Study L-649 March 16, 1998

First Supplement to Memorandum 98-19

Uniform Principal and Income Act: Preliminary Considerations (Letter from E. James Gamble)

Attached to this supplement is a letter from E. James Gamble, Co-Reporter on the Uniform Principal and Income Act. The letter responds to comments submitted by Alexander Misheff, attached to Memorandum 98-19 as Exhibit pp. 15-36.

Mr. Gamble analogizes the power to adjust under Section 104 of the UPAIA to a trustee's traditional discretionary powers to structure investments to meet the settlor's goals. He also makes clear that the uniform act drafting committee carefully considered the American Bankers Association comments (which were forwarded by Mr. Misheff) and made extensive changes to the provision as originally proposed. This is consistent with the staff's comparison of the American Bankers Association comments to the final form of the UPAIA.

Most importantly, Mr. Gamble underlines the necessity of the adjustment power in certain situations where the trustee follows the prudent investor rule and produces a fine total return but only a small amount of dividend and interest income. He concludes that "typical principal invasion provisions in existing trust instruments will frequently be inadequate to solve that problem, and that is why Section 104 is needed to give the trustee a power to adjust from principal to income in such a situation."

Respectfully submitted,

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Assistant Executive Secretary

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March 14, 1998

VIA TELECOPY (650-494-1827)

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California Law Revision Commission
400 Middlefield Road, Room D-1
Palo Alto, CA 94303-4739

Re: Uniform Principal and Income Act (1997)

Dear Mr. Ulrich:

Thanks very much for your letter of March 10. Because I am leaving on a trip this afternoon and will not be back in the office until March 19, I can give you only a brief response before your meeting on March 17.

I can appreciate the concerns expressed by the California Bankers Association and Alexander Misheff. Because Mr. Misheff served as the American Bankers Association observer to the NCCUSL drafting committee, I have had the opportunity to discuss his concerns with him at some length. However, I have learned in speaking to a number of groups in various parts of the country that not all professional trustees share these concerns. For example, I gave a presentation on the Act at the University of Miami 32d Annual Institute on Estate Planning in January, and conducted a workshop on the Act the next day. The persons who attended the workshop were predominantly trust officers from various banks in a number of states. I discussed Section 104 and the concerns that have been expressed about the power to adjust that it gives to the trustee, and I asked the professional trustees who were present to tell me about the concerns that they might have so that we could discuss them. No trust officer said that he or she was concerned about the section, and a number of them stated affirmatively that

they were comfortable with it. In fact, one woman who identified herself as trust counsel for a New York bank said that she viewed Section 104 as no different than a broad, discretionary power to invade principal of the kind found in many trust instruments.

When I talk about the Act, this is how I describe the role of Section 104: Trustees already have a very broad, discretionary power under traditional trust instruments (although not usually expressed in so many words as a discretionary power) to structure a trust portfolio in the way they believe accomplishes a settlor's intentions about how the income and remainder beneficiaries should be treated. Typically, they meet with the income beneficiary soon after the trust is created, discuss the beneficiary's expenses and other sources of income, and make a decision about how much income the beneficiary will need each year. Then, if the trust assets are adequate to meet the income requirement and also give due regard to the rights of the remainder beneficiaries, they structure the portfolio in a way that will produce the targeted amount of dividend and interest income. Operating under Section 104, I expect that a trustee's thought processes will be very much the same, if not identical. The trustee must still determine the needs of the income beneficiary, and will express those needs in terms of a specific dollar amount (e.g., $30,000 a year) or a dollar range (e.g., from $25,000 to $35,000 a year), just as they now do. If the trustee then invests under the prudent investor rule in a way that produces a larger proportion of the total return in capital appreciation than in dividends and interest, the trustee will transfer funds from principal to income to meet the dollar objective established for the income beneficiary.

One of my purposes in using the scenario I describe above has been to find out if I have been wrong in my observations over the last 40 years about how trustees go about their business. No professional trustee has said that the practice of his or her institution is different from the process that I describe.

One last comment, about Mr. Misheff's June 1995 memorandum regarding what was then called Section 601 (that section was an early version of Section 104). The NCCUSL drafting committee listened very carefully to the American Bankers Association's concerns about the language in Section 601 and the comments that accompanied it. Extensive changes have been made since 1995, both in the statutory language and the comments, in response to specific concerns that Mr. Misheff expressed about them. The bottom line, however, when considering the possibility that a trustee who operates under the prudent investor rule may wind up with a fine total return but only a small amount of dividend and interest income, is that typical principal invasion provisions in existing trust instruments will frequently be inadequate to solve that problem, and that is why Section 104 is needed to give the trustee a power to adjust from principal to income in such a situation.

Sincerely,

E. James Gamble

EJG/njf