based in part on Section 7-307 of the Uniform Probate Code. For provisions governing consent, release, and ratification by beneficiaries to relieve the trustee of liability, see Section 1106. The reference in the introductory clause to claims previously barred also includes principles such as estoppel and laches that apply under the common law of trusts. See Section 103. During the time that a trust is revocable, the person holding the power to revoke is the one who must receive the report or other statement in order to commence the running of the limitations period provided in this section. See Section 603 (rights of settlor).

Subsection (b) provides special rules concerning who must receive the report or other statement for it to have the effect of later barring claims based on the information disclosed. This subsection addresses only the issue of when the clock will start to run for purposes of the statute of limitations. Should the trustee wish to immediately foreclose possible claims based on the information disclosed, a consent to the report or other information may be obtained pursuant to Section 1106.

For the provisions relating to the duty to report information to beneficiaries, see Section 814.

SECTION 1105. EXCULPATION OF TRUSTEE.

(a) A term of the trust relieving a trustee of liability for breach of trust is unenforceable to the extent that it:

(1) relieves a trustee of liability for breach of trust committed intentionally, in bad faith, or with reckless indifference to the purpose of the trust or the interest of the beneficiaries; or

(2) was inserted as the result of an abuse by the trustee of a fiduciary or confidential relationship to the settlor.

(b) An exculpatory term drafted by or on behalf of the trustee is presumed to have been inserted as a result of an abuse of a fiduciary or confidential relationship unless the trustee proves that the exculpatory term is fair under the circumstances and that its existence and contents were adequately communicated to the settlor.

Comment

Subsection (a) is the same in substance as Section 222 of the Restatement (Second) of Trusts (1959). It is also consistent with the standards expressed in Sections 801 and 815 relating to the extent to which a settlor may negate a duty in the terms of the trust. There is a minimum standard of conduct to which a trustee must comply, whether stated as a negation of a duty or in the form of an exculpatory provision. A trustee must always act in good faith and with regard to the purpose of the trust and the interest of the beneficiaries.

Subsection (b) disapproves of *Marsman v. Nasca*, 573 N.E.2d 1025 (Mass. App. Ct. 1991), which held that an exculpatory clause in a trust instrument drafted by the trustee was valid absent proof that it was inserted as a result of an abuse of a fiduciary relationship. Subsection (b) responds to the danger that the insertion of such a clause by the fiduciiry or its agent may have been undisclosed or inadequately understood by the settlor. To overcome this presumption of abuse, the trustee must establish that the clause was fair and that its existence and contents were adequately communicated to the settlor. In determining whether the clause was fair, the court may wish to examine: (1) the extent of the prior relationship between the settlor and trustee; (2) whether the settlor received independent advice; (3) the sophistication of the settlor with respect to business and fiduciary matters; (4) the trustee's reasons for inserting the clause; and (5) the scope of the particular provision inserted. See Restatement (Second) of Trusts § 222 cmt. d (1959).

SECTION 1106. NONLIABILITY OF TRUSTEE UPON BENEFICIARY'S CONSENT, RELEASE, OR RATIFICATION. A beneficiary may not hold a trustee liable for a breach of trust if the beneficiary, while having capacity, consented to the conduct constituting the breach, released the trustee from liability for the breach, or ratified the transaction constituting the breach, unless:

(1) the beneficiary at the time of the consent, release, or ratification did not know of the beneficiary's rights and of the material facts that the trustee knew, or with the exercise of reasonable inquiry, the beneficiary should have known, and that the trustee did not reasonably believe that the beneficiary knew; or

(2) the consent, release, or ratification of the beneficiary was induced by improper conduct of the trustee.

Comment

This section combines Sections 216 through 218 of the Restatement (Second) of Trusts (1959). When one beneficiary has consented but others have not, courts give a remedy to the nonconsenting beneficiaries. Restatement (Second) of Trusts § 216 cmt. h (1959). But consent by the settlor of a revocable trust or by the holder of a presently exercisable power of withdrawal binds all of the beneficiaries. See Section 603.

Restatement (Second) of Trusts § 218, comment d, states that its rule relating to affirmance applies only to breaches which give beneficiaries the option to affirm or disaffirm, but that in other cases the trustee may be protected by laches.

SECTION 1107. LIMITATION ON PERSONAL LIABILITY OF TRUSTEE.

(a) Except as otherwise agreed, a trustee is not personally liable on a contract properly entered into in the trustee's fiduciary capacity in the course of administration of the trust if the trustee in the contract discloses the fiduciary capacity.

(b) A trustee is personally liable for obligations arising from ownership or control of trust property, or for torts committed in the course of administering a trust, only if the trustee is personally at fault, whether negligently or intentionally.

(c) A claim based on a contract entered into by a trustee in the trustee's fiduciary capacity, on an obligation arising from ownership or control of trust property, or on a tort committed in the course of administering a trust, may be asserted against the trust in a judicial proceeding against the trustee in the trustee's fiduciary capacity, whether or not the trustee is personally liable on the claim.

Comment

This section is based on Section 7-306 of the Uniform Probate Code. However, unlike the Uniform Probate Code, subsection (a) excuses the trustee from personal liability on a contract if *either* the trustee's representative capacity *or* the identity of the trust is disclosed in the contract. Under this section, it is assumed that either one of these statements in a contract puts the other contracting party on notice that a trust is involved. The protection afforded the trustee by this section applies only to contracts that are properly entered into in the trustee's fiduciary capacity, meaning that the trustee is exercising an available power and is not violating a duty. This section does not excuse any liability the trustee may have for breach of trust.

Subsection (b) addresses liability arising from ownership or control of trust property and for torts occurring incident to the administration of the trust. Liability in such situations is imposed on the trustee personally only if the trustee was personally at fault, either intentionally or negligently. This is contrary to Restatement (Second) of Trusts § 264 (1959), which imposes liability on a trustee regardless of fault, including liability for acts of agents under respondeat superior.

Subsection (c) alters the case law rule that a trustee could not be sued in a representative capacity if the trust estate was not liable.

SECTION 1108. PROTECTION OF PERSON DEALING WITH TRUSTEE.

(a) A person who in good faith assists a trustee or who in good faith and for value deals with a trustee without knowledge that the trustee is exceeding or improperly exercising the trustee's powers is protected from liability as if the trustee properly exercised the power.

(b) A person who in good faith deals with another person with knowledge that the other person is a trustee is not solely on that account placed on notice to inquire into the extent of the trustee's powers or the propriety of their exercise or to see to the proper application of assets of the trust paid or delivered to a trustee.

(c) A person who in good faith assists a former trustee or who for value and in good faith deals with a former trustee without knowledge that the person is no longer a trustee is protected from liability as if the former trustee were still a trustee.

(d) The protection provided by this section to persons assisting or dealing with a trustee is secondary to that provided under comparable provisions of other laws relating to commercial transactions or to the transfer of securities by fiduciaries.

Comment

This section is originally derived from Section 7 of the Uniform Trustees' Powers Act, but with several important changes. The key to understanding the section are the definitions of "good faith" and "know," codified at Section 105(5) and (7). The definition of "good faith," with respect to third persons, requires not only honesty of intention but also observance of reasonable standards of fair dealing. The definition of "know" refers to more than actual knowledge. While a person is not charged with knowledge of facts discoverable upon reasonable inquiry, the third party is charged with knowledge of facts the person had reason to know based on the facts and circumstances actually known to the person at the time in question. In other words, if the person should have been aware of a particular fact based on the circumstances and other facts of which the person was actually aware, the person is charged with knowledge of that fact. The Uniform Trustees' Powers Act, on the other hand, by failing to define good faith, left open the issue of whether its requirement that a trustee act in good faith was totally subjective or instead contained an objective element.

Subsection (a) protects two different classes; persons who assist a trustee with a transaction, and persons who deal with the trustee for value. The third person is protected in the transaction despite the fact the trustee was exceeding or improperly exercising the power as long as the assistance was provided or transaction was entered into in "good faith" and without "knowledge" as defined in Section 105(5) and (7).

Subsection (b) performs two functions. First, it negates the common law rule that a third party does not receive credit if the trustee misapplies assets paid or delivered to the trustee which are properly part of the trust. To receive the protection provided by this subsection, the third person must have been acting in good faith and without knowledge of the misapplication. Second, subsection (b) confirms that a third party acting in good faith and without knowledge is not charged with a duty to inquire into the extent of a trustee's powers or the propriety of their exercise.

Subsection (c) extends the protections afforded by the section to assistance provided to or dealings for value with a former trustee. The third party is protected the same as if the former trustee still held the office.

Subsection (d) clarifies that the protections provided by this section will in many cases be superseded by protections provided by other statutes, in particular the statutes relating to commercial transactions or to transfers of securities by fiduciaries. The principal statutes in question are the various articles of the Uniform Commercial Code, including Article 8 on the transfer of securities, as well as the Uniform Simplification of Transfer of Securities by Fiduciaries Act.

SECTION 1109. CERTIFICATION OF TRUST.

(a) To establish the existence or terms of a trust, a trustee may present a certification of trust to any person in lieu of providing a copy of the trust instrument.

(b) A certification of trust must contain a statement that the trust has not been revoked or modified in any manner that would cause the representations contained in the certification of trust to be incorrect and must contain a statement that it is being signed by all of the currently acting trustees of the trust.

(c) A certification of trust need not contain the dispositive terms of a trust.

(d) A person may require that the trustee offering a certification of trust provide copies of those excerpts from the original trust instrument and later modifications that designate the trustee and confer upon the trustee the power to act in the pending transaction.

(e) A person who acts in reliance upon a certification of trust without knowledge that the representations contained therein are incorrect is not liable to any person for so acting and may assume without inquiry the existence of the facts contained in the certification. Knowledge may not be inferred solely from the fact that a copy of all or part of the trust instrument is held by the person relying upon the certification. A lien created by a transaction entered into by the trustee and a person acting in reliance upon a certification of trust is enforceable against the trust property.

(f) A person making a demand for the trust instrument in addition to a certification of trust or excerpts is liable for damages, including reasonable attorney's fees, incurred as a result of the refusal to accept the certification of trust or excerpts in lieu of the trust instrument if the court determines that the person did not act in good faith in requesting the trust instrument.

(g) This section does not limit the rights of beneficiaries to obtain copies of the trust instrument or rights of others to obtain copies in a judicial proceeding concerning the trust.

Comment

This section, based on California Probate Code § 18100.5, is designed to protect the privacy of a trust instrument by reducing requests by third parties for complete copies of the instrument when verifying a trustee's authority. Third parties frequently insist on receiving a copy of the complete trust instrument solely to verify a specific and narrow authority of the trustee to engage in a particular transaction. While a testamentary trust, because it is created under a will, is a matter of public record, an inter vivos trust instrument is private. Such privacy is compromised, however, if the trust instrument must be widely distributed among third parties. A certification of trust is a document signed by all currently acting trustees that may include excerpts from the trust instrument necessary to facilitate the particular transaction. The benefit of a certification is that it will enable the transaction to proceed without disclosure of the trust's beneficial provisions. Nor is there a need for third parties who may already have a copy of the instrument to pry into its provisions. Persons acting in reliance on a certification may assume the truth of the certification even if they have a complete copy of the trust instrument in their possession. To encourage compliance with this section, persons demanding a trust instrument despite having already been offered a certification may be liable for damages, including reasonable attorney's fees, if their refusal is determined not to have been in good faith.

ARTICLE 12

TRANSITIONAL AND MISCELLANEOUS PROVISIONS

SECTION 1201. 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 1202. SEVERABILITY CLAUSE. If any provision of this [Act] or its application to any person or circumstances 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 1203. EFFECTIVE DATE.

(a) This [Act] takes effect on ______________.

(b) Except as provided elsewhere in this [Act], on [the effective date of this [Act]]:

(1) this [Act] applies to all trusts created before, on, or after [its effective date];

(2) this [Act] applies to all judicial proceedings concerning trusts commenced on or after [its effective date];

(3) this [Act] applies to judicial proceedings concerning trusts commenced before [its effective date] unless the court finds that application of a particular provision of this [Act] would substantially interfere with the effective conduct of the judicial proceedings or the rights of the parties, in which case the particular provision of this [Act] does not apply and the superseded law applies;

(4) any rule of construction or presumption provided in this [Act] applies to trust instruments executed before [the effective date of the [Act]] unless there is a clear indication of a contrary intent in the terms of the trust; and

(5) an act done before [the effective date of the [Act]] in any proceeding and any accrued right is not impaired by this [Act].

(c) If a right is acquired, extinguished, or barred upon the expiration of a prescribed period that has commenced to run under any other statute before [the effective date of the [Act]], that statute remains in force with respect to that right.

Comment

This section addresses the applicability of the Act, including application to pending judicial proceedings and the administration of existing trusts. The Act is intended to receive the widest possible application. The Act applies to all trusts subject to the jurisdiction of the enacting State, whether created before or after the date of enactment. But recognizing constitutional concerns, excluded from coverage are trusts created prior to the Act's effective date if such application would impair a vested right. For such an impairment to occur, however, the trust would have to be irrevocable as of the effective date and the particular provision of the Act would have to actually reduce or otherwise threaten a beneficial interest.

SECTION 1204. SPECIFIC REPEALER AND AMENDMENTS.

[(a)] The following Acts and parts of Acts are repealed:

(1) Uniform Trustee Powers Act;

(2) Uniform Prudent Investor Act;

(3) Uniform Principal and Income Act (1931);

(4) Revised Uniform Principal and Income Act (1962);

(5) Uniform Probate Code, Article VII;

(6) Uniform Trust Act (1937);

(7)

[(b) The following Acts and parts of Acts are amended:

(1)

(2)

(3)]

Comment

For the reasons why the above uniform acts should be repealed upon enactment of this Act, see the Prefatory Note. States which have not enacted one or more of the specified uniform acts should repeal their comparable legislation. Because of the comprehensive scope of this Act, many states will have trust provisions not based on any uniform act which will need to be repealed upon enactment of this Act. This section does not attempt to list the types of conforming amendments, whether in the enacting State's probate code or elsewhere, which will need to be made upon enactment of this Act. But blank spaces are included in subsection (b) in order to alert enacting jurisdictions to this issue.