PENNSYLVANIA BANKERS ASSOCIATION

TESTIMONY OF THE PENNSYLVANIA BANKERS ASSOCIATION

BEFORE THE

HOUSE JUDICIARY COMMITTEE

regarding House Bill 326, Printer's No. 329

Presenters: Richard H. Brown, Chairman
PBA Trust Legislative Committee
& Executive Vice President
York Bank and Trust Company

and

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Vice President
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Session of 1995

Good afternoon. My name is Dick Brown. I chair the Trust Legislative Committee of the Pennsylvania Bankers Association. I am also the Executive Vice President of the York Bank and Trust Company in York. With me today is Lou Sozio of PNC Bank in Philadelphia. We appreciate the opportunity granted to us to appear here today to state the concerns of the Pennsylvania Bankers Association about House Bill 326, Printer's No. 329 which would amend Title 20, the Decedents, Estates and Fiduciaries Code.

As the state bank trade association in Pennsylvania, PBA represents approximately 250 commercial and savings institutions ranging from the smallest to the largest in this Commonwealth. PBA's member institutions represent over 99% of the commercial banking assets in this state. The PBA's legislative policies are recommended by committees of specialists, such as the committee which I chair which focuses exclusively upon legislation and regulations which affect trust and estate administration. The PBA's legislative policies are determined by its State Government Relations Policy Committee which consists of bank chief executive officers and senior managers from member institutions of all sizes in a variety of locations. I also sit on the PBA's State Government Relations Policy Committee. These committees work very hard to review legislation assigned to them. They carefully consider the impact of bills not only from the perspective of the banking industry, but from the perspectives of the customers and communities we serve as well as the broader, public policy perspective.

Fiduciary replacement legislation, such as the bill before you today, is one of the issues which PBA has examined most closely. As you may know, the proposal contained in House Bill 326 is not new in concept. Senator Edwin G. Holl (R-Montgomery), Majority Chairman of the Senate Banking and Insurance Committee, introduced S.B. 1302 during the 1991-92 session. PBA testified in opposition to the bill at a hearing before that Committee on April 7, 1992. Senator Holl reintroduced his bill in the 1993-94 session as S.B. 43. S.B. 43 was assigned to the Senate Judiciary Committee and was never considered.

Senator Stewart Greenleaf (R-Montgomery), the Majority Chairman of the Senate Judiciary Committee and the Chairman of the Joint State Government Commission's Task Force on Decedents' Estates Laws, sponsored a revised version of this legislation in the Senate during the 1993-94 session as S.B. 1813. S.B. 1813 was assigned to the Senate Judiciary Committee and was never considered.

You may also be aware that a similar bill has been introduced this session in the Senate, S.B. 770. It is assigned to the Senate Judiciary Committee, chaired by the

bill's prime sponsor, Senator Stewart Greenleaf. Senator Greenleaf's staff informed PBA that the Chairman will not schedule the bill for Committee action unless and until a majority of his Committee members express support for the bill, and that has not been the case to date.

The proponent of this bill, the HEIRS® organization, has revised its technical provisions markedly over the years. These changes have not affected the PBA's view of this legislation. We remain adamantly opposed. Our opposition is based on the fact that the proposal ignores centuries of common and statutory law. Its enactment would do a grave disservice to Pennsylvania's citizens and their estate plans. We respectfully urge you to take the same position for these reasons which Mr. Sozio and I will more fully outline for you today.

Some basic background on trust administration might be helpful to you.

How do trusts operate?

Trustors create trusts to hold and manage property for the benefit of beneficiaries in accordance with the trustor's directions within the trust document. The duration of trusts is usually measured by a number of years or the lifetimes of the beneficiaries. Principal is the property that a trustee receives at the time a trust is created, and includes any substitutions or additions to it. Principal is paid over to the remainderman at the termination of a trust. Income is the return on principal which is paid to the income beneficiary and includes interest, dividends and rents.

Why do individuals establish trusts?

Trustors create trusts for a variety of reasons which may include the desire to obtain skilled, independent management of assets, provide for protection in case of disability, protect beneficiaries, achieve federal or state tax savings, streamline administration of assets, or preserve assets for a charitable remainderman after the needs of individual beneficiaries have been met. Trusts usually contain protective provisions which prevent a beneficiary from assigning his or her interest.

What is the trustee's responsibility?

In general, trustees have duties to collect and safeguard assets, provide a particular, definite disposition of assets on an on-going basis that cannot be changed absent extraordinary circumstances, collect income, keep records and make reports and make distributions in accordance with the trust instrument. The trustee may have the ability to make discretionary distributions ("sprinkle" income among a class of beneficiaries or use principal for the reasons specified by the trustor). However, Pennsylvania law is clear that the trustee is duty-bound to decline a beneficiary's request for more income or an allocation of trust principal inconsistent with the provisions of the trust document and the trustee's interpretation of the trustor's intent. Such a situation creates an inherent conflict between trustees and income beneficiaries.

Why do trustors select banks to manage trusts?

Banks and other corporate fiduciaries are often selected as trustees because they can provide flexible, sophisticated asset management expertise that individual trustees often cannot. This is because corporate fiduciaries have employees with specialized skills.

Banks also provide security to trustors for a variety of reasons, most of which are due to the fact that the banking industry is one of the most highly-regulated industries in America. Banks are currently subject to regulation by at least two federal regulatory agencies, and many face regulatory oversight and intervention by several more, including state bank supervisors.

This regulatory oversight requires banks to maintain extensive internal compliance and auditing functions to reduce their customers', and the federal deposit insurance fund's, exposure to loss. Banks and well-capitalized and typically maintain extensive liability insurance coverage. Individual trustees, on the other hand, generally are not subject to much regulatory oversight, if any, and lack capital adequacy which corporate fiduciaries must maintain. These are merely factual distinctions which PBA notes only because the House Bill 326 would address both corporate and individual fiduciaries. Banks generally accept a sharing of responsibility with individual co-trustees if that is the trustor's wish.

Perhaps the overriding reason banks are so often chosen by trustors is that they are perpetually objective and independent. Because they are institutions, even though they are staffed by individuals like Mr. Sozio and me, they are capable of a degree of objectivity that an individual trustee simply cannot achieve.

The proponents of this legislation seem to target banks in their campaign. PBA views this legislation as much broader than an attack on the banking industry -- we view it as an attack on individual trustors and their counsel. The proponents would have the Committee conclude that so much has changed in the banking industry that trustors' selection of particular bank trustees should be drawn into question.

PBA would like you to know that trust services provided by the banking industry have improved greatly over recent years due to advances in technology and the enhanced asset management capability that technology enables. That has freed trust officers from what used to be drudging detail work to providing an increased level of personal service to trust customers and beneficiaries.

How have PA appellate courts addressed fiduciary responsibility?

The Pennsylvania Supreme Court has held that removal is an extreme form of relief which should only be granted where the trust estate is actually endangered and intervention is necessary to save trust property.

Current Pennsylvania law

Pennsylvania law affords the Orphans' Courts the exclusive power to remove a corporate or individual trustee. The governing statutory provision[1] provides numerous grounds upon which an Orphans' Court may base its removal of a trustee. These circumstances address a trustee who is:

(1) wasting or mismanaging the estate, is or is likely to become insolvent, or has failed to perform any duty imposed by law, or

(2) incapacitated to discharge the duties of his or her office because of sickness or physical incapacity which is likely to continue to the injury of the estate; or

(3) has removed from the Commonwealth or has ceased to have a known place of residence therein, without furnishing such security or additional security as the court shall direct; or

(4) when, for any other reason, the interests of the estate are likely to be jeopardized by his or her continuation in office.

These conditions are also grounds for surcharge as provided by other sections of the Probate Code. (Surcharge is a proceeding under which a trustee can be forced to reimburse a trust or its beneficiaries for some breach of fiduciary responsibility.)

Why is the PBA against legislation which the proponents couch as merely providing trust "portability?"

This legislation would do much more than merely provide "portability." Any attempt to categorize it so simply or to call it trust "reform" is simply disingenuous.

"Portability" sounds nice, and PBA acknowledges that shifting a trust from one fiduciary's management to another's is sometimes indicated. The fact is that "portability" is already fully possible under current Pennsylvania fiduciary performance standards and the statutes governing trusts.

First of all, a trustor is free, subject to certain tax law constraints, to provide for successor trustees and the circumstances under which they may be empowered. As an alternative, an individual who merely seeks tax shelter and limited liability for his or her progeny could consider establishing an outright limited partnership to govern his or her assets with the limited partners (beneficiaries) granted the right to vote the general partner out of office. Frankly, that is not usually what the trustor wants to do.

[1] 20 Pa.C.S.§ 3182 (regarding personal representatives made applicable to trustees by §7121)

Second, "portability" implies that freedom to change trustees is necessarily good. Freedom to change the trustee at the whim of the current income beneficiaries is often exactly what the trustor wished to draft against. The trustor would not have established a trust in the first place if he or she wished to substitute the desires of the beneficiaries, or their spouses, friends and others who may seek to influence them, for the trustor's own legacy plan.

Let's not forget, the purchaser of trust services -- the one to whom the fiduciary owes its first duty -- is the trustor, not the beneficiary. Trustors are often able to see in their progeny characteristics that those heirs do not, or cannot, acknowledge. Many of yesterdays and today's trust customers are "self-made" individuals who amassed their fortunes through old-fashioned hard work. If they wanted to hand that wealth directly to their heirs they could, but they have chosen not to for a variety of reasons. Some of those reasons are obvious, such as the fact that they may prefer that their children and grandchildren work for their basic living, with trust income only as an additional support for specified needs or emergencies, with the remainder eventually designated for other family members or a favorite charitable cause.

Trustors may be guarding against their heirs' use of accumulated wealth to fund devastating addictions such as gambling or other risky financial speculation, or drugs. The point is that Pennsylvania law and the law of most other states has refused to substitute the desires of current trust beneficiaries for the considered wisdom of their ancestor trustors and the counsel and financial experts who advised them.

Changes proposed by H.B. 326

An examination of each of the new criteria proposed by the HEIRS® group demonstrates how their application could completely change the controlling trust law of Pennsylvania and subvert the intent of trustors.

The proposal would add a new § 7122 which would substitute the judgment of the current beneficiaries of a trust for that of the Orphans' Court. Under the proposal a simple majority of beneficiaries of a trust could vote to require a court of common pleas to appoint a "special disinterested individual trustee," who would then have the power to remove and replace the existing corporate or individual trustee, whether grounds for removal exist under § 7121 or not. This vote would be weighted in favor of the current income beneficiaries of the trust and against the remaindermen who are still awaiting their shares.

The appointed "special trustee" contemplated by the proposal would make his or her removal decision based upon nebulous and unmeasurable criteria:

(1) the working relationship between the trustee and the petitioners has become sufficiently impaired,

(2) trustee compensation is sufficiently excessive,

(3) administrative or investment performance has been sufficiently substandard.

Why is the current proposal so objectionable?

Current law rests its protection on the principle of allowing a donor to condition his or her bounty as suits himself as long as he violates no law in doing so.[2] This long-standing and central principle of Pennsylvania law would be reversed by enactment of the proposed legislation. Let's examine each of the bill's criteria more closely.

"The working relationship between the trustee and the petitioners has become sufficiently impaired." -- This criterion of the proposed statute would subordinate the primary relationship between the fiduciary and the trustor to the relationship between the trustor and the petitioners. Trustees are duty-bound to carry out the wishes of a trustor, and those wishes might not please the beneficiaries. For example, a grandchild might resent that his or her grandfather created a trust for his or her benefit during life and later for a future generation or a charity rather than allowing the grandchild to inherit the entire estate outright. That resentment might spill over to affect the "relationship" the beneficiary has with the independent trustee whom the grandfather selected to invest, manage and maintain the trust. It is entirely conceivable that the grandchild would like to see a trustee who is following the grandfather's wishes replaced in favor of one who might be more susceptible to improper influence by the grandchild or his or her spouse. The grandfather chose an independent trustee to avoid exactly that.

"Trustee compensation is sufficiently excessive." -- This nebulous standard should not be allowed to replace the considered and well-reasoned fiduciary compensation standards which are currently the law in Pennsylvania. In addition, the mandatory exclusive jurisdiction of the Pennsylvania Orphans' Courts over the issue of reasonable trustee compensation should not be delegated to an appointed individual. Current law provides that fiduciary compensation is tested by a combination of factors including the labor involved, risks and responsibilities incurred, the results achieved for trustors or beneficiaries and prevailing market rates.

"Administrative or investment performance has been sufficiently substandard." As noted above, Pennsylvania law currently grants the Orphans' Court the power to remove and replace a fiduciary when there is waste or mismanagement of the estate or its interests are otherwise jeopardized. The substitution of a vague standard such as this would be a serious public policy mistake. Fiduciaries are bound to invest according to prevailing law as that might be varied by specific directives of trustors. This standard completely disregards those facts.

The current fiduciary investment standard in Pennsylvania is the "prudent person rule" which requires the fiduciary to make investment decisions in the manner in

[2] Morgan's Estate, 223 Pa. 228 (1908).

which a prudent person would if managing his or her own funds. This standard has always been viewed as risk-averse and conservative.

Pennsylvania will soon be faced with a decision whether to adopt uniform legislation which would cause a change in this investment standard to a "prudent investor" standard which judges a fiduciary's investment performance under modern portfolio investment theories which allow the trustee to determine the risk and return objectives reasonably suited to a trust as if the trust were a separate entity rather than a combination of relationships with multiple beneficiaries with potentially differing interests.

PBA believes that the issue of fiduciary investment standards and performance should not be addressed in the context of fiduciary replacement legislation supported by individual beneficiaries with their own agenda which may be in conflict with that of the trustor, but instead should be left to the day when the broad issue of fiduciary investment standards can be considered in light of a new uniform statute which has the recommendation of the National Conference of Commissioners on Uniform State Laws (the "Uniform Prudent Investor Act").

Another objectionable aspect of the fiduciary replacement legislation is its provision which would disable corporate trustees from even arguing that the testator's intent was being subverted by its removal merely if ownership of the corporate trustee or its management had changed subsequent to the trust's creation. This is absurd. Given that many trustors establish trusts with the intent of their existing for long periods of time, the mere changeover in personnel at a financial institution should not determine whether it is time to replace the institution selected by the trustor.

In addition, the legislation would bar a trustee from seeking reimbursement for its costs in defending against a removal or surcharge action. This would constitute a reversal of existing law and would invite unjustified allegations against trustees. This would be a change in the direction opposite of the current trend toward the "English Rule" under which the prevailing party's costs are paid by the non-prevailing party. In fact, the legislation would require each trustee of an irrevocable trust to send a "notification of the provisions" of this legislation to each beneficiary at least once every five years for the duration of the trustee's management of the trust.

The most objectionable aspect of the proposed legislation is that it would apply to trusts created long before its effective date, including those of deceased trustors barring their ability to amend their trusts to include a specific directive that the trustee shall not be changed.

Conclusion

More than adequate protection is available under current law to redress actual cases of fiduciary neglect of the interests of beneficiaries. As pointed out earlier, trustors have always had the option of naming a successor trustee who would assume

the trust under specified circumstances. This legislation would enact complicated statutory burdens. It would undermine the right of individuals to provide protection of their legacies for the uses they ultimately intend. It would create a "causeless" cause of action and encourage needless litigation for which there is no judicial precedent. It would most certainly invite disputes among families which the already-overburdened courts are not equipped to manage under the nebulous standards outlined in this bill. It would eradicate ~~two hundred~~ 200 years of well-developed case law and remove authority from the expert Orphans' Courts and hand it to individuals. The end result of this legislation may well be to drive trustors to site their trusts, and their wealth I might add, in states other than Pennsylvania. The PBA certainly sees no public policy benefit in that relocation of wealth and businesses.

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This concludes PBA's prepared testimony. I thank you again for the opportunity to present PBA's views and urge you to reject this radical upheaval in Pennsylvania law which is not grounded upon any reasonable basis for change. The intent of the trustor should remain paramount under Pennsylvania law. Mr. Sozio and I would be glad to answer any questions you may have at this time or in the future.

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