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# Recent Decisions: Trusts: Discretionary Power to Allocate Receipts to Income or Principal: Abuse of Discretion

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**Trusts: Discretionary Power to Allocate Receipts to Income or Principal: Abuse of Discretion** — In *Will of Clarenbach*[1] testatrix created a testamentary trust and named her son and daughter as co-trustees. The trustees were also life beneficiaries of the trust income, and their children had a remainder interest in the trust corpus. While the provisions of the will included no express authorization to invade corpus for the benefit of the life beneficiaries, the trustees were given the following discretion as to the allocation of receipts between income and principal:

> I hereby grant to my executors[2] the power to determine how all receipts, whether realized or accrued (inclusive of stocks, rights, securities received upon reconversion or upon reorganization, or other securities) and all disbursements, whether paid or accrued, shall be charged or apportioned as between income and principal in making current or final distributions, and the decision of the executors shall be final and not subject to question by any court or by any beneficiary hereof.

A dispute arose when the trustees petitioned for the allowance of their accounts and for instructions for making future allocations of capital gains. Included in the 1962 account was a net capital gain of $19,858.63 realized on the sale of certain securities. The account showed that $5000 of this amount had been distributed to each of the trustees. The minor remaindermen, by their guardian *ad litem,* objected to these distributions.

The trial court held that the capital gains were properly principal and that the trustees had exercised their discretion unreasonably by allocating $10,000 of such gains to themselves as income. The trustees appealed, contending that whether or not they considered the capital gains to be income or corpus, they had a discretionary power to allocate them to income. The fact that they allocated only approximately one-half of the gain to income, they contended, refuted any charge of their having abused their discretion. A bare majority of the Wisconsin Supreme Court disagreed, holding that the trustees were required to first make a good faith determination whether any of the capital gains were income or principal.

It has been stated generally that "where discretion is conferred upon the trustee with respect to the exercise of a power, its exercise is not subject to control by the court, except to prevent an abuse by the trustee of his discretion."[3] In dealing with a contention that a trustee has abused his discretion it would seem that the degree of discretion

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[1] 23 Wis. 2d 71, 126 N.W. 2d 614 (1964).

[2] While the clause speaks of executors rather than trustees, it was conceded that the trustees succeeded to the same discretionary powers.

[3] RESTATEMENT (SECOND), TRUSTS §187 (1959); *accord,* Will of Razall, 243 Wis. 152, 154, 9 N.W. 2d 639, 640 (1943).

conferred upon the trustee would be of primary importance. A recent study suggests classification of discretionary powers as *simple* or *extended*.[4] A grant of "discretion" or authorization to exercise "judgment" would fall into the classification of simple discretion, while addition of words to the effect that the discretion is to be "absolute," "final," or "uncontrolled" would extend the discretion thus granted. In simple discretion cases it is well settled that a trustee must act reasonably in his exercise of discretion in order to avoid judicial intervention. But when the grant is of extended discretion, the *Restatement of Trusts*' position is that the test of reasonableness is dispensed with:

> These words are not interpreted literally but are ordinarily construed as merely dispensing with the standard of reasonableness. In such a case the mere fact that the trustee has acted beyond the bounds of a reasonable judgment is not sufficient ground for interposition by the court. . . .[5]

As the *Restatement* points out, the exercise of such a power is not completely free from judicial control. "Absolute" discretion would be absolute possession, and the separation of legal and equitable title essential to a trust would be lost.[6] Rather, in such a case the *Restatement* standard is a "state-of-mind" test. Simply stated, the test is this: at the time he exercised his extended discretionary power, was the trustee acting in a state of mind contemplated by the settlor?[7] It must be emphasized that the state of mind looked for is that of the trustee. This state of mind is then tested in the light of the settlor's intent as reflected in the instrument and the circumstances.[8] "Thus, the trustee will not be permitted to act dishonestly, or from some motive other than the accomplishment of the purposes of the trust, or ordinarily to act arbitrarily without an exercise of his judgment."[9]

While these distinctions are fairly clear in the abstract, attempts to apply them to given fact situations, particularly in extended discretion cases, often meet with difficulty. It has been argued that there is in fact no distinction in kind between the tests applied in extended and simple discretion cases, but rather that the test is that of the reasonable man in all cases.[10] The only effect of words extending discretion is that in extended discretion cases a greater range of actions appear reasonable. Another difficulty may arise in determining if the particular words used are words of simple or extended discretion.

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[4] Halbach, *Problems of Discretion in Discretionary Trusts*, 61 COLUM. L. REV. 1425 (1961).
[5] RESTATEMENT (SECOND), TRUSTS §187, comment *j* (1959).
[6] 54 AM. JUR. *Trusts* §36 (1945); BOGERT, TRUSTS AND TRUSTEES §162 (1935).
[7] RESTATEMENT (SECOND), TRUSTS §187, comment *j* (1959); see also BOGERT, TRUSTS AND TRUSTEES §560 (2d ed. 1960).
[8] Miller v. Douglass, 192 Wis. 486, 492, 213 N.W. 320, 322 (1927).
[9] RESTATEMENT (SECOND), TRUSTS §187, comment *j* (1959).
[10] Halbach, *supra* note 4; see also BOGERT, TRUSTS AND TRUSTEES §560 (2d ed. 1960).

Wisconsin's treatment of simple discretion can be seen in *Will of Hafemann,*[11] where trustees were authorized to invade corpus if necessary for the support of the settlor's widow "should the income alone prove insufficient in the judgment of said trustees."[12] Despite illness and extraordinary medical expenses, the trustees refused to invade corpus to enable the widow to deal with the emergency situation. The trustees contended that the beneficiary's income from all sources since her husband's death was sufficient to meet her expenses. The court held against the trustees in an action by the widow's administratrix:

> We conclude that in the situation as it was presented and known to them, these trustees acted beyond the bounds of a reasonable judgment when they considered only the entire period from date of testator's death to date of beneficiary's death as the period of calculation of expense and income, and that their action in such respect amounted to an abuse by them of their discretion. When trustees act outside the bounds of a reasonable judgment, the court may interfere.[13]

In *Estate of Wells,*[14] the earliest extended discretion case in Wisconsin, and on its facts quite similar to *Clarenbach,* the settlor left a large financial empire which he obviously desired to preserve intact as a monument to his industry. His trustees were given "final" discretion in apportioning cash dividends from corporate stock between income and principal. While admitting that the trustees had acted in good faith, the income beneficiaries contended that too much had been allocated to corpus. The supreme court held that the trustees had acted properly, stating:

> It is doubtless true that the executors in dividing the dividends received by them between income and *corpus* took good care to make such a division as would render it certain that the estate should not be diminished. . . . The testator placed the most implicit confidence in them, and gave them the fullest and freest control over the property . . . and he further said specifically in item 23 that 'the judgment and decision of my said executors and trustees respectively shall be *final* in ascertaining how much of every dividend received upon shares of capital stock shall be considered as income received from the profits of the corporation for that year upon the capital invested.' . . . In view of all these considerations, we cannot doubt that he concluded to make the executors' decision final and conclusive on every beneficiary. It was perfectly competent for him to do so, and it is the duty of the courts to see that his wish is fully carried out. *In the absence of bad faith, fraud, or mere arbitrary action (neither of which is claimed), the executors' determination must be held conclusive.*[15] (Emphasis added.)

[11] 265 Wis. 641, 62 N.W. 2d 561 (1953).
[12] *Id.* at 642, 62 N.W. 2d at 562.
[13] *Id.* at 646, 62 N.W. 2d at 564.
[14] 156 Wis. 294, 144 N.W. 174 (1914).
[15] *Id.* at 305-06, 144 N.W. at 178.

In *Estate of Teasdale*[16] the court purported to adopt the *Restatement* view that trustees with "final and conclusive" discretion could not be held to the test of reasonableness. In that case one of the trustees was also a beneficiary, and the will provided a formula for the determination of each beneficiary's share of the estate. When the trustees, given discretion in determining the value of the assets, inserted figures into the formula obviously intended to favor the trustee-beneficiary, the court said:

> The trustees submit that their discretion in adopting values is conclusive and the court may not substitute other values. The words of the will putting the acts of the trustees beyond review are not taken literally; otherwise a trustee would have power to destroy the trust. The words do dispense with the standard of reasonableness in judging the trustee's conduct but do not permit him to act dishonestly or act in a state of mind in which the trustor did not contemplate he would act.[17]

Again, in *Estate of Koos,*[18] the court held that when a trustee is clothed with absolute rights, powers, and discretions, "the test of 'reasonableness' or 'reasonable judgment' is not applicable,"[19] and "the court may interfere only with the bad faith, fraud or mere arbitrary action of such fiduciary."[20]

Prior to *Will of Clarenbach,*[21] therefore, the court had stated only limited grounds for overturning an exercise of extended discretion in addition to the state-of-mind test: bad faith, dishonesty, and mere arbitrary action.[22] It is not completely clear from the case which test was applied in *Clarenbach,* although the case is subject to either of two analyses.

First, it could be argued that the trustees failed to pass the state-of-mind test. The trustees were endowed with discretion which was to be "final and not subject to question." These are clearly words of extended discretion on their face, and the court began by searching for the intent of testatrix. The majority noted that the trust instrument was drafted prior to Wisconsin's adoption of the Uniform Principal and Income Act[23] in 1957. At the time of the drafting, therefore, Wisconsin

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[16] 261 Wis. 248, 52 N.W. 2d 366 (1951).
[17] *Id.* at 261, 52 N.W. 2d at 372.
[18] 269 Wis. 478, 69 N.W. 2d 598 (1955).
[19] *Id.* at 492, 69 N.W. 2d at 605.
[20] *Ibid.*
[21] 23 Wis. 2d 71, 126 N.W. 2d 614 (1964).
[22] The only possible exception found is Estate of Filzen, 252 Wis. 322, 31 N.W. 2d 520 (1948), in which a trustee granted "sole judgment and discretion" was required to act within the bounds of a reasonable judgment. The case is treated as an extended discretion case in Comment, 7 MERCER L. REV. 375 (1956). However, there may be a dispute as to whether certain words are sufficient to extend discretion, and the court in *Filzen* possibly felt that the words of the grant were insufficient to take it out of the class of simple discretion.
[23] WIS. STAT. §231.40 (1961).

still followed the Pennslyvania rule with regard to apportioning stock dividends.[24] This rule placed a considerable accounting burden on the trustee, encouraging disputed apportionments and expensive litigation. The majority concluded that this may have been one of the reasons why the testatrix gave the trustees a power to allocate which contained words of extended discretion. The majority was also influenced by the fact that the trustees were not authorized to invade corpus for the benefit of the life income beneficiaries. The apportionment of capital gains to income would have been in fact such an invasion. It could be argued, therefore, that the state of mind in which the testatrix intended that the trustees act was confidence that their apportionments would would be free from litigation. An invasion of corpus for the benefit of the income beneficiaries would clearly abuse this discretion.

On the other hand, the *Clarenbach* case can be explained as an extended discretion case in which the trustees were found to have acted arbitrarily. The court noted that there was no apparent reason for allocating an even $10,000 out of $19,858.63 to income and the remainder to principal, particularly when no single transaction in realizing the gain was in even figures. "The only justification advanced by the trustees for this arbitrary distribution was that they were given discretion to do this by [the terms of the will]."[25]

While applying the test of reasonableness in simple discretion cases, Wisconsin appears to have adopted a "good faith" test in dealing with extended discretion, at least in those cases involving a discretionary power to allocate receipts between income and principal. The court, however, gives no clear instructions as to how a trustee can prove good faith. The court's concern with arbitrary action may provide a clue. The court remarked in *Clarenbach* that the only justification which the trustees advanced for apportioning the gain as they did was the fact that they were given discretion to do it. This implies that no actual judgment was exercised by the trustees. The *Restatement* view is that

> the court will control the trustee in the exercise of a power where its exercise is left to the judgment of the trustee and he fails to use his judgment. Thus, if the trustee without knowledge of or inquiry into the relevant circumstances *and merely as a result of his arbitrary decision or whim* exercises or fails to exercise a power, the court will interpose.[26] (Emphasis added.)

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[24] The Pennslyvania rule, adopted in the case of Soehnlein v. Soehnlein, 146 Wis. 330, 131 N.W. 739 (1911), held that stock dividends representing earnings accrued before the life interest commenced were apportioned to principal and those representing earnings accrued after the commencement of the life tenancy were properly income. See also 3 SCOTT, TRUSTS §236.6 (2d ed. 1956), and will of Allis, 6 Wis. 2d 1, 94 N.W. 2d 226 (1959).

[25] 23 Wis. 2d at 77, 126 N.W. 2d at 617.

[26] RESTATEMENT (SECOND), TRUSTS §187, comment *h*; see also 2 SCOTT, TRUSTS §187.3 (2d ed. 1956).

What is to be a satisfactory basis for judging will depend on the circumstances of each case. For example, if a trustee realizes capital gains on the sale of low yield growth stock, he might allocate a part of the capital gain to income, using as his basis for allocation the fact that less dividend income was received from such stocks while held in trust than on other stocks paying regular dividends. It appears that this is the kind of determination which the trustee must make to pass the good faith test.

The effect of that provision of the Uniform Principal and Income Act[27] providing that "any profit or loss resulting upon any change in form of principal shall enure to or fall upon principal" is not clear from the case. Some jurisdictions allow the trustee to exercise discretion only when there is no local law or when local law is in doubt.[28] Other cases have held that extended discretion may permit a trustee to act in a manner other than that which would be required by local law in the absence of such a discretionary grant.[29] It appears that Wisconsin is in the group which more liberally construes the trustee's discretion; otherwise, the court could have simply held that the trustees must follow the provisions of the statute. A cautious draftsman, however, would include language specifically exempting the trustee from statutory provisions if such is intended.[30]

Finally, clarification of the settlor's intent as to the extent of the discretion granted may help to avoid judicial intervention. A grant of discretion in apportioning receipts between income and principal might work as an authorization to invade corpus. An express authorization to make the invasion would make it clear that such discretionary power is, in fact, intended.

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[27] WIS. STAT. §231.40(3)(b) (1961).

[28] Colt v. Duggan, 25 F. Supp. 268, 271 (S.D.N.Y. 1939): "In the State of New York, it is definitely settled that capital gains derived from the sales of trust assets are added to the corpus, *unless* the settlor has by unmistakeable language directed otherwise." While in strictness under the Georgia Code a receipt was corpus, the trustee in White v. Rose, 73 F. 2d 236 (5th Cir. 1934), was allowed to distribute it to the life income beneficiaries, since the trustors "did not leave their rights to be determined by strict law but agreed that in this respect the trustees should determine them." *Id.* at 238.

[29] American Security & Trust Co. v. Frost, 117 F. 2d 283 (App. D.C. 1940), *cert. denied*, 312 U.S. 707 (1941) (to allow trustees to allocate to income that which under judicial decisions is principal would open the whole trust to such revision and change as the trustees might think desirable); *In re* Talbot's Will, 170 Misc. 138, 9 N.Y.S. 2d 806, 812 (1939) ("[W]e cannot assume that this testator intended to violate any of the settled rules of law in giving this authority to his trustees, but rather to authorize them to come to a conclusion upon matters of doubt . . ."); *In re* Watland, 311 Minn. 84, 300 N.W. 195 (1941) (trustees may not allocate gains on the sale of trust securities to income in contravention to the Minnesota rule that such gains are principal).

[30] WIS. STAT. §231.40(2) (1961); RESTATEMENT (SECOND), TRUSTS §233, comment *p* (1959); 2 SCOTT, TRUST: §233.5 (2d ed. 1956).