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Fiduciary Administration: Retention of Investments and the Duty to Diversify

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RECENT DECISIONS

Fiduciary Administration—Retention of Investments and the Duty to Diversify: In *Will of Mueller*[1] the testator, as sole stockholder of Mueller Furnace Co., left shares of stock in the corporation in two testamentary trusts with the income of the first of these trusts to go to his widow for life and the corpus on her death to her children. The second testamentary trust was for the benefit of the children of a deceased son. The appellant, testator's son by a previous marriage, and the widow were named co-trustees of both of these trusts. Under another article of the testator's will, the appellant received some shares outright. Several years after the death of the testator, the appellant declared himself trustee of an *inter vivos* trust funded by some of the shares he had received outright—with the income to his father's widow for life and the remainder to her children.

In 1954 Mueller Furnace was merged into the Worthington Corporation, a large national corporation. As a result of the merger, all of the Mueller Furnace stock was exchanged for Worthington common stock. Thus, Worthington stock became the sole asset of each of the three trusts and remained so until 1963 when all of it was sold.

When the appellant petitioned the court for an approval of accounts for each of the trusts, objections were made by the beneficiaries of all of the trusts, including the widow who was also co-trustee under the two testamentary trusts. The trial court concluded that the trustees of the testamentary trusts and the trustee of the *inter vivos* trust should have diversified the investments within a reasonable time after a 1958 approval of accounts for the testamentary trusts, and that the trustees should have disposed of 80 percent of the Worthington stock in October or November of 1961. The court then surcharged the trustee of the two testamentary trusts, required the appellant-trustee to indemnify his co-trustee stepmother in full, and surcharged the appellant for the loss to the corpus of the *inter vivos* trust.

The theory of the trial court was that the appellant had failed to exercise prudence in light of his special knowledge. Such knowledge stemmed from the fact that the appellant, who had been president of Mueller before the merger, had been appointed a vice president and director of Worthington, and therefore he should have been aware of the anti-trust actions in the electrical industry and the profit squeeze in the capital goods industry during 1961. The conclusive fact which seemed to convince the court that the appellant had failed to act prudently was that the appellant had sold some of his personal holdings of Worthington stock in 1961 with knowledge of the "squeeze" and

[1] 28 Wis. 2d 26, 135 N.W. 2d 854 (1965).

"antitrust actions" without selling any of the stock held by the trusts or informing his co-trustee of the sale of his own stock.

In upholding the trial court's finding generally (though not with regard to the indemnification of the co-trustee), the Wisconsin Supreme Court first looked to statutory law. Chapter 320[2] is the trust fund investment statute; but, since it was completely revised in 1959,[3] the first question is whether the post-1959 or the pre-1959 statutes apply to the case. Since the action was commenced in 1963, presumably the statutory law in effect at that time would govern. Further, present law provides that:

> The provisions of this chapter shall govern fiduciaries, including executors, administrators, guardians, and trustees acting under will, agreements, court orders and other instruments *now existing* or hereafter made.[4] (Emphasis added.)

Because the case dealt with the duty of the trustees regarding the retention of investments, it would seem a reasonable construction under section 320.06 to apply the post-1959 statutes.

However, the application of pre-1959 statutes would not be completely without foundation since present law also states:

> Nothing contained in this chapter shall affect any investment made prior to the enactment hereof or any amendment hereof or *affect any rights or interests established, accrued or created thereunder* or affect any suit or action pending when this chapter or any amendment hereof becomes effective.[5] (Emphasis added.)

Because the trial court picked October 16, 1958, as the date when the trustees' duty arose to diversify within a reasonable time, it would be possible to interpret this to mean that the beneficiaries had a right established as of that date. If this was the case, then under section 320.04 the pre-1959 statutes would govern.

Another possible reason for the application of pre-1959 statutes would be that the trial court seemed to apply a pre-1959 statute when it found that the trustee should have disposed of 80 percent of the Worthington stock. According to prior law, which was repealed in 1959, investment in any one common stock was limited to 20 percent of the total trust fund.[6] The supreme court, however, did not apply the pre-1959 statutes. Rather it reasoned that:

> Since the trial court concluded that the Worthington stock in the trusts should have been sold in October or November, 1961, the provisions of this section [320.02(4), Stats., 1957] were

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[2] WIS. STAT. ch. 320 (1963).
[3] Wis. Laws 1959, ch. 233.
[4] WIS. STAT. §320.06 (1963).
[5] WIS. STAT. §320.04 (1963).
[6] WIS. STAT. §320.02(4) (1957).

not in effect at the time and have no bearing on any legislative standard of what is prudent.[7]

Thus, without ever referring to sections 320.04 or 320.06, the court's holding could be considered consistent with section 320.04 if the above statement of the court would be interpreted to mean that no right had been established in the beneficiaries until the time given the trustees to perform their duty to diversify had run.

After concluding that the post-1959 statutes were to govern, the next step would be to determine which sections would be applicable to the three trusts in the case. Section 320.01 deals with the investment of trust fund assets. The opening language provides that trustee should invest the trust fund in accordance with the investment provisions of the instrument under which they are acting. Lacking such provisions, this section sets up standards upon which the trustees are to act in the investment of the fund. The first subsection sets out the prudent man standard:

> (1) In acquiring, investing, reinvesting, *exchanging, retaining,* selling and managing property for the benefit of another, a fiduciary shall exercise the judgment and care under the circumstances then prevailing, which men 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.[8] (Emphasis added.)

Thus, this subsection establishes the general standard for the investment of trust funds including the situations of exchange and retention. The second subsection qualifies the first by limiting the holding in common stock to 50 percent of the total market value of the funds. This 50 percent rule seems, however, to be limited to the situation of the *initial* investment of funds and not their subsequent reinvestment.[9]

Applying section 320.01 to the case, the two testamentary trusts

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[7] 28 Wis. 2d at 38, 135 N.W. 2d at 861.

[8] WIS. STAT. §320.01(1) (1963).

[9] WIS. STAT. §320.01(2) (1963): "Nothwithstanding the provisions of sub. (1), a fiduciary shall not purchase or otherwise invest in common stocks if the percentage of the fund invested in common stocks immediately after such purchase or investment will exceed 50 percent of the total market value of the fund. The preceding sentence shall not be construed (a) to require the sale or other liquidation of a portion of a fund's holdings of common stocks even though at any given time the market value of the common stock investments of the fund exceeds 50 percent of the total market value of the fund, or (b) to prevent the reinvestment of the proceeds of the sale or other disposition of common stocks in other common stocks even though at the time the market value of the common stock investments of the fund exceed 50 percent of the total market value of the fund. A fiduciary may rely upon published market quotations as to those investments for which such quotations are available, and upon such valuations of other investments as are fair and reasonable according to available information."

would seem to come within the opening language because of the broad powers given the trustees in the instrument:

> My trustees *shall have power in their discretion* to take, receive, hold, administer, collect, *invest, and reinvest the assets of said trust estates,* with full power to bargain, sell, and convey at such prices and upon such terms as to them may seem best, or to exchange or otherwise realize upon any or all of the assets of said trust estates *as and when said trustees, in their discretion, deem it advisable.* . . . (Emphasis added.)[10]

Thus the court concluded that "the standards set forth in section 320.01(1) and (2) of the Wisconsin Statutes, do not apply to the two testamentary trusts in view of the authority vested in the trustee by the provisions above cited."[11]

The *inter vivos* trust instrument did not contain any such investment provision and so it would seem that the statutory standards of section 320.01(1) would apply. Further, the 50 percent standard of section 320.01(2) might be applicable if the exchange of Worthington stock for the Mueller stock would be interpreted to be within the scope of "purchase or otherwise invest" as set out in the section. However, a qualification in section 320.01(2)(b) might be applied to relieve the trustee of the duty of following the section. That qualification excludes the reinvestment of the proceeds of the sale or other disposition of common stock from the 50 percent rule. Thus, if the exchange of stock is viewed as being within the scope of "reinvestment of the proceeds," then section 320.01(2) would not apply.

The next section which could possibly apply, although not referred to by the court, would be section 320.05, which deals specifically with the retention of securities.[12] It provides that a trustee would not be required to dispose of any property except upon the discretion of the trustee, but that this discretion must be exercised at reasonable intervals. The section would seem applicable to the retention of any property by a trustee, no matter how the property was acquired. The problem with this statute is to see how it relates to section 320.01.

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[10] 28 Wis. 2d at 35, 135 N.W. 2d at 859.

[11] *Id.* at 38, 135 N.W. 2d at 861. The court here relied upon *In Re Allis's Estate,* 123 Wis. 223, 225, 101 N.W. 365, 367 (1904): ". . . full power and authority in their discretion to invest, reinvest . . . ." and *Welch v. Welch,* 235 Wis. 282, 294 n.1, 290 N.W. 758, 763 n.1, 293 N.W. 150 (1940): "trustees . . . shall have full power to grant, bargain, sell, convey . . .. and to invest and re-invest the proceeds of any sales . . . ."

[12] WIS. STAT. §320.05(1) (1963): "Unless the trust instrument or a court order specifically directs otherwise, a trustee shall not be required to dispose of any property, real or personal, or mixed, in the estate or trust, however acquired, until the trustee determines in the exercise of a sound discretion that it is advisable to dispose of the same; but nothing herein contained shall excuse the trustee from the duty to exercise discretion at reasonable intervals and to determine at such time the advisability of retaining or disposing of such property."

Section 320.01 seems to set up a general standard for reinvestment, including retention, as a prudent man standard while section 320.05 sets up a discretionary standard as a specific exception regarding retention.

If this statute would have been applied to the property acquired by the exchange of stock in the case, then the trustees would have had a duty to exercise discretion at reasonable intervals in determining the advisability of retaining the trust property. Conceivably, a court could have found that the trustees in this case had breached the trust by not exercising this discretion at reasonable intervals. However, the opening language of section 320.05 purports to provide a method for circumventing the standard set up in the statute. The section begins: "Unless the trust instrument or a court order specifically directs otherwise. . . ." Thus, by including some provisions in the trust instrument, a trustee can be relieved of the duty of following the statute. Exactly what type of provision would effectively circumvent section 320.05 is not entirely clear, but presumably an unqualified direction to retain certain investments would prohibit a fiduciary from exercising any discretion.

There would seem to be no reason why section 320.05 would not be applicable to the *inter vivos* trust. Furthermore, even the two testamentary trusts would seem to be within the section because there were no provisions in the instrument specifically directing retention of shares received in a stock exchange. Unfortunately, the court did not refer to section 320.05 and so the decision offers no guidance as to its scope and application.

Instead of applying section 320.05, the court relied on common law rules of trust administration. The court quoted the *Restatement* (1) concerning the general duty to diversify trust investments,[13] and (2) the duty of a trustee to dispose of undiversified assets included in the trust at the time of its creation.[14] This second rule seems to establish an unqualified duty to diversify as soon as the trust is created. Had the court relied on this rule it would have normally found the duty to diversify to have arose in 1954 as to all of the trusts because there was no direction to retain anything but the Mueller stock in the testamentary trust instruments. Presumably, the court felt that it had

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[13] RESTATEMENT (SECOND), TRUSTS §228 (1959): "Except as otherwise provided by the terms of the trust, the trustee is under a duty to the beneficiary to distribute the risk of loss by a reasonable diversification of investments, unless under the circumstances it is prudent not to do so."

[14] RESTATEMENT (SECOND), TRUSTS §230, comment *j* (1959): "*Diversification.* Except as otherwise provided by the terms of the trust, the trustee is under a duty to the beneficiary to distribute the risk of loss by disposing of investments included in the trust at the time of its creation which, although otherwise proper investments for the trustee to retain, are improper because not properly diversified."

to give effect to the 1958 approval of the two testamentary trusts. Because the court used the language of acting prudentially, they may well have relied on the first, more general rule of the Restatement.

There seems to be several reasons for the court to apply the common law rules rather than the statutory rules. First, the trustees of the two testamentary trusts were relieved of the duty to comply with section 320.01 because of the investment provisions in the trust instrument. However, this did not free the trustees from all duties regarding investment. Rather the court held that the trustees were still required to act as prudent and provident persons would act under similar circumstances and that what is prudent is governed by the common law rules regarding diversification.[15] Thus, the trustees are still bound to a prudent man standard. The only practical effect of the instrument provisions in the testamentary trusts would seem to be that the trustees were relieved of the duty of following the 50 percent rule set out in section 320.01(2).[16]

Second, regarding the *inter vivos* trust, the court initially said that section 320.01 did apply and thus, the common law rules did not apply. However, the court then stated:

> Since the trial court concluded that the stock in all three trusts should have been diversified to the extent of 80 percent of the holding of Worthington, the statutes, *even as to the* inter vivos *trust,* do not control what is prudent, and the determination as to whether or not the conduct of the appellant was prudent, in the last analysis, is governed as to all three trusts by the fundamental rules regarding diversification.[17] (Emphasis added.)

There seems to be two possible explanations of this apparent inconsistency. The first is that if section 320.01 is viewed as an incorporation of the common law prudent man standard, then, regardless of whether the statute applies or not, the standard is the same.[18] The second explanation would be that the court was looking for a specific percentage standard which would establish, as a matter of law, what was prudent. An example of what they seemed to be looking for would be the 20 percent figure used in the statutes prior to 1959.[19] In the presently effective statutes the only such standard is the 50 percent standard in section 320.01(2). This section, however, seems only to apply to an initial investment situation and so would not be relevant in the case of retention.

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[15] 28 Wis. 2d at 36, 135 N.W. 2d at 859. Here the court relies on *Welch v. Welch,* 235 Wis. at 314, 290 N.W. at 772 (1940), and also *Estate of Allis,* 191 Wis. 23, 33, 209 N.W. 945, 949, 210 N.W. 418 (1926).

[16] Note, Trusts—Fiduciary Administration—Prudent Man Rule 1960, WIS. L. REV. 142, discusses section 320.01 and concludes that the statute is a codification of the common law prudent man rule.

[17] 28 Wis. 2d at 38, 135 N.W. 2d at 861.

[18] This reasoning follows the analysis in note 16 *supra.*

[19] WIS. STAT. §320.02(4) (1957).

Failing to find any set standard in the statutes, the court resorted to the common law in order to be able to uphold the trial court's finding that 80 percent of the Worthington stock should have been sold. The question left unanswered is whether the could could have reached the same result by applying section 320.05 without ever resorting to the common law rules.

In conclusion, the *Mueller* case shows that a broad powers investment provision in a trust instrument will only relieve a trustee of the duty of following the 50 percent rule of section 320.01(2). Further, because the court failed to refer to section 320.05, the scope and application of that section, and its relation to the general standard of section 320.01, is left unclear.

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