HOUSE RESEARCH ORGANIZATION bill analysis | 4/25/2003 | HB 2240 Paxton (CSHB 2240 by Christian)

SUBJECT: Adoption of the Uniform Prudent Investor Act

COMMITTEE: Financial Institutions — committee substitute recommended

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

0 nays

WITNESSES: For — Dave Folz, Texas Capital Bank; Jim O'Connell, Texas Banker's Association, Trust Division; *(Registered, but did not testify):* Melody Bohlmonn, The Trust Company; Mark Morris, JP Morgan Chase; Robert Richardson, JP Morgan Chase.

Against — Alvin Golden, Real Estate, Probate and Trust Law Section, State Bar of Texas; Glenn M. Karisch, Real Estate, Probate and Trust Law Section, State Bar of Texas.

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

TTC Sec. 113.056(a) sets forth the prudent person rule, which is the default investment standard applicable to Texas trusts. The prudent person rule specifies that a trustee shall exercise the judgment and care that a prudent person similarly situated would under the same circumstances with respect to management of the trust property. For example, if the trustee invested 15 percent of the trust property in the stock market and a prudent person could be assumed to have done this under the same circumstances, then the trustee has complied with the prudent person standard. A trustee is evaluated based on the performance of each asset of the trust. Modern investment theory is a method of measuring investing performance by looking at the return of the overall asset, and not the return of each piece of the investment. Sec. 113.003 allows a trustee to retain assets, meaning that the trustee can hold an original trust asset, is not required to diversify trust investments, and can do so without incurring any liability for losses caused by the retention.

TTC Sec. 113.060 authorizes a trustee to delegate investment decisions to an investment agent. The trustee is liable for the decisions of the agent unless the trustee exercises the appropriate amount of judgment and care in choosing and monitoring the agent, executes a written agreement with that agent requiring the agent to accept liability for investment decisions, and notifies all trust beneficiaries of this agreement.

The TTC has a few categoric restrictions on the type of assets that a trust can invest in. For example, a corporate trustee cannot purchase insurance using trust funds from an insurance company that is an affiliate of the trustee. That trustee still may invest in insurance, but cannot invest in a company with which it is affiliated.

The statute of limitations for claiming a breach of fiduciary duty is four years from the date of the breach or the date that a reasonable person would have discovered the breach.

The Uniform Prudent Investor Act, promulgated by the Uniform Law Commissioners (a group of law professors and lawyers from around the country) was established in 1994 and has been adopted in 38 states. It is designed to allow fiduciaries to utilize modern investment theory to guide investment decisions and to delegate investment decisions to qualified and supervised agents.

DIGEST: CSHB 2240 would add Chapter 117 to the Property Code and would call it the "Uniform Prudent Investor Act," which would be based closely upon the national act.

The bill would establish the prudent investor rule, rather than the prudent person rule, as the default rule for investments. The prudent investor rule would allow a trustee's actions to be judged based on what a prudent investor would have done under the circumstances, rather than what a prudent person would have done. It would allow the performance of individual trust assets to be evaluated based on the performance of the trust portfolio as a whole and as part of an overall investment strategy. CSHB 2240 would allow a trustee to invest in any type of asset that played an appropriate role in the risk/return objectives of the trust and that met the other objectives of prudent investing. It would add the requirement that fiduciaries diversify their investments. CSHB 2240 would permit a trustee to delegate investment and management functions to an agent and release the trustee from liability for the actions or decisions of the agent.

CSHB 2240 would delete sections of the Property Code that would be obviated by the implementation of this bill. It would repeal TTC Sec. 113.003, which permits a trustee to maintain any part of the original trust property and not diversify it. It also would make conforming changes to the TTC and the Probate Code.

The bill would take effect January 1, 2004.

SUPPORTERS SAY:

General arguments. New allocation rules are necessary because there are new types of investments today, such as hedge and index funds, that were not even anticipated when this statute was enacted more than 20 years ago. The law needs to be updated to allow trustees to take advantage of these newer types of investing and reap the greatest returns they can for their beneficiaries.

Although some trustees might have to obtain extra knowledge to meet the prudent investor standard, many will not. A prudent investor is one that is knowledgeable about investment decisions. Trustees already make investment decisions, and many already have achieved the appropriate level of knowledge. Besides, requiring trustees to become knowledgeable about investing would help beneficiaries. Additionally, trustees are able to delegate investment decisions to others that are more qualified, which trustees still would be allowed to do this under this bill.

CSHB 2240 would modernize Texas law and better enable trustees to manage trusts by working under modern investment theory. This is necessary in an interstate investment environment because so many other states already have adopted the national act and thus use modern investment theory. Trusts would be likely to realize greater investment returns following this shift because the focus would be on the return of the trust assets as a whole rather than on the performance of each individual asset.

This bill would do away with the antiquated notion that a trustee can retain the original trust assets and not be liable for failing to invest them. By requiring a trustee to analyze, monitor, and decide whether to retain or invest an asset, beneficiaries would be assured that their property would be managed to their advantage. Because these are the default rules, a family heirloom, for example, easily could be protected from being sold by the settlor providing that it be retained.

This bill would go hand in hand with CSHB 2241 by Paxton, in that the investment principles in this bill rely upon the accounting principles in CSHB 2241. CSHB 2241 would update the traditional principal and income allocation rules so that trustees could work with the modern portfolio approach. However, CSHB 2240 still would be needed even if CSHB 2241 did not pass because it would modernize investment strategies while making the delegation rules more user friendly.

Delegation. The delegation provision in CSHB 2240 would provide the same ability for a trustee to delegate to an agent as current law except it would dispense with the cumbersome notice provision. Many trustees choose to not use this provision because it is difficult to apply due to the requirement that a trustee notify all beneficiaries of an impending delegation agreement with an agent at least 30 days prior to entering into that agreement. By removing this notice requirement, more trustees could delegate their duties and would not have to rely on their own knowledge or expertise. The same protection would be offered to the beneficiary in that the trustee would have to choose and monitor the agent with the same standard of care as under current law, but the delegation would be more likely to occur because it would be easier to implement. This, in turn, likely would provide a beneficiary with a greater return on the trust assets because the trustee would be able to delegate investment duties to an agent that specialized in investing.

The trustee would not and should not be personally liable for an agent's improper investment of trust funds. A trustee that chose the agent using the proper level of care should be absolved from incurring liability for choosing an agent that another investor prudently would have chosen under the same circumstances. The trustee also would monitor the agent to ensure that the assets were being taken care of. In order to allow trustees to perform their duties without the constant fear of being sued, the bill would give them some protection over their decisions and assure them in particular instances that they would not be liable. Absent these assurances, a trustee's ability to manage the trust to the best of his or her capabilities would be impeded. Therefore, limiting the trustee's liability in this instance would benefit both the trustee and beneficiaries.

The delegation provision would not take away the trustee's duty to sue an agent under certain circumstances. The trustee still would be obligated to sue an agent for mishandling of assets on behalf of the trust. Failure to do this could expose the trustee to liability for breach of fiduciary duty.

This bill would not increase the amount of trust litigation and, in fact, probably would decrease it because beneficiaries would be precluded from suing trustees for reasons other than breaches of fiduciary duty.

Some companies use arbitration agreements, and they have every right to do so. This is a free enterprise society where one can negotiate the terms of a contract and can choose from a variety of companies. Additionally, if the intent of a trust was against the use of arbitration agreements, a settlor could prevent their usage merely by providing explicit language against them.

OPPONENTS SAY:

General arguments. Changing the prudent person rule to the prudent investor rule would place an undue burden on trustees. Most trustees are just regular people who might not have much education. The prudent investor rule would require a trustee to obtain a sufficient amount of investment knowledge to be considered an "investor." To achieve this, many trustees would have to attend classes and conduct research unnecessary under current law. These activities would be costly and take trustee time away from managing trust assets.

Delegation. It is extremely important a single person or entity be responsible for following the terms of a trust. Current law requires either the trustee or the agent to whom power is delegated to bear the liability for a breach of fiduciary duty for their decisions because of the great power they wield. By removing this level of responsibility, this bill could be harmful to beneficiaries.

Under this bill, it is possible and even likely that no one would be held liable for the misuse of beneficiary funds. CSHB 2240 would provide that, as long as the trustee made a reasonable delegation, the agent merely would have to follow the terms of the delegation agreement, not the trust, thus rendering both agent and trustee free from liability to the beneficiary for losses. While the agent may be liable contractually to the trust for breaching the delegation agreement, a breach of fiduciary duty would be more egregious and offer greater damages than a breach of contractual duty.

Due to this removal of liability from the trustee and the agent, the only way that beneficiaries could recover losses would be to sue trustees alleging a breach of fiduciary duty in choosing and/or monitoring the agent. It is possible that, as a precaution, they would begin to sue trustees for every delegation, claiming that it violated the terms of the trust, thereby increasing the amount of trust litigation.

This bill would remove the prohibition against affiliate delegation, meaning that a bank acting as trustee could delegate its investment duties to an affiliated brokerage house and forego all liability for that delegation, thereby ensuring that it received a fee and exercised power free from responsibility. Although it is true that a trustee would have the duty to seek to recover damages from an agent that acted improperly, a beneficiary could not sue the agent, and under this bill, could not sue the trustee for hiring the agent.

To make matters worse, the brokerage house likely would have a clause in its contract containing an arbitration clause with a shortened statute of limitations, such as 120 days from the date of the breach, meaning that any disputes would have to be settled in front of an arbitrator, not a jury, and would have to be addressed as soon as they occurred. In theory, a trustee could look elsewhere to delegate investment powers or could negotiate arbitration clauses and statutes of limitations out of the contract. In practice, however, many companies have all of these things in their standard contracts and will consider removing them only for their very best customers. This would leave a smaller trust with poison provisions in the contract, and out in the cold when it came to fairness in seeking remuneration for damages caused by agent investment mistakes.

This provision violates a basic principle of American jurisprudence: that people should take responsibility for their actions. Removing liability from the trustee and effectively from the agent as well would send the message that they could cause damage without consequences. It makes no sense to allow a trustee or agent to perform fiduciary duties without requiring them to step up to the plate and take responsibility like a fiduciary. Removing responsibility from trustees and leaving agents with only contractual duties goes against the fundamental tenets of trust law and would endanger trust assets because there would be no means of acquiring compensation for all of the damages that could be incurred when agents were liable only under contract.

Although arbitration could be a more efficient method of resolving a claim, it would not achieve justice in all cases. There need to be limits to subjecting a beneficiary to arbitration where a settlor did not provide otherwise. If a settlor wanted to subject all claims regarding a trust to arbitration, then he or she could provide for that explicitly in the trust documents.

NOTES:

The committee substitute differs from the bill as introduced by adding a provision permitting a trustee to delegate investment and management functions and releasing the trustee from liability for the decisions or actions of an agent. CSHB 2240 would place the Uniform Prudent Investor Act in Chapter 117 of the Property Code rather than in Chapter 116. The substitute would delay the effective date of the bill from September 1, 2003 to January 1, 2004.

The companion bill, SB 575 by Harris, has been referred to the Senate Jurisprudence Committee.

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