

Explanation of the Uniform Prudent Investor Act

Table of Contents

Introduction	2
California's Uniform Prudent Investor Act	2
Criteria for Investment and Management of Trust Assets (Probate Code Section 16047):	3
Duty to Diversify Trust Investments (Probate Code Section 16048)	4
Delegation of Trustee Duties (Probate Code Section 16052)	5
Duty to Review Trust Assets (Probate Code Section 16049)	6
Documentation of Decisions	6
Tips For Following the UPIA	6
Should You Modify Your Trust?	7
California Probate Code Sections 16045-16054 - Uniform Prudent Investor Act	8

Introduction

The Uniform Prudent Investors Act (UPIA) was a very important change in California trust law. Trustees, as well as persons who advise trustees and those who just have continuing contact with trustees should be aware of the law's effect. It puts a spotlight on investments made by the trustee and may create a large potential for lawsuits against trustees (and their advisors) who ignore the law!

Sources of Trustee Duties and Powers

In addition to the terms in each trust that the trustee must follow, most trusts include a list of powers of the trustee; these powers may be unique to each trust. The California Probate Code sets forth statutory duties for trustees (Probate Code Sections 16045-16054) as well as trustee powers (Probate Code Sections 16200-16249). Federal law also imposes the following responsibilities on a Trustee:

- Requirements to file annual income tax returns;
- Personal liability for payment of any unpaid estate tax on assets directed elsewhere, e.g., distributed to trust beneficiaries.

California's Uniform Prudent Investor Act

The California Uniform Prudent Investor Act is patterned on the Uniform Prudent Investor Act now codified in ten states. The UPIA made five basic changes in the criteria for prudent investing (some of which were already accepted in California):

1. **Portfolio:** The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. (For some years California has recognized a total portfolio approach to investments.)
2. **Risk:** The trustee's central consideration is the tradeoff in all investing between risk and return. The UPIA sets forth criteria for investment and management of trust assets and codifies modern trust investment principles.
3. **Investments:** Restrictions on types of investments are eliminated. 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 investment.
4. **Diversification:** The trustee's traditional duty to diversify trust investments is codified in the UPIA. (In California, the duty to diversify was previously recognized only in case law.)

5. **Delegation:** The UPIA rejected the traditional trust rule that generally prohibited delegation of duties by the trustee, especially the duty of investment of trust assets. Delegation is now permitted, subject to safeguards. Agents are now made specifically liable for not following the new law.

Criteria for Investment and Management of Trust Assets (Probate Code Section 16047):

The UPIA abandons the former premise that certain property is not a proper trust investment and must be disposed of. The trustee is specifically authorized to invest in any type of property or investment strategy consistent with the UPIA as long as the overall mix of assets is satisfactory. Decisions as to the retention and disposition of assets are to be evaluated not in isolation but in the context of the entire trust portfolio and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust. For example, a "risky" stock that may have previously been considered an imprudent investment might be part of a prudent portfolio if it provides significant potential for growth.

A change in the analysis of risk is a cornerstone of the UPIA. Risk is viewed as unavoidable. Even fixed income investments involve risk in the sense that they may lose purchasing power as a result of inflation. Risk is often desirable so long as it is sufficiently compensated. An investor can get a greater return if he is willing to accept a greater risk; for example securities, are riskier than cash, but yield a greater return.

The standard of prudence under the UPIA is not based on risk alone, but on considerations of the appropriateness of the level of risk under all of the circumstances. The UPIA seeks to compel trustees to analyze the tradeoffs between risks and returns, taking into consideration the needs and objectives of the trust. The trustee should then choose the portfolio level of risk and anticipated return appropriate to the trust.

The UPIA (Probate Code Section 16047, et seq.) outlines specific circumstances that are appropriate to consider in investing and managing trust assets:

- General economic conditions
- Possible effect of inflation or deflation
- Expected tax consequences of investment decisions or strategies
- Role of each investment or action within overall portfolio
- Expected total return from income and capital appreciation
- Other resources of the beneficiaries
- Needs for liquidity, regularity of income, and preservation or appreciation of capital.
- Special relationship or value of an asset, to the trust or beneficiary.

The UPIA requires a fairly formal process of information gathering -- including soliciting information from beneficiaries -- and an overall plan for achieving the investment goals of the trust. Documenting the investment strategy is clearly a good idea, since a trustee who can prove that he or she has properly complied with the statute is protected from liability from negative investment results. Probate Code Section 16051 provides that compliance with the statute is not determined by hindsight. In other words, while a trustee must act reasonably when he or she makes investment decisions; he or she is not expected to predict future events.

Duty to Diversify Trust Investments (Probate Code Section 16048)

The UPIA creates a duty in the trustee to diversify investments unless, under the circumstances, it is not prudent to do so. The reason for the diversification requirement is to reduce the risk inherent in investments. In addition, the trustee has a duty to be impartial as between income and remainder beneficiaries, as the interests of these two types of beneficiaries may conflict. The theoretical solution to this conflict is a portfolio that is well diversified and holds assets that can produce income as well as principal appreciation.

Generally the duty to diversify pertains to both the variety of industries invested in (e.g. health care, communications) and the variety of types of investments (e.g. real estate, bonds, stocks, cash). The theory is that different types of investments respond in different ways to economic and other changes and that diversification increases the possibility that losses in one investment will be mitigated by gains in others. Over time, diversification reduces the overall volatility of the portfolio.

General trust law makes it clear that, unless the trust instrument provides otherwise, a failure to extensively diversify an investment portfolio will be a breach of trust in most cases. Excessively conservative investment strategies (for example, all cash and Treasury Bills) may violate the prudent investor standard, as such investments expose the remainder beneficiaries to an inevitable reduction in purchasing power as a result of inflation.

The provisions of the trust may expand or restrict the prudent investor rule. This means that the trustee may not be required to follow certain aspects of the UPIA, if the trust instrument allows this and the trustee is following the trust terms in good faith. For example, many trusts allow the trustee to retain trust property received from the trustor (the creator of the trust) even if such investment does not constitute a diversification. Typically, this might include the retention of sentimental assets such as a residence or a family business. It is imperative for the trustees to carefully review the trust instrument to see if it has unusual investment requirements or waiver of normal investment rules. For example, some very cautious trustors may limit investments to cash or government-backed securities.

Delegation of Trustee Duties (Probate Code Section 16052)

Under traditional trust rules a trustee was prohibited from delegating acts that the trustee could reasonably be required to perform personally. This rule generally meant that a trustee could delegate ministerial duties (i.e. clerical or administrative duties) but could not delegate discretionary duties (i.e. acts that a business person would consider important and within his or her own capacity so that he or she must perform such acts personally). For example, under the traditional rule, the trustee of a trust holding investment real property might delegate day to day property management duties to an agent, but must retain decision making as to major repairs, lease terms and sales.

The UPIA reverses the prior law and specifically allows a trustee to "delegate investment and management functions as prudent under the circumstances." (Probate Code Section 16052.) The change in the trust law was motivated by changes in investment vehicles.

Traditionally, trusts were created to hold ancestral land. Trust administration required little experience or authority by the trustee, who was mostly a mere stakeholder. The trustee held the land for the use and benefit of one generation, and arranged for the land to be passed on to the next generation. By contrast, today's trusts often serve as sophisticated investment vehicles in complex markets. The diversity of modern trust investments requires a level of skill and knowledge beyond that of most individual trustees (and even beyond some institutional trustees).

Underlying the UPIA is the "modern portfolio theory" of investments -- a radical reordering of the acceptable modes of investment. Under modern portfolio theory, investment performance is evaluated on the basis of the performance of the entire portfolio, rather than the performance of a single investment. This theory seeks to minimize risk by encouraging the diversification of investments. This emphasis on overall performance and diversification requires a high level of expertise by the investor, one that many individuals do not have. (This is a reason that, in selecting a trustee to manage the trust, the trustor should consider the skills and knowledge of the named individuals to be sure they can handle the job of trustee appropriately.)

Probate Code Section 16052 specifically requires that, in delegating investment and management functions, the trustee must exercise care, skill and caution in:

- Selecting the agent
- Establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust (an engagement letter is recommended)
- Monitoring the agent's performance

Trustees who relinquish investment control under the UPIA limit their liability for the acts

of agents with regard to investments, as long as they carefully carry out the above duties.

The UPIA creates duties and liabilities for the investment agent. The agent has a duty to exercise reasonable care to comply with the terms of the delegation. By accepting the delegation of a trust function from the trustee, the agent submits to the jurisdiction of California courts. However, since most brokerage account agreements include a provision which requires disputes to be resolved by arbitration, there is a question as to the applicability to brokerage houses of the requirement that the agent submit to the court's jurisdiction.

Duty to Review Trust Assets (Probate Code Section 16049)

In order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust and the requirements of the UPIA, a trustee is required to review the trust assets and make and implement decisions concerning the retention and disposition of assets within a reasonable time after accepting a trusteeship or receiving trust assets. For new trusts, a "reasonable time" is not yet determined, but it probably will not exceed one year.

Documentation of Decisions

In fulfilling its delegation duties, the trustee should document each decision, including investment decisions, and include such documentation in the trust records. Investment and delegation decisions should be memorialized at the time they are made.

A Trustee can significantly limit his or her liability by sending beneficiaries a memorandum regarding proposed decisions and obtaining their consent prior to the investment or delegation.

In selecting an investment advisor, the trustee should interview several advisors and articulate in the trust record why one advisor was chosen over the others. A local probate judge has stated that he would be looking for trustees to keep a regular written record of their actions. Therefore, it is advisable for trustees to make an annual written report to reflect that the investment portfolio has been reviewed and careful thought has been given to all investment decisions and other actions.

Tips For Following the UPIA

- Read the trust instrument to see if diversification or other normal investment rules are specifically waived or if unusual investment rules are set out.
- The trust instrument controls -- even if it says to invest only in Treasury Bills.

- Check to see if assets originally owned by the trustor may be kept, including non-productive assets.
- Many Family Trusts specifically provide that the welfare of the surviving spouse is paramount in making investments; check to see if this applies. However, it is not clear that this waives the diversification requirement -- probably not! -- although it may be effective to waive the requirement for balance between the income beneficiary and the remainder person. If the trust does not favor the income beneficiary over the remainder persons, then the surviving spouse, as trustee, may have to sell some high income assets to purchase growth assets in order to benefit the children.
- The trustee should have a written plan for investment of the trust assets and make a written analysis of the existing assets and the basis for retention.
- A waiver of accounting in the trust does not obviate the need for a written investment plan.
- Obtaining written approval of current and future trust beneficiaries to the investment plan may avoid future lawsuits.

Should You Modify Your Trust?

Consideration should be given to amending revocable trusts to waive all investment requirements, spell out the paramount goal of benefitting the surviving spouse (without regard to remainder persons) and to add a specific provision waiving any need for diversification. However, if children from prior marriages are remainder persons, it may be appropriate to let the normal rules remain in place.

For trusts that are no longer revocable, and which do not have sufficient provisions to make the welfare of the surviving spouse paramount, consider seeking a court modification of the trust while the remainder persons are loving children rather than money hungry grandchildren or surviving spouses of children.



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California Probate Code Sections 16045-16054
Uniform Prudent Investor Act

Section

- 16045. Prudent investor rule
- 16046. Duty of trustee to comply with rule
- 16047. Standard of care
- 16048. Trustee's duty to diversify investments of trust
- 16049. Review of assets to comply with requirements of chapter
- 16050. Permissible costs
- 16651. Determination of compliance with rule
- 16052. Delegation of investment and management functions
- 16053. Terms authorizing investments permitted under chapter
- 16054. Application of article

16045. Prudent investor rule

This article, together with subdivision (a) of Section 16002 and Section 16003, constitutes the prudent investor rule and may be cited as the Uniform Prudent Investor Act.

16046. Duty of trustee to comply with rule

(a) Except as provided in subdivision (b), a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule.

(b) The settlor may expand or restrict the prudent investor rule by express provisions in the trust instrument. A trustee is not liable to a beneficiary for the trustee's good faith reliance on these express provisions.

16047. Standard of care

(a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

(b) A trustee's investment and management decisions respecting individual assets and courses of action 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 are appropriate to consider in investing and managing trust assets are the following, to the extent 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.
- (5) The expected total return from income and the appreciation of capital.
- (6) Other resources of the beneficiaries known to the trustee as determined from information provided by the beneficiaries.
- (7) Needs for liquidity, regularity of income, and preservation or appreciation of capital.
- (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 ascertain facts relevant to the investment and management of trust assets.

(e) A trustee may invest in any kind of property or type of investment or engage in any course of action or investment strategy consistent with the standards of this chapter.

16048. Trustee's duty to diversify investments of trust

In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.

16049. Review of assets to comply with requirements of chapter

Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of this chapter.

16050. Permissible costs

In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, overall investment strategy, purposes, and other circumstances of the trust.

16051. Determination of compliance with rule

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.

16052. Delegation of investment and management functions

(a) A trustee may delegate investment and management functions as prudent under the circumstances. The trustee shall exercise prudence in the following:

- (1) Selecting an agent.
- (2) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust.
- (3) Periodically reviewing the agent's overall performance and compliance with the terms of the delegation.

(b) In performing a delegated function, an agent has a duty to exercise reasonable care to comply with the terms of the delegation.

(c) Except as otherwise provided in Section 16401, a trustee who complies with the requirements of subdivision (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.

16053. Terms authorizing investments permitted under chapter

The following terms or comparable language in the provisions of a trust, unless otherwise limited or modified, authorizes any investment or strategy permitted under this chapter: "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."

16054. Application of article

This article applies to trusts existing on and created after its effective date. As applied to trusts existing on its effective date, this article governs only decisions or actions occurring after that date.



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