TRUSTEE RESPONSIBILITY FOR INVESTMENT DECISIONS IN THE POST-CRASH ENVIRONMENT—STEP 24 NOVEMBER 2010

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The word 'investment' has no very precise legal meaning,
but its natural meaning, in a financial context,
is the acquisition of an asset to be held as a source of income:
see for instance Jenkins J in *Re Power* [1947] Ch 572, 575.
Dominicia Social Security Board v Nature Island
Investment Company Limited & Anor (Dominica)
[2008] UKPC 19 (2 April 2009) 8 (PC).

NEED THE CHIEF RABBI BE JEWISH? MUST THE POPE BE CATHOLIC? Would it not be enough that the persons filling these important offices be persons of honesty and good faith?

There can be no doubt that anyone lacking in honesty and good faith could do serious damage to either of these important offices. On the other hand, honesty and good faith, alone, could never sufficiently qualify anyone for either office.

Each role requires its holder to confirm, strengthen, and generally shepherd the faith of his worldwide congregation. No one could be up to that daunting task who was not personally steeped in, and dedicated to, that faith.

So it is with trustees. Anyone other than a person of honesty and good faith could do serious damage to the trust estate, and to the interests of the beneficiaries. The *necessity* for those qualities therefore goes without saying.

But vital as they are, honesty and good faith are not *sufficient*. The trustee also must be a person steeped in the culture of the single-minded shepherding and strengthening of the interests of others who depend on her, and of doing so without any regard for the interests of anyone else—particularly the trustee herself.

If the trustee fails in these matters, no amount of good faith and honesty will save her. *Webb v Jonas*[1] is a case in point. The Court began its judgment this way:

> I cannot help regretting that I am obliged to decide this point, and still more so because I think it is my duty to decide it against the trustees. Personally, if I may say so, I am extremely unwilling to treat trustees otherwise than with the greatest leniency which the law permits when they have acted honestly; and I have not the slightest doubt that in this case they acted honestly, that is to say, with an anxious desire to do their best for their *cestuis que trust*, and to invest the money on what they believed to be a sufficient and prudent security. But I have not to consider in this case any question of prudence, exercise of discretion, or honesty in the usual and proper sense of the word. I have only to consider whether the trustees, as agents of their *cestuis que trust*, have fulfilled the terms of their authority or gone beyond their authority. I have already said, and I repeat, that it is no answer for an agent, who is

[1] (1888) 39 Ch D 660.

> blamed for having omitted to do that which he was told to do, or done something in excess of that which he was told to do, to say: 'What I have done has been done in good faith, and is beneficial to my principal.' The agent is bound to keep himself within the terms of his authority.

That is, the "most important duty of the trustee is to obey the terms of the trust."[2]

NO AUTHORISED INVESTMENT: BREACH OF TRUST: ACCOUNT FALSIFICATION

So, to start with, the trustee who fails to invest the trust estate at all is in breach of trust. The trustee who invests the trust estate in an unauthorized investment is in breach of trust. The trustee who makes an unauthorized delegation, to an investment manager, of the investment of any of the trust estate is in breach of trust.

In each and every one of those cases, the trustee will be liable for all loss suffered by the trust estate, no matter how unpredictable that loss might have been.

If a trustee, in his trust accounts, tries to debit the cost of an unauthorized investment, his account will be "falsified." The unauthorized payment will be deleted from it.[3] The trustee will have to make up the loss to the trust estate from his own resources. This is the remedy of compensation way of *substitutive* performance.

From a beneficiary point of view, this is the best head under which to bring an action against the trustee. Under this head a trustee is liable for the *whole loss* even if, for example, he was to have invested in an investment which, though unauthorized, was viewed by investment professionals as a very sound investment at the time; and even if the loss was incurred only because of an unpredictable crash in the market, and not because of negligence on the trustee's part.[4]

AUTHORIZED BUT CARELESS INVESTMENT: BREACH OF DUTY OF CARE: ACCOUNT SURCHARGING

Well then, if it is not a defence that the trustee acted honestly and in good faith, surely it is a defence that she has read the trust deed, and that she has invested in precisely the type of investment authorized by the deed?

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[2] *Youyang Pty Ltd v Minter Ellison Morris Fletcher* (2003) 212 CLR 484, 498.

[3] Hayton et al, *Underhill & Hayton, Law Relating to Trusts and Trustees* (2006) 17th edn 89.1(1), 89.3.

[4] Hayton et al, *Underhill & Hayton: Law Relating to Trusts and Trustees* (2006) 17th edn 89.38 say:

> In *Target Holdings Ltd v Redferns* [[1994] AC 421, HL] the court endorsed Lord Cottenham's views in *Clough v Bond* [(1838) 3 My & Cr 490 at 496-497] that if a trustee or personal representative invests funds in unauthorised securities or puts them within the control of persons who are not authorised to be entrusted with them and a loss be sustained, then such trustee or personal representative will be liable to make it good, however unexpected the result, however little likely to arise from the course adopted and however free such conduct may have been from any improper motive. On this basis if trustees delegated management of their investment portfolio to a discretionary manager where not authorised to do so, then the trustees would be automatically liable even if the loss in value of the portfolio was caused by an unforeseeable market crash. The beneficiaries could therefore derive a significant advantage from framing their claim as a substitutive performance claim rather than as a reparation claim, in a case where the trustee's decision to delegate management of the trust portfolio is negligent as well as unauthorised. In such a case, their reparation claim for breach of the trustee's equitable duty of care would be subject to principles relating to causation, foreseeability and remoteness that would not apply to their substitutive performance claim.

Not so. Others depend on, and are vulnerable to, the trustee. So more is expected of the trustee than mere black letter compliance with the terms of the trust deed. A trustee who, both, invests, and invests only, in authorized investments, therefore *will still be liable for foreseeable loss attributable to any want of care on her part*.

This time, however, because the careless investment is an *authorized* investment, her account cannot be falsified.

Her accountability for it can be only on the basis of “wilful default”. She will be personally liable to make up the amount the trust fund would have been worth if she had been diligent rather than careless. To the extent that the loss was caused by her want of care and skill, ie by her negligence, the trustee’s account will be “surcharged.” She will have to credit the trust estate with the amount of the surcharge.

So to the extent to which the trust’s loss on the authorized but negligent investment is caused by an unforeseeable market event, the trustee will not be liable for *substitutive* relief. Her liability will be limited to *reparative* compensation: reparation only for the foreseeable consequences of her negligence.

So, from the beneficiary point of view, this is a less favourable cause of action against the trustee in respect of investment losses.

PRUDENCE—THE PRACTICAL, REASONABLE, VIRTUE THAT IS KEY TO CONTROLLING TRUSTEE INVESTMENT RISK

Nothing can save a trustee from the consequences of his having made an *unauthorized* investment.

But where *authorized* investment is concerned, the key to avoiding trustee risk is the cultivation, and exercise of the virtue of prudence.

In the philosophy of St Thomas Aquinas, prudence is the virtue of “actions, choices, and means to ends. Prudence is knowledge put to use.”[5] It is “right reason about things to be done.”[6]

On the one hand, it is the antithesis of impulsive, heat-of-the-moment, testosterone-driven, decision-making—“non solum ex impetu aut passione.”[7] On the other hand, it is not to be confused with “over-cautious bean counting.”[8]

Put another way, it is “the quality of an integrated personality,”[9] and is the virtue “most necessary for human life,”[10] in the sense that it helps us to lead a good life and not merely

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[5] Nemeth, *Aquinas in the Courtroom: Lawyers, Judges, and Judicial Conduct* (2001) 95.
[6] *Summa Theologica* I-II Q 57 a 4 c.
[7] *Summa Theologica* I-II Q 57 a 5 c.
[8] In her interview with Chris Blackhurst, “The nun who knew first”, *The Tablet* 11 April 2009, 12, 13, Sister Catherine Crowley, whose prescient book *The Value of Money: Ethics and the World of Finance* Continuum, 2006, effectively predicted the August 2008 crash in 2006, is reported as having said:

> ‘There's been a lack of certain virtues, for example, justice, and a lack of understanding of certain virtues, for example, prudence. … When Aristotle wanted to give an examp1e of the prudent person, he chose a successful general, because prudence involves looking at all your options and working out what the most effective means are to achieving what one wants to achieve. So the good general will deploy troops in an effective way. It’s got nothing to do with over-cautious bean counting. That is not prudence. I think the way we have lost sight of what prudence originally meant means we can’t develop prudence very easily.’ She chuckles again. ‘Which is why it’s simple to use another term which is practical wisdom.’

become a good person.[11] A distinction made his own by Sir Robert Megarry,[12] who held that the requirement of prudence "is not discharged merely by showing that the trustee has acted in good faith and with sincerity. Honesty and sincerity are not the same as prudence and reasonableness."[13]

The American Law Institute *Restatement of the Law Third: Trusts: Prudent Investor Rule* § 227 provides a convenient statement of the principles:

> *General Standard of Prudent Investment*
> The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.
>
> (a) This standard requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.
> (b) 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.
> (c) In addition, the trustee must:
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> (1) conform to fundamental fiduciary duties of loyalty (§170) and impartiality (§183);
> (2) act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents (§171); and
> (3) incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship (§188).
>
> (d) The trustee's duties under this Section are subject to the rule of §228, dealing primarily with contrary investment provisions of a trust or statute."

The classic case on prudent investment is *Re Whiteley, Whiteley v Learoyd*.[14] Every trustee should be familiar with it.

The terms of the trusts in that case expressly permitted investment in "real securities in England and Wales".

The trustees invested by taking title—as mortgagees—to the legal estate, subject to the right of the mortgagors to redeem. The mortgagors became insolvent, and failed to redeem.

When the trustees tried to exercise their power of sale, they found that the property was unsaleable.

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9 Nemeth, *Aquinas in the Courtroom: Lawyers, Judges, and Judicial Conduct* (2001) 91, citing Eschmann, *The Ethics of St Thomas Aquinas* (1997) 179.
10 "Maxime necessaria ad vitam humanam": *Summa Theologica* I-II Q 58 a 2.
11 *Summa Theologica* I-II Q 57 a 5, ad 1.
12 See also Kekewich J in *Webb v Jonas* (1888) 39 Ch D 660, 665-666.
13 *Cowan v Scargill* [1985] Ch 270, 289.
14 (1886) 33 Ch D 347.

In the Court of Appeal, Cotton LJ discussed the matter[15] on the footing that:

- Just because the investment—the mortgage in this case— was technically within the investment power, it did not follow that the trustees were free from liability in respect of the loss suffered when they were unable to sell up.
- Trustees are not required to have special knowledge, but they are required to recognize where special knowledge is required.
- Where special knowledge *is* required, the trustees must seek it from appropriate experts.
- When they have obtained specialist advice—as they had done in that case, in the form of a report from a valuer—the trustees are not free to accept that advice (in this case, the advice that the property was good security for a certain sum) without first having subjected to critical analysis the reasons for the advice and the underlying assumptions of the adviser.
- The present trustees had failed in that regard.

Lindley LJ famously restated the trustees' obligation (the bullet points are added for clarity) in this way:[16]

> The principle applicable to cases of this description was stated by the late Master of the Rolls in *Speight* v. *Gaunt*[17] to be that a trustee ought to conduct the business of the trust in the same manner that an ordinary prudent man of business would conduct his own, and that beyond that there is no liability or obligation on the trustee. I accept this principle; but in applying it care must be taken not to lose sight of the fact that
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> - the business of the trustee, and the business which the ordinary prudent man is supposed to be conducting for himself*, is the business of investing money for the benefit of persons who are to enjoy it at some future time, and not for the sole benefit of the person entitled to the present income.*
> - *The duty of a trustee is not to take such care only as a prudent man would take if he had only himself to consider; the duty rather is to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide.*
>
> That is the kind of business the ordinary prudent man is supposed to be engaged in; and unless this is borne in mind the standard of a trustee's duty will be fixed too low … .
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> - Whilst on the one hand the Court ought not to encourage laxity and want of care,

[15] Ibid 350-352.

[16] Ibid 355; 357. See also Lopes LJ at 358. See further *Re Partington* (1888) 57 LT 654, 657; *Bartlett v Barclays Bank Trust Co Ltd (No 1)* [1980] Ch 515, 531-534; *Cowan v Scargill* [1985] Ch 270, 289; *Steel v Wellcome Custodian Trustees Ltd* [1988] 1 WLR 167, 171; *Nestle v National Westminster Bank plc* [1993] 1 WLR 1260; and Getzler, "Duty of Care", in Birks and Pretto, *Breach of Trust* (2002) 41-74.

[17] 22 Ch D 739. When *Speight v Gaunt* came before the House of Lords, Lord Blackburn held that a trustee "sufficiently discharges his duty if he takes in managing trust affairs all those precautions which an ordinary prudent man of business would take in managing similar affairs of his own": (1883) 9 App Cas 1, 19.

- on the other hand the Court ought not to prevent people from becoming trustees by converting honest trustees into insurers of the moneys committed to their care.

PRUDENCE IS CONCERNED WITH "DUE CARE OF THE CAPITAL SUM"

The asset in which the trustees had invested was a brickworks. The land on which it stood was being wasted in the production of the bricks. As Cotton LJ had observed in the Court of Appeal,[18] the taking of the clay for the production of bricks was "constantly exhausting the security." The rate of diminution may not have been so rapid as to have been a threat to the security of the interest of the life tenant, but Lindley LJ clearly was awake to the possibility of disadvantage to the remaindermen on the life tenant's death.

His Lordship's reference[19] to the investment having been intended for the benefit of the persons to take on the death of the life tenant appears to have intended to make the long-term safety of the capital the bedrock consideration.[20]

Cotton LJ,[21] and, particularly, Lopes LJ,[22] made similar remarks in their judgments.[23]

On appeal, Lord Halsbury LC declared himself:[24]

> unable to follow or adopt some observations of the Court of Appeal which seem to point to a different degree of care in regard to the conduct of the business of a trust according to whether there are persons to take in the future, or whether the trust fund is to be held for one beneficiary absolutely. *The question must be the due care of the capital sum*. Whether that capital sum is one in which there is a life estate only, or absolutely for the use of the beneficiary, seems to me to bear no relation to the question of the due caution which a trustee is bound to exercise in respect of the investment of the trust fund.

The learned Lord Chancellor, like Lord Fitzgerald—who made similar remarks[25]–may have failed to get properly to grips with the basis on which Lindley LJ had found that the trustees had failed to get properly to grips with their expert's advice. Lindley LJ's remarks are expressive of, and they are consistent with, "due care of the capital sum" being the uppermost consideration.

There is nothing in the judgment of the third member of the Court, Lord Watson, to indicate that the judgments of the Court of Appeal had struck him in the way they seem to have struck Lord Halsbury LC and Lord Fitzgerald.

In any event, the House of Lords upheld the judgment of the Court of Appeal.

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[18] (1886) 33 Ch D 347, 352.
[19] (1886) 33 Ch D 347, 355.
[20] See Getzler, "Fiduciary Investment on the shadow of the financial crisis: as Lord Eldon right?" (2009) 3 *J Eq* 219.
[21] (1886) 33 Ch D 347, 350.
[22] (1886) 33 Ch D 347, 358.
[23] (1886) 33 Ch D 347, 350 (Cotton LJ), 358 (Lopes LJ).
[24] *Learoyd v Whiteley* (1887) 12 App Cas 727,732.
[25] *Learoyd v Whiteley* (1887) 12 App Cas 727,736.

The like sentiment was again voiced by the Court of Appeal more than a century later, in *Nestle v National Westminster Bank plc*:[26]

> The importance of preservation of a trust fund will always outweigh success in its advancement. Inevitably, a trustee in the bank's position wears a complacent air, because the virtue of safety will in practice put a premium on inactivity. Until the 1950s active management of the portfolio might have been seen as speculative, and even in these days such dealing would have to be notably successful before the expense would be justified.

BUT DUE CARE FOR THE CAPITAL IS NOT ALWAYS, AND NECESSARILY, MAINTENANCE OF THE CAPITAL AT ALL COSTS

The sane, rational, prudent trustee, investing for the benefit of those for whom there is a perceived moral obligation to provide, provides an adaptable benchmark. That adaptability sometimes may require that "due care" for the capital should not be elevated to an absolute consideration. Hoffmann J has pointed out that any other view could impact unfairly on the income beneficiaries:[27]

> Modern trustees acting within their investment powers were entitled to be judged by the standards of current portfolio theory, which emphasises the risk level of the entire portfolio, rather than the risk attaching to each investment taken in isolation.[28] But care must be taken not to endow the prudent trustee with prophetic vision or expect him to have ignored the received wisdom of his time. A trustee must have regard to the interests of those entitled in the future to capital, and such regard will require them to take into consideration the potential effects of inflation, but a rule that real capital values must be maintained would be unfair to both income beneficiaries and trustees.

TRUSTEES ARE TO BE JUDGED ACCORDING TO "RIGHT REASON", AND CANNOT PLEAD PERSONAL LUNACY

In *Learoyd v Whitely*,[29] their Lordships did not expressly cite St Thomas' view that prudence is "right reason about things to be done."[30] An important consideration against ascribing this omission to Protestant malice was that Lord Fitzgerald was sitting with the Lord Chancellor and Lord Watson on this appeal. As well as hinting at, at least, bedroom Catholicism, his Lordship's thirteen children suggest that, when it came to recognizing a

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[26] [1993] 1 WLR 1260, 1284 per Staughton LJ.

[27] *Nestle v National Westminster Bank plc* [2000] WTLR 795, 797; affd [1993] 1 WLR 1260 (CA).

[28] In *Dominicia Social Security Board v Nature Island Investment Company Limited & Anor (Dominica)* [2008] UKPC 19 (2 April 2009), their Lordships [at page 10-11] said that:

> It may well be that investing in a telecommunications and broadcasting business operating in Dominica is a relatively high-risk investment, and DSSB is in a position of stewardship for the people of Dominica. But the law recognises that when very large investment funds are available, the degree of risk acceptable to fiduciaries should to some extent be judged by reference to the entirety of the holdings in a diversified portfolio, rather than by reference to individual holdings (see Sir Robert Megarry V-C in *British Museum Trustees v Attorney-General* [1984] 1 WLR 418, 425 and the extra-curial observations of Lord Nicholls of Birkenhead in (1995) 9 Tru LI 71, quoted in *Lewin on Trusts,* 18th ed (2008) p1285). Those are all matters which the DSSB, and in particular its Investment Committee, must be supposed to have taken into account in deciding on the joint venture with WRB; and they go to prudence, not to *vires*.

[29] (1887) 12 App Cas 727.

[30] *Summa Theologica* I-II Q 57 a 4 c.

deficiency of prudence and due care in others, it took one to know one.

But if he did not cite the Angelic Doctor, Lord Halsbury LC was at least of like mind with him:[31]

> No one either at the Bar or in either of the Courts in which this matter has been litigated has doubted that the trustees intended to do what was right, and no imputation can certainly be made against them that they were actuated by any other motive than that of procuring the highest amount of interest that they could for their cestui que trust. But the goodness of their motives cannot justify the propriety of the investment.
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> … *I do not think* it is true to say that *one is entitled to consider the special qualities or degree of intelligence of the particular trustee. Persons who accept that office must be supposed to accept it with the responsibility at all events for the possession of ordinary care and prudence.*

In this, Lord Halsbury was of one mind, also, with Bowen LJ: who—four years earlier—had held that the standard of "honesty" is that of a sane and rational person:[32]

> Bona fides cannot be the sole test, otherwise you might have a lunatic conducting the affairs of the company, and paying away its money with both hands in a manner perfectly bona fide yet perfectly irrational.

Bowen LJ said this in the context of his famous dictum that the bona fides of the provision of gratuities to directors and staff of a company are to be considered in the light of the principle that there can be "no cakes and ale except such as are required for the benefit of the company"[33] —an admonition seldom mentioned by directors who vote bonuses in the tens of millions to the chief executives to whom they owe their own appointments to the Board.

TRUSTEES' DUTY NOT ONLY TO OBTAIN COMPETENT AND SKILLED ADVICE, BUT TO "TEST THE SOUNDNESS" OF THAT ADVICE FOR THEMSELVES: A TRUSTEE *MUST* UNDERSTAND

To bring the trustee to "right reason" about the "things to be done" in order to make such an investment as the ordinary prudent person would make *for the benefit of other people for whom she felt morally bound to provide*, "it is quite clear," held the Lord Chancellor in *Learoyd v Whiteley*:[34]

> that a trustee is entitled to rely upon skilled persons in matters in which he cannot be expected to be experienced. He may perhaps rely upon a lawyer on some matters of law, and in this case I do not deny that he would be entitled to rely on a valuer upon a pure question of valuation. But unless one examines with reference to what question the skilled person gives advice it is possible to confuse the reliance which may be properly placed upon the skill of a skilled person with *the judgment which the trustee himself is bound to form* on the subject of the performance of his trust."

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[31] *Learoyd v Whiteley* (1887) 12 App Cas 727,731.
[32] *Hutton v West Cork Railway Co* (1883) 23 Ch D 654, 672-673.
[33] *Hutton v West Cork Railway Co* (1883) 23 Ch D 654, 671.
[34] (1887) 12 App Cas 727, 731.

The trustees' instructions to their valuer appear to have been vague. The issue the valuer addressed—the value of the land, plant, and business—was not the relevant issue of the value of the *land alone*. Lord Watson put the tenor of their Lordships' reasoning this way:[35]

> If they employ a person of competent skill to value a real security, they may, so long as they act in good faith, safely rely upon the correctness of his valuation. But the ordinary course of business does not justify the employment of a valuator for any other purpose than obtaining the data necessary in order to enable *the trustees* to judge of the sufficiency of the security offered. They are not in safety to rely upon his bare assurance that the security is sufficient, in the absence of detailed information which would enable them to form, and without forming, an opinion for themselves. At all events *if they choose to place reliance upon his opinion without the means of testing its soundness they cannot, should the security prove defective, escape from personal liability, unless they prove that the security was such as would have been accepted by a trustee of ordinary prudence, fully informed of its character*, and having in view the principles to which I have already adverted.

So for the trustees to have retained an expert adviser is not, in itself, a free pass for them to invest in whatever the expert might suggest of approve. If the suggested investment is outside the range that a trustee of ordinary prudence would have found acceptable, the expert advice will not help the trustees at all.

TRUSTEES CANNOT BE PRUDENT WITHOUT BRINGING TO BEAR AN "INDEPENDENT AND CRITICAL EYE": "BLIND PARTICIPATION" IS NOT AN OPTION

If it is based on "uneducated assumptions", an investment almost certainly *will* be outside the range that a trustee of ordinary prudence would have found acceptable. This is what the plaintiff beneficiaries argued in the US District Court for New Jersey in *Olsen v Hegarty*:[36]

> The decision-making process that justified this makeup, according to the Plaintiff, was marked by uneducated assumptions, a lack of independent investigation, and a failure to obtain needed expertise as to the best way to meet the Plan's goals.
>
> The Plaintiff argues that the overall investment strategy was the result of the majority of Trustees merely attending monthly meetings and rubber stamping the judgment of Defendants Hegarty and Campbell, along with Mr Foley, thereby abdicating their duty to make informed and independently investigated investment decisions.

Rejecting the defendant trustees' summary judgment application, the Court held that:[37]

> Even with the assistance of outside consultants making up for their lack of investment experience, the Trustees still were required to maintain an independent and critical eye toward the decisions that they approved. …
>
> The investment making process revealed in the record illustrates an approach

[35] (1887) 12 App Cas 727,734.
[36] 180 F Supp 2d 552, 568 (2001).
[37] Ibid 571.

wherein Defendants Hegarty and Campbell, along with Mr Foley, were in total control of the Fund's investments, while the other Defendants *passively looked on, moving only to blindly participate when their official approval was called for under the terms of the Trust*. At the very least, the Plaintiff here has raised a genuine issue of material fact as to whether the Trustees, for the most part not competent enough to rely on their own expertise, exercised this level of independent scrutiny when approving the Fund's investments.

NOT EVEN "BLIND PARTICIPATION" BASED ON THE APPARENTLY SUCCESSFUL, IF INCOMPREHENSIBLE, EXPERIENCE OF OTHERS

The passages I have italicized in the *Learoyd v Whiteley*,[38] and *Olsen v Hegarty*[39] judgments, relate to matters likely to feature in any arguments about investments in hedge funds, collateralized debt obligations, and other such "securities" of the current era.

Take Lord Jacobs. He is said—although, fortunately for him, not as a trustee—to have blown £30 million of his £128 million fortune by placing it with Mr Madoff. According to the *Sunday Times*:[40]

> Madoff's 'Ponzi' fraud used cash from new investors to pay high returns to those who had already committed money, giving the illusion of genuine profits. Jacobs said: 'Ponzi schemes typically fold after two to three years but this went on for 20 years and it was paying out 10% a year and $2^{1}/_{2}$% a quarter.' …
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> Asked what he had done to look into Madoff before injecting funds, he said: 'When people say you should have done due diligence, what could I have done? I knew several people that had been in the fund for more than 15 years.
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> 'The only joke is my friends in England who are quite savvy said, "What return are you getting?". I said, '9%-11%'. They said they were in hedge funds that were producing 25%. I went for the lower return because I am risk-averse, which makes me out to be a total idiot.'

TO REPEAT: TRUSTEES *HAVE TO UNDERSTAND*

Trustees cannot be so reticent.

They *have* to understand.

They *must* seek advice.[41]

They *must* be prepared to ask, and they *must* ask, the hard questions.

They cannot possibly invest "prudently" otherwise.

Trustees *must* be prepared, and able, to point to a diversified investment strategy.

They *must* be able to explain how this strategy was developed for *this* Trust.

They *must* be able to explain why they considered it to be prudent under the circumstances.

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[38] (1887) 12 App Cas 727.
[39] 180 F Supp 2d 552 (2001).
[40] Waples, *Sunday Times* 15 February 2009.
[41] In *Cowan v Scargill* [1985] Ch 270, 289, Sir Robert Megarry refers to the duty of trustees to "seek advice on matters which the trustee does not understand, such as the making [and reviewing] of investments."

Where those circumstances have changed from time to time, the trustees *must* be able to explain how they adjusted the strategy to meet those new circumstances; or why they considered that no adjustments were necessary on the particular occasion.

Prudence is knowledge put to use"[42]—not ignorance, and impulse, run amok. Yet, hedge funds that are not Ponzi schemes have turned out to be run by companies the managers of which could not begin to explain what they are doing—apart from making an unconscionable lot of money irrespective of the damage they may be in the course of inflicting on their clients and on the world economy.[43]

If, like Lord Jacobs, the trustees cannot understand, but—in desperation—are hell bent on investing "solum ex impetu aut passione,"[44] they are going to be vulnerable to all manner of charlatanism.

TRUSTEES AND RATINGS AGENCIES

What if Lord Jacobs had been a trustee, and what if he was to have invested in Madoff's schemes because a rating agency had given them a high recommendation?

A rating is not an explanation. It may be an obfuscation.

Derivatives, hedge-funds, and collateralized debt obligations routinely were so constructed as to have precluded any due diligence on the investment, let alone any understanding of what the investment really comprised. One hedge fund investment was found to have been "backed" by tranches from forty different residential mortgage backed securities. These, in their turn, sat atop tens of thousands of residential mortgages. Warren Buffett, is said to have calculated that one might "have to read 750,000 pages to understand the instruments that were underneath" such an instrument.[45]

In "Faith and Reason in the Mathematics of the Credit Crunch," Jerome Ravetz wrote:[46]

> Now we consider how it actually happened. Did no one realise what was going on? Did no one blow the whistle? In fact, some did, and the strength of the Gadarene syndrome in this case is shown by the quality of the signals that were ignored. Warren Buffet is the great guru of American finance; almost always the marketers hang on his every word. But this time, when he repeatedly warned of the 'toxic' derivatives and hedges, he was ignored. A successful trader turned critic, Nassim Nicholas Taleb, warned about the uncertainties in unpredictable events, his famous 'black swans', and (he claims) he was ridiculed by the economists at the time."

Professor Grieves' 29 March 2010 *Report re ING (NZ) Limited*, deals with investments made by a company jointly owned by a New Zealand bank. It appears that, through its agents, the bank was advising its customers to take up these investments.

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42 Nemeth, *Aquinas in the Courtroom: Lawyers, Judges, and Judicial Conduct* (2001) 95.

43 See, for example, Cowley, *The Value of Money* (2006) 145, "if market practitioners cannot be sure of the risk, how are others to know?"; and Tavakoli, *Structured Finance & Collateralized Debt Obligations: New Developments in Cash & Synthetic Securitization* 2nd edn (2008) Chapter 5, "Risk and Valuation Issues".

44 St Thomas Aquinas, *Summa Theologica* I-II Q 57 a 5 c.

45 Molloy, "I am a trustee. I cannot make head or tail of $P_0 = S_0N(d_1) - Xe^{-rt} N(d_2)$, where $d_1 = (\mathrm{Ln}\ (S_0/X) + (r + \sigma^2/2)\ t) / (\sigma\sqrt{t})$ and $d_2 = d_1 - (\sigma\sqrt{t})$. Am I at risk?" (2009) 15 *Trusts & Trustees* 524. 578, n 260. The article has been cited by Professor Getzler, of St Hugh's College, Oxford, as having put the problem into "the broadest of contexts and with deft humour": (2009) 3 *Journal of Equity* 219, 235.

46 *The Oxford Magazine*, July 2009.

The Report illustrates graphically that neither the Bank nor its subsidiary had any idea what some of the investments being sold to the customers actually involved. The Report found that the subsidiary had sold investors, who had been relying on the bank to advise them, "investments for which it could not know the contents".[47]

Professor Grieves managed to obtain the investment statements of the issuers of many of the investments underlying the positions into which the bank's advisers sold their clients. Many of these statements made it clear that, for example:

> None of the Issuer, the Trustee and the Noteholders will otherwise have the right to know, as of any particular date, the specific identities of the Reference Entities or the Reference Assets on the basis of which any payments under the Credit Swap will be determined or, except as specifically required by the terms of the Credit Swap, any other information regarding the Reference Pool.[48]

This was South Sea Bubble stuff. One prospectus of that 18th century financial scandal offered 5000 shares of £100 each, on a £2 deposit. It promised that, by payment of this deposit, the subscriber would become entitled to £100 per annum per share in "a company for carrying on an undertaking of great advantage, but nobody to know what it is.[49]

Fuller and better particulars of this venture were promised in a month, when a call was to have been made for the outstanding £98. A thousand of the shares were subscribed in the five hours following publication of the prospectus. At that stage, the promoter was "philosopher enough to be contented with his venture, and set off the same evening for the Continent. He was never heard of again."[50]

Professor Grieves' Report—on the financial products of the company part-owned by the bank, to which the investment advisers selling for the bank referred their clients—indicates that that company was entering into Investment Management, Administration, and Custody Agreements with the clients. Those Agreements represented that credit leverage of up to 20% of the portfolio was permitted.[51]

However, through yet further portfolio managers, that company part owned by the bank was investing in Collateralized Debt Obligations, equity tranches of which "have leverage embedded in them."[52]

So, even if the investing company in which the Bank owned an interest had strictly complied with the 20% leverage constraint, "the (undisclosed) effective leverage is several-to-many times the 20% stated."[53]

There seem to have been no known capital and margin restraints. It was leveraged betting of this sort which, following the 1998 Russian debt crisis, brought down Long Term Capital Management. That fund, the brainchild of winners of the Nobel prize in economics, had leveraged the USD134 billion venture to such an extent that the investors in it had been, without realizing it, gambling a sum in excess of USD 1 trillion.

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[47] Paras 138 and 186 of the *Report*.
[48] Para 140 of the *Report* cites several examples.
[49] Mackay, *Extraordinary Popular Delusions and the Madness of Crowds* (1841, Crown Trade Paperbacks, New York, reprint 1980), 58.
[50] Idem.
[51] Para 107 of the *Grieves Report*.
[52] Para 109 of the *Report*.
[53] Para 108 of the *Report*.

That was a bet that nearly caused a meltdown in the US financial system in that year.[54] The subsidiary recommended by the bank was selling "regular income funds" with a proclaimed "low to moderate" risk profile. On examination of the prospectuses for the underlying investments there were found warnings that "this investment has a high degree of risk".[55]

Professor Grieves' conclusion was that these "low" and "moderate" risk funds, to which the bank steered those to whom it was giving investment advice,

> contained multiple, large risks that [the subsidiary] did not measure or manage, which led to a loss of nearly 80% of the capital. This outcome is impossible with either low to moderate risk or moderate risk. It would be nearly unheard of with conventional investments of high risk.[56]

Yet investments of this type were routinely accorded high ratings by the agencies that supposedly were scrutinizing them on behalf of investors.

The celebrated US economist, Professor Davidson, has written very recently:[57]

> Since the condition and location of the collateral, the creditworthiness of the borrower, and other factors of every home mortgage [or other underlying "security"] are so individualized, there is *no possible way that investors or rating agencies can evaluate the worth of financial assets that combine many mortgages into one investment vehicle*. Accordingly the prohibition of securitization for such assets is a necessary protection for all investors, just as the Pure Food and Drug Act protects consumers from buying toxic goods that the are incapable of testing on their own.

THE RELEVANCE OF A "GOOD NAME"

So the trustee relies on rating agencies at his peril.

What about relying on reputable "names"?

Unhappily, at times, medical students without bank accounts, and wine merchants with "very small" businesses, can become trustees. They certainly did in *Robinson v Harkin*.[58] The medical student left the investment decisions entirely in the hands of the wine merchant. In his turn, the latter left it all up to a broker who was not a member of the Stock Exchange. The small time wine merchant had selected him on the basis that the broker was "regarded as a good customer by a firm of wine merchants in a small way of business."

Judgment was given against both trustees for the mess that they made of the trust estate. Lord Watson saw similar features in *Learoyd v Whitely* when it was before the Lords:[59]

> The course which was followed by the appellants in entering into the transaction of January 1878 is very compendiously stated by Mr Learoyd [*one of the trustees: an*

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[54] This is discussed in Molloy, "I am a trustee. I cannot make head or tail of $P_0 = S_0N(d_1) - Xe^{-rt} N(d_2)$, where $d_1 = (\text{Ln}\ (S_0/X) + (r + \sigma^2/2)\ t) / (\sigma\sqrt{t})$ and $d_2 = d_1 - (\sigma\sqrt{t})$. Am I at risk?" (2009) 15 *Trusts & Trustees* 524. 569-579.

[55] Para 170 of the *Report*.

[56] Para 191 of the *Report*.

[57] *The Keynes Solution: the path to global economic prosperity*, (Palgrave Macmillan, New York, 2009) 98-99.

[58] [1897] 2 Ch 415, 416.

[59] (1887) 12 App Cas 727, 735.

> *accountant*], in whose evidence, so far as it related to matters within his personal knowledge, Mr Carter [the other trustee: a schoolmaster] generally concurred. In his examination in chief Mr Learoyd was referred to a report by Messrs Uttley & Gray [the 'valuators], dated the 8th of October 1877, and interrogated:
>
> (Q) Did you and Mr Carter on that report form an opinion that it was a proper security for the investment? —
>
> (A) We did after further inquiries.
>
> Being interrogated in cross-examination:
>
> (Q) What other inquiries did you make about the brick properties?—
>
> (A) I instructed our solicitor to make inquiries respecting the respectability of the parties.
>
> It plainly appears from these answers that the appellants had no information regarding the subjects mortgaged except what was contained in the report of their valuators.

The "parties" on whose "respectability" the trustees staked the trust estate had been identified in the Court of Appeal as the proprietors of the "speculative and fluctuating brickmaking business":

> a business largely dependent on the energy and solvency of those working in it … and which cannot be carried on without such an excavation and destruction of the soil as must eventually leave what remains nearly useless.[60]

If they had been convicted fraudsters, or serial bankrupts, the check would have been useful, and might have put the trustees off. But to have plunged in just because the solicitors had not been able to impugn the proprietors' "respectability" in some such way was hardly prudent.

Professor JK Galbraith repeatedly advised the taking of great care when dealing with big names. Thus:[61]

> The world of high finance can be understood only when it is recognized that the greatest admiration is accorded those who are paving the way for the greatest catastrophe.

And thus:[62]

> It must be recognized that from few matters has modern society more suffered than from the excesses and errors of what is now called the financial community, although it once had the more luminous sobriquet of high finance.

Lord Kylsant almost certainly would have passed a "respectability" check by a provincial solicitor before he went to jail because the prospectus for which—as a director—he bore legal responsibility failed the test stated by the Court of Criminal Appeal in *Rex v Kylsant*:[63]

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[60] (1886) 33 Ch D 347, 359 per Lopes LJ; adopted as having stated the position accurately in (1887) 12 App Cas 727,737 per Lord Fitzgerald.

[61] *The World Economy Since the Wars* (1994) 73.

[62] *The Good Society: The Humane Agenda*, (1996), 79-80.

[63] [1932] 1 KB 442, 448.

> The falsehood in this case consisted in putting before intending investors, as material on which they could exercise their judgment as to the position of the company, figures which apparently disclosed the existing position but in fact hid it.

The prospectus Lord Kylsant had signed represented that the company had paid a dividend in every year since the end of World War I. It had, too. So one might have thought that its business was prospering. But the prospectus failed to mention that, for the last seven years, the company had been making large trading losses. The dividends had been possible only because the company had made large profits in a brief artificial shipping "boom" attributable to the ending of the war, and because it had been the beneficiary of a number of non-recurring items such as refunds by the Revenue authorities of wartime excess profits taxes.

Trustees accordingly need to wash investment proposals in "cynical acid,"[64] for, as Professor Galbraith has also noted:[65]

> Having money may mean, as often in the past and frequently in the present, that the person is foolishly indifferent to legal constraints and may, in modern times, be a potential resident of a minimum-security prison.

A risk which Lord Walker, likewise, has stressed:[66]

> A director who is also controlling shareholder of a company may need a lot of persuasion that he is not fully entitled to feather his own nest at the expense of 'his' company. Indeed he may find himself serving a custodial sentence before he begins to believe it.

RECONCILING PRUDENCE AND RISK

The ordinary prudent person might well invest more expansively for herself than she would invest as trustee *for the benefit of other people for whom she felt morally bound to provide*. As Lord Watson explained, in *Learoyd v Whiteley*, the trustee is denied:[67]

> the same discretion in investing the moneys of the trust as if he were a person sui juris dealing with his own estate. Business men of ordinary prudence may, and frequently do, select investments which are more or less of a speculative character; but it is the duty of a trustee to confine himself to the class of investments which are permitted by the trust, and likewise to avoid all investments of that class which are attended with hazard.

In *Estate of Rodney B Janes*,[68] the Surrogate Judge held that the prudential obligation entailed that the trustee "does not have a license to speculate."

None of this means that the trustee is forbidden *all* risk. He is not an insurer of the trust estate.[69] Life presents many dangers. Not the least of them is safety. As the faithless

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[64] Holmes, "The Path of the Law" 10 *Harvard L Rev* 457 (1897).
[65] *The World Economy Since the Wars* (1994) 14.
[66] "Fraud, Fault, and Fiduciary Liability" Vol 10 No 2 *Jersey & Guernsey L Rev* (2006) para 14.
[67] (1887) 12 App Cas 727, 733.
[68] 214 NYLJ (Jul 5 1995) para 11. Affd *In re Janes* 90 NY 2d 41; 681 NE 2d 232; 659 NYS 2d 165 (1997).
[69] *Re Mulligan* [1998] 1 NZLR 481, 501, "I accept that a trustee is neither a surety, nor an insurer of the fund for which he is responsible. Loss of trust money, or … diminution in the real value of a trust fund, does not of itself render a trustee liable. It must be shown that the loss of diminution arose from some failing on the part of the trustee, which can be properly characterised as a breach of trust." See also *Re Whiteley, Whiteley v*

servant in Matthew's *Parable of the Talents*[70] discovered, totally risk-free investment is an oxymoron.

Not even burying the trust estate affords protection against loss,[71] and, as Geoffrey Shindler has put it:[72]

Learoyd, (1886) 33 Ch D 347, 357 per Lindley LJ— "Whilst on the one hand the Court ought not to encourage laxity and want of care, on the other hand the Court ought not to prevent people from becoming trustees by converting honest trustees into insurers of the moneys committed to their care." See, too, and *Bartlett v Barclays Bank Trust Co Ltd (No 1)* [1980] Ch 515, 531-534 (Brightman J); *Re Partington* (1888) 57 LT 654, 657; *Cowan v Scargill* [1985] Ch 270, 289; *Steel v Wellcome Custodian Trustees Ltd* [1988] 1 WLR 167, 171; *Nestle v National Westminster Bank plc* [1993] 1 WLR 1260; and Getzler, "Duty of Care", in Birks and Pretto, *Breach of Trust* (2002) 41-74.

[70] Mt 25: 14-30:

> Again, [the 'Kingdom of Heaven'] will be like a man going on a journey, who called his servants and entrusted his property to them. To one he gave five talents of money, to another two talents, and to another one talent, each according to his ability. Then he went on his journey. The man who had received the five talents went at once and put his money to work and gained five more. So also, the one with the two talents gained two more. But the man who had received the one talent went off, dug a hole in the ground and hid his master's money.
>
> After a long time the master of those servants returned and settled accounts with them.
>
> The man who had received the five talents brought the other five. 'Master,' he said, 'you entrusted me with five talents. See, I have gained five more.' [These early wealth managers hadn't yet learned about charging up-front fees, success fees, flat fees, and commissions.] His master replied, 'Well done, good and faithful servant! You have been faithful with a few things; I will put you in charge of many things. Come and share your master's happiness!'
>
> The man with the two talents also came. 'Master,' he said, 'you entrusted me with two talents; see, I have gained two more.' His master replied, 'Well done, good and faithful servant! You have been faithful with a few things; I will put you in charge of many things. Come and share your master's happiness!'
>
> Then the man who had received the one talent came. 'Master,' he said, 'I know that you are a hard man, harvesting where you have not sown and gathering where you have not scattered seed. So I was afraid and went out and hid your talent in the ground. See, here is what belongs to you ' His master replied, 'You wicked, lazy servant! So you knew that I harvest where I have not sown and gather where I have not scattered seed? Well then, you should have put my money on deposit with the bankers, so that when I returned I would have received it back with interest.' 'Take the talent from him and give it to the one who has the ten talents. For everyone who has will be given more, and he will have an abundance. Whoever does not have, even what he has will be taken from him. And throw that worthless servant outside, into the darkness, where there will be weeping and gnashing of teeth.'

[71] Under the headline "Exec loses buried treasure" the Singapore *Straits Times* for 29 January 2009 reported that:

> "An elderly Japanese businessman buried US$4 million (S$6 million) in his garden for safekeeping only to find it dug up by a thief, police said on Thursday. The man in his 80s discovered the theft in October and died two months later. As he left no records, it took time for investigators to piece together the details. The man, who was still serving on a corporate board when he died, had put cash into a container over four decades, repeatedly digging it up and then placing it back in the ground in his yard in southern Saga prefecture. On Oct 10, he noticed at around 6.00am that something was amiss. 'He noticed that there are signs that parts of his yard were dug up. Then he learned that the container in which he kept the money was gone,' a local police official said. Police were searching for the culprit behind the theft of the cash, estimated at 360 million yen (S$6 million). 'He buried the money because financial institutions are offering only low interest rates, and he thought it was better to keep his cash himself,' the official said. 'He chose to bury the cash in his garden to avoid damage from possible house fires or earthquakes,' he said. The businessman had recollected that the last time he had checked the money was in the middle of 2007, the official said. —AFP"

[72] "Should we be devoted followers of investment fashion?" *Trusts and Estates Law & Tax Journal*, (Oct 2003) 3.

> Keeping the money under the bed is not risk-free; you are subject both to inflation and burglars (though not necessarily in that order). Even if money at the bank ought probably to remove the burglar risk, it will not remove the inflation risk.

Indeed, at the beginning of his reasons for judgment in *Re Godfrey*, Bacon V-C held that:[73]

> No doubt it is the duty of a trustee, in administering the trusts of a will, to deal with property intrusted into his care exactly as any prudent man would deal with his own property. But the words in which the rule is expressed must not be strained beyond their meaning. Prudent businessmen in their dealings incur risk. That may and must happen in almost all human affairs.

Reconciling Lord Watson's deprecation of hazard with Bacon V-C's recognition and acceptance of the inevitability of risk, Brightman J has held that "the distinction is between a prudent degree of risk on the one hand, and hazard on the other."[74]

TRUSTEES NOT TO BE JUDGED BY REFERENCE TO AN IDEAL RETURN ON AN IDEAL PORTFOLIO

In drawing this distinction, the court will judge the trustee with reference to the real world, and will not condemn her for failure to achieve an ideal return on an ideal portfolio. The US District Court for New Jersey in *Olsen v Hegarty* accordingly held:[75]

> Whether the Defendants have violated their fiduciary duty of prudence cannot be decided solely based on a comparison of the Plan's performance in light of the ideal return of a portfolio with a similar purpose over the same time period. It is not within the province of this Court to create an artificial standard of return, against which all portfolios are measured to determine whether a violation of fiduciary duty has occurred. Rather, this Court must examine and analyze the particular behavior and decision-making processes that account for these investments and determine whether these actions or omissions were so imprudent as to constitute a violation of [their duty], regardless of the outcome of the investment.

This is another way of saying that a trustee is not an *insurer* of the trust estate.[76]

In *Nestle v National Westminster Bank*, Staughton LJ agreed with Hoffmann J:[77]

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[73] (1883) 23 Ch D 483, 493.

[74] *Bartlett v Barclays Bank Trust Co Ltd (No 1)* [1980] Ch 515, 531.

[75] 180 F Supp 2d 552, 569 (2001).

[76] *Re Mulligan* [1998] 1 NZLR 481, 501, "I accept that a trustee is neither a surety, nor an insurer of the fund for which he is responsible. Loss of trust money, or … diminution in the real value of a trust fund, does not of itself render a trustee liable. It must be shown that the loss of diminution arose from some failing on the part of the trustee, which can be properly characterised as a breach of trust." See also *Re Whiteley, Whiteley v Learoyd*, (1886) 33 Ch D 347, 357 per Lindley LJ— "Whilst on the one hand the Court ought not to encourage laxity and want of care, on the other hand the Court ought not to prevent people from becoming trustees by converting honest trustees into insurers of the moneys committed to their care." See, too, and *Bartlett v Barclays Bank Trust Co Ltd (No 1)* [1980] Ch 515, 531-534 (Brightman J). See further *Re Partington* (1888) 57 LT 654, 657; *Cowan v Scargill* [1985] Ch 270, 289; *Steel v Wellcome Custodian Trustees Ltd* [1988] 1 WLR 167, 171; *Nestle v National Westminster Bank plc* [1993] 1 WLR 1260; and Getzler, "Duty of Care", in Birks and Pretto, *Breach of Trust* (2002) 41-74.

[77] *Nestle v National Westminster Bank plc* [1993] 1 WLR 1260, 1275 (CA).

> Of course it is not a breach of trust to invest the trust fund in such a manner that its real value is not maintained. At times that will be impossible, and at others it will require extraordinary skill or luck. The highest that even the plaintiff puts her claim is that, if the equity portion in the fund as it stood in 1922 (74 per cent) had been invested so as to achieve no more than the index, the fund as a whole would have been worth over £1·8m in 1986.

In the Court of Appeal in the same case, Dillon LJ noted that:[78]

> as Hoffmann J pointed out,[79] that the evidence showed that if the BZW Equity Index was applied over the period from July 1974 to December 1986 to 'growth' unit trusts (as opposed to 'income' unit trusts) it appeared that 12 of the 'growth' trusts had done better than the index, but 21 had done worse. It is impossible to say that those 21 unit trusts must have been managed with a degree of incompetence which, in a trustee like the bank, would have amounted to a breach of trust. The BZW Equity Index is calculated by reference to the performance of the leading equity shares, the composition of the list being changed from time to time with fluctuations of the companies' fortunes. It is thus difficult to beat, particularly for a fund which is not large enough to include substantial holdings in all the leading equities. It cannot be the criterion for the degree of performance which is expected of the ordinary prudent trustee.

There was no doubt that the trustee had misunderstood the investment clause, and that, over a long period, it had failed to keep the investments under review.[80] But, as Staughton LJ put it:[81]

> the misunderstanding of the investment clause and the failure to conduct periodic reviews do not by themselves, whether separately or together, afford the plaintiff a remedy. They were symptoms of incompetence or idleness—not on the part of National Westminster Bank but of their predecessors; they were not, without more, breaches of trust. The plaintiff must show that, through one or other or both of those causes, the trustees made decisions which they should not have made or failed to make decisions which they should have made. If that were proved, and if at first sight loss resulted, it would be appropriate to order an inquiry as to the loss suffered by the trust fund.
>
> It may be difficult to discharge that burden, and particularly to show that decisions were not taken when they should have been. But that does not absolve a plaintiff from discharging it, and I cannot find that it was discharged in this case … .

But Dillon LJ pointed out that the appellant's complaint was not that:[82]

> of failure to invest any adequate part of the annuity fund in equities. It is that the part invested in equities was from 1922 to 1960 invested in bank and insurance shares (which were good equities) only and not in a wider spread of equities. Since therefore, for the reasons given above I would reject the suggested use of the BZW

[78] *Ibid*, 1267 (CA).
[79] *Nestle v National Westminster Bank plc* [2000] WTLR 795.
[80] *Nestle v National Westminster Bank plc* [1993] 1 WLR 1260, 1275 per Staughton LJ.
[81] *Ibid,* 1275-1276.
[82] *Ibid*, 1269.

> Equity Index as proving loss as between bank and insurance shares only and fully diversified equities, the crucial question is whether the onus remains on the plaintiff to prove loss for which fair compensation should be paid, or whether it is enough for her to claim compensation for loss of a chance [as in *Chaplin v Hicks* ([1911] 2 KB 786) that she would have been better off if the equities had been properly diversified.
>
> The starting point must, in my judgment, be that, as the plaintiff is claiming compensation, the onus is on her to prove that she has suffered loss because from 1922 to 1960 the equities in the annuity fund were not diversified: see *Hotson v East Berkshire Area Health Authority* [1987] AC 750 and *Wilsher v Essex Area Health Authority* [1988] AC 1074. In some cases, it is sufficient to prove loss of a chance because in such cases, as in *Chaplin v Hicks* [1911] 2 KB 786, the outcome, if the plaintiff had not lost the chance, can never be proved. But in the present case, if the annuity fund had been invested wholly in fixed interest securities, it would have been relatively easy to prove, even though the event never happened, that the annuity fund would have been worth much more if a substantial part had been invested in equities. Consequently fair compensation could have been assessed. Equally *it would have been possible, even though more difficult and much more, expensive, to prove, if it be the fact, that the equities in the annuity fund would have performed even better if diversified than they did as concentrated in bank and insurance shares. But the plaintiff has not* provided any such proof. She has not even provided any material which would enable the court to assess the strength of, or value, the chance which she claims she has lost. Therefore her claim for compensation or damages in respect of the investment of the annuity fund from 1922 to 1960 must, in my judgment, fail.

Leggatt LJ was of the same mind:[83]

> The essence of the bank's duty was to take such steps as a prudent businessman would have taken to maintain and increase the value of the trust fund. Unless it failed to do so, it was not in breach of trust. *A breach of duty will not be actionable, and therefore will be immaterial, if it does not cause loss*. In this context I would endorse the concession of Mr. Nugee for the bank that 'loss' will be incurred by a trust fund when it makes a gain less than would have been made by a prudent businessman. A claimant will therefore fail who cannot prove a loss in this sense caused by breach of duty. So here in order to make a case for an inquiry, the plaintiff must show that loss was caused by breach of duty on the part of the bank.
>
> ...
>
> In my judgment either there was a loss in the present case or there was not. Unless there was a loss, there was no cause of action. It was for the plaintiff to prove on balance of probabilities that there was, or must have been, a loss. If proved, the court would then have had to assess the amount of it, and for the purpose of doing so might have had recourse to presumptions against the bank. In short, if it were shown that a loss was caused by breach of trust, such a presumption might avail the plaintiff in quantifying the loss. The plaintiff's difficulty is in reaching that stage.
>
> The plaintiff therefore had to prove that a prudent trustee, knowing of the scope of the bank's investment power and conducting regular reviews, would so have

[83] *Ibid,* 1283-1284

invested the trust funds as to make it worth more than it was worth when the plaintiff inherited it. That was a matter for expert evidence. …

No testator, in the light of this example, would choose this bank for the effective management of his investment. But the bank's engagement was as a trustee; and as such, it is to be judged not so much by success as by absence of proven default. The importance of preservation of a trust fund will always outweigh success in its advancement. Inevitably, a trustee in the bank's position wears a complacent air, because the virtue of safety will in practice put a premium on inactivity. Until the 1950s active management of the portfolio might have been seen as speculative, and even in these days such dealing would have to be notably successful before the expense would be justified. The very process of attempting to achieve a balance, or (if that be old-fashioned) fairness, as between the interests of life-tenants and those of a remainderman inevitably means that each can complain of being less well served than he or she ought to have been. But by the undemanding standard of prudence the bank is not shown to have committed any breach of trust resulting in loss.

WHERE THE SETTLOR WANTS ALL THE TRUST EGGS IN ONE BASKET, THE TRUSTEE HAD BETTER WATCH THE BASKET CLOSELY

The reconciliation of Lord Watson's deprecation of hazard with Bacon V-C's recognition and acceptance of the inevitability of risk, can be hardest where the terms of the trust fetter what otherwise might be trustee's better judgment.

The "prototypical trust asset" of old was ancestral land.[84] Today it is more likely to be a family company. In either situation, sentiment is a fetter on the trustee—who is more on her mettle than ever.

In the family company context, Cross J held, in *Re Lucking's Will Trust*,[85] and, in *Bartlett v Barclays Trust Co (No 1)*,[86] Brightman J repeated and elaborated, that a trustee of a controlling shareholding in a family company must keep a close eye on the company's activities. The trustee must not rest content with receiving no more than the statutory accounts. Without having to go so far as to monitor the directors' every move, the trustee nonetheless must not just turn a blind eye. Rather, he must secure the regular supply of all the information that an ordinary prudent investor would require, so as to enable him to act timeously for the protection of the trust estate. Their Lordships said that this could involve the trustee in, for example, all or some of:

- Running the business himself.
- Becoming a non-executive director.
- Appointing a nominee to the board to report to him.
- Overseeing the company's affairs by studying the agenda and minutes of board meetings, the management accounts, and the quarterly or other periodical reports to the board.

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[84] Langbein, "The Uniform Prudent Investor Act and the Future of Trust Investing" 81 *Iowa L Rev* 641, 665 (1966).
[85] 1968] 1 WLR 866, 874.
[86] [1980] Ch 515, 533.

The same principle applies whenever the share parcel included in the trust estate is big enough to empower the trustees to insist on such, or similar, rights in respect of the company's business.[87]

If the information so secured begins to show that drastic action is called for, including even selling the underlying business or property, the trustee must continue as a prudent investor, and do what has to be done.

This is just what the trustee in *In the Matter of Repus Trust and Trustcorp Ltd*[88] had set out to do in respect of a trust estate the sole asset of which was the illiquid 744 acre Barne Estate in Tipperary, Ireland, on which stood a period house, and other buildings, all in a state of decay and disrepair. The estate had been in the family for more than three centuries. Confirming the trustee's decision to sell up, against beneficiary opposition, the Bailiff, Sir Philip Bailhache, exercised the jurisdiction which Robert Walker J had confirmed in these terms in an unnamed, undated, and unreported judgment in the Chancery Division:[89]

> The second category is where the issue is whether the proposed course of action is a proper exercise of the trustees' power where there is no real doubt as to the nature of the trustees' powers and the trustees have decided how they want to exercise them but, because the decision is particularly momentous, the trustees wish to obtain the blessing of the court for the action on which they have resolved and which is within their powers. Obvious examples of that which are very familiar in the Chancery Division are a decision by the trustees to sell a family estate or to sell a controlling holding in a family company. In such circumstances there is no doubt at all as to the extent of the trustees' powers nor is there any doubt as to what the trustees want to do, but they think it prudent and the court will give them their costs of doing so, to obtain the court's blessing on a momentous decision. In a case like that there is no question of surrender of discretion and indeed it is most unlikely that the court will be persuaded in the absence of special circumstances to accept the surrender of discretion on a question of that sort, where the trustees are prima facie in a much better position than the court to know what is in the best interests of the beneficiaries.

On the other hand, the beneficiaries in *Gregson v HAE Trustees*[90] claimed that their trustee had failed to takes the steps it ought to have taken in respect of the old-established family furniture business which—like the trustee, whose directors were being sued in a "dog leg" claim—had become insolvent. The estimated deficiency for shareholders was £70 million.

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[87] Thus, in *Dominicia Social Security Board v Nature Island Investment Company Limited & Anor (Dominica)* [2008] UKPC 19 (2 April 2009), their Lordships [at page 10] denied the possibility of viewing the interposition of a company, to manage the assets in question,

> as a mere matter of form. They would add (to avoid any misunderstanding) that trustees or other fiduciaries cannot of course use a limited liability company as a means of insulating themselves from responsibility for recklessness in the conduct of a business (see *Bartlett v Barclays Bank Trust Company Ltd* [1980] Ch 515). DSSB, and in particular its Director and its Investment Committee, will have a heavy and continuing responsibility for monitoring the way in which the new company's board of directors carry on its business. So, in a rather more remote way, will the Minister. But in doing so they will be taking care of an investment, not running a business.

[88] Jersey Royal Court, Samedi Division, [2005] JRC 081,15 June 2005.

[89] Jersey Royal Court, Samedi Division, [2005] JRC 081,15 June 2005, para 11.

[90] [2008] WTLR 999.

The court ruled that the directors of the corporate trustee owed fiduciary duties to that company alone, and not to the beneficiaries of the trust which it had been administering. Nonetheless the court noted what would have been in issue had it ruled against the directors:[91]

I should also say what is not in issue on these applications. The defendants say that they did in fact consider the question of diversification of the Courts [Bros (Furnishers) Limited] shares from time to time and had good grounds for concluding that the shares should be retained. They say it was always the wish of the Cohen family, including the claimant and the other appointees of the Settlement, that Courts should remain substantially a family owned and managed company. They rely on letters of wishes by which the settlor stated in 1988 that the shares should not be sold except in the case of a takeover. They point out that the holdings of the various family members in Courts, which together comprised a majority holding, continued until late 2004, and that diversification would have risked eliminating the family's controlling holding. They also refer to the terms of shareholders agreements affecting the shares, to potential tax liabilities from a sale of the shares and to the possibility of a disposal of Courts or its business during 2004, all of which they say were good reasons not to diversify. They also allege that the claimant, with full knowledge, consented to and concurred in the retention by HAE of the Courts shares. It is common ground that I cannot deal with these issues on the present applications, and that the application is restricted to the two narrow points I have already identified. However, this brief survey shows that if this case is to continue there will be a reasonably substantial trial.

Irrespective of the outcome of the dog-leg claim, the parties fully argued, and asked the court to decide, the issue whether the trustee had been dispensed from any duty to consider whether to act as the trustee of the *Repus Trust* had done. Although expressed in terms of provisions of the Trustee Act 2000, the decision accords with the general prudential trustee obligation:[92]

> Fifth, the imposition of the duty to review diversification of the trust investments under section 4(3) of the 2000 Act is not, in my view, inconsistent with, or inimical to, the … notion that this was a trust of shares in a family company, or the settlor's letters of wishes, or any other indications that the settlor wished HAE, if possible, to retain the Courts shares. I reach this view for several reasons.
>
> In the first place, the settlor did not, as he could have done, insist that the Courts shares never be sold. He gave the Trustees a power to sell them and, as already explained, this meant that they were always 'available for investment'.
>
> The second reason is that section 4(3)(b), which deals with diversification, contains the qualification 'in so far as is appropriate to the circumstances of the trust'. This important qualification is echoed also in section 5(3), where the exception to the need to obtain advice refers to 'all the circumstances'. In my view, the nature and purposes of the Settlement, the existence of cl 2, the letters of wishes, and, indeed such matters as the shareholdings of other members of the family or family trusts in Courts, are all 'circumstances of the trust' for the purposes of section 4(3)(b) capable of qualifying the appropriateness of diversification. Hence, all the arguments that the settlor intended HAE to hold the Courts shares and reflected this in cl 2 of the Settlement come into play in the exercise of the section 4(3) duty. This

[91] [2008] WTLR 999 at para 21.
[92] Ibid, at paras 87-91.

> approach appears to me to be far more consonant with the statutory purpose of requiring trustees to review the trust investments and to consider diversification than the argument that these factors serve to oust the duty altogether.
>
> The third reason is that the section 4(3) duty is a duty to review and consider diversification of the investments of the trust, it is not a duty to diversify. In my view, it is not inimical to or inconsistent with the terms or purposes of the Settlement to require HAE to review the diversification of the investments of the trust from time to time, where the circumstances relevant to their review might well justify deciding to retain the entire block of Courts shares.

That approach must be right. Of course the sentimental attachments to the particular enterprise must be weighed in the balance. The identity of the family may be closely entwined with the business of the estate, and that is not to be ignored. But that does not absolve the trustee from her *Re Lucking's Will Trust*; [93] *Bartlett v Barclays Trust Co (No 1)*[94] duties. If you have all your eggs in one basket, you need to keep a close watch on the basket.[95] And if, at some point, her vigilant discharge of these duties shall have brought her to the point at which she must make a decision to bail out, then she must do so—first applying to the court for confirmation where beneficiary dismay makes that wise.

WHEN FAILING TO DIVERSIFY IS INEXCUSABLE FAILURE TO BALANCE THE PORTFOLIO

Save for cases like these—where the trustee has undertaken the trust on the basis that all or most of its eggs are intended to be in the one basket—the tension between hazard and prudent risk must be resolved by balancing diverse investments.[96] Professor Langbein thus identifies the foregoing as:[97]

> two situations in which resisting diversification might be appropriate: first, when the tax cost of selling low-basis securities would outweigh the gain from diversification; and second, when the settlor mandates that the trust retain a family business.

But, he is quick to add:[98]

> When, however, the trust investor starts with cash in hand, failing to diversify is inexcuseable [sic].

Loring J certainly thought so in the Massachussetts case, *Warren v Pazolt*.[99] The trustees had managed to tie up 92% of the trust estate in a single investment. The learned judge held that:[100]

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[93] [1968] 1 WLR 866, 874.
[94] [1980] Ch 515, 533.
[95] Cf n 87 above.
[96] In "English Fiduciary Standards and Trust Law (The Rise of the International Trust)" 32 *Vanderbilt Journal of Transnational Law* 555, 558 (1999), Professor David Hayton pointed out that "the need to diversify arises from the duty to act as a prudent person would in investing for others".
[97] "The Uniform Prudent Investor Act and the Future of Trust Investing," 81 *Iowa L Rev* 641, 646 (1966).
[98] "The Uniform Prudent Investor Act and the Future of Trust Investing," 81 *Iowa L Rev 641*, 646 (1966).
[99] 89 NE 381 (1909).
[100] 89 NE 381, 388 (1909).

> The fundamental objection to the erection of the Carney Building being an act in the exercise of a sound discretion lies in the large proportion which that investment bears to the whole trust estate. … The value of the land when the new building was determined upon was therefore $403,000. The new building cost about $450,000 all of which was borrowed on mortgage. This single investment was an investment of $850,000 out of a trust principal of a little over $920,000. We do not see how this can be justified as the exercise of a sound discretion … .
>
> … The error made by the trustees was adding to this land then worth $375,000 another lot worth $28,000 and erecting upon it a $450,000 building, when the whole trust amounted to no more than $920,000, in place of selling the land valued at $375,000 with the old buildings then on it as they stood.

Taking a like view in *Estate of Rodney B Janes*,[101] the New York Surrogate Judge found against a trustee bank which had maintained 71% of the trust estate in a single blue chip stock (Eastman Kodak) which had long been experiencing a decline in value. The witness for the trustee, Mr Patterson, testified that the testator's widow had told the bank that she "loved" Kodak.

> Patterson testified that Mrs Janes agreed with each of the Patterson recommendations to the extent that she 'loved Kodak' and her husband 'loved' Kodak. As appears later, the bank's reliance on these expressions was part of the basis to retain a concentration in EK. The loose statements made by Mrs Janes can hardly be equalled [sic] with a consent to the retention. The record is devoid of any signed consent, further communications [sic] by her, acknowledged or otherwise.

The Surrogate Judge said:

> Notwithstanding turbulent worldwide economic conditions including an OPEC oil embargo, all of which resulted in a monumental and precipitous decline in the stock market during the 1973-74 period, the bank's position continued to be one to retain the Eastern Kodak stock in its concentrated form. In that one year the EK stock dropped from approximately $115 a share to about $60 a share. In summary, the Bank's position in demonstrating prudence is that the retention of the EK was part of a conscious and studied investment plan. *In reality, the Bank's responsiveness to the admittedly turbulent and precipitous tenor of the times (1973) was to do nothing. To assert that mere review, analysis, and monitoring satisfies the standard of due care by a prudent person where action and activity are indicated, tests the Court's sense of reason and logic and more importantly flies in the face of the surcharge cases* heretofore cited.

The decision of the learned Surrogate Court judge on liability was affirmed by the Court of Appeals New York:[102] That Court held that:

> First, petitioner failed to consider the investment in Kodak stock in relation to the entire portfolio of the estate … , ie, whether the Kodak concentration itself created or added to investment risk. The objectants' experts testified that even high quality growth stocks, such as Kodak, possess some degree of volatility because their market value is tied so closely to earnings projections … . They further opined

[101] 214 NYLJ 31 (5 July 1995).
[102] *In re Janes* 681 NE 2d 332, 338-339 (1997).

that the investment risk arising from that volatility is significantly exacerbated when a portfolio is heavily concentrated in one such growth stock.

> Second, the evidence revealed that, in maintaining an investment portfolio in which Kodak represented 71% of the estate's stock holdings, and the balance was largely in other growth stocks, petitioner paid insufficient attention to the needs and interests of the testator's 72-year-old widow, the life beneficiary of three quarters of his estate, for whose comfort, support and anticipated increased medical expenses the testamentary trusts were evidently created. Testimony by petitioner's investment manager, and by the objectants' experts, disclosed that the annual yield on Kodak stock in 1973 was approximately l.06%, and that the aggregate annual income from all estate stockholdings was $43,961, a scant l.7% of the $ 2.5 million estate securities portfolio. Thus, retention of a high concentration of Kodak jeopardized the interests of the primary income beneficiary of the estate and led to the eventual need to substantially invade the principal of the marital testamentary trust. Lastly, there was evidence in the record to support the findings below that, in managing the estate's investments, petitioner failed to exercise due care and the skill it held itself out as possessing as a corporate fiduciary … .
>
> Notably, there was proof that petitioner:
>
> (1) failed initially to undertake a formal analysis of the estate and establish an investment plan consistent with the testator's primary objectives;
> (2) failed to follow petitioner's own internal trustee review protocol during the administration of the estate, which advised special caution and attention in cases of portfolio concentration of as little as 20%; and
> (3) failed to conduct more than routine reviews of the Kodak holdings in this estate, without considering alternative investment choices, over a seven-year period of steady decline in the value of the stock.
>
> Since, thus, there was evidence in the record to support the foregoing affirmed findings of imprudence on the part of petitioner, the determination of liability must be affirmed … .

Senator Janes' widow might have been a sweet and complaisant little old lady who could live on the smell of an oily rag, but the court was not going to condone the bank treating her that way. Referring again to the hapless bank witness, the learned Surrogate judge had said:[103]

> That the EK stock in 1973 had a yield of 1.1% is again uncontroverted. The Patterson testimony and indeed the thrust of the bank's position vis-a-vis this income level is that yield in its broader form involves not only the actual dividend ratio to the price but also involves the growth nature of the stock and the probabilities for future appreciation. … With this position, the Court does not agree. Given the age, health and status of Mrs Janes in 1973 and the fact that the ultimate beneficiaries were charities, the income yield was insufficient and unacceptable.

Sweetness and complaisance may well have been lurking somewhere deep in the character of the widow in *Re Mulligan*,[104] but she seems to have suppressed any urge to reveal those qualities. She was the life tenant. She was one of the trustees. The other trustee was a

[103] 214 NYLJ 31 (5 July 1995).
[104] [1998] 1 NZLR 481.

trustee corporation. Although her personal solicitor gave evidence—the relevance of which is unclear—that she "was not obdurate or unreasonable in his experience,"[105] the officers of that corporation seem to have seen her as something of a Madame Lash. The court found that "she was a person of some business acumen," that she had been "alive to the wisdom that a share portfolio historically and into the future would provide a measure of protection against inflation," but that "she was quite hostile to any suggestion of diversification when that issue was raised" by officers of the trust company.[106] She turned her income situation into the reverse of that from which the New York courts rescued the widow in *Janes*.

She outlived her farmer husband by 41 years. The farm was sold after 16 of those years, and she then received the balance of a substantial legacy: which enabled her to buy a home, a rental apartment, and (although the trustee knew nothing of this) to make significant investments in shares.

The $108,000 balance remaining in the hands of the trustees would have sufficed to purchase 14 average residential properties in the city of Christchurch in 1965. From that year until the widow's death 25 years later, the trustees invested it entirely in fixed interest securities such as mortgages and central and local government stock.

The life-tenant-widow-trustee had a very good income as a result. The realty and shares on which she spent her legacy were worth $686,000 when she died in 1990.

Thanks to the investment policy, the trust capital was then worth only $102,000: $10,000 short of the average price of a single residential property in Christchurch at that date.

The question identified by the court was "whether exclusive investment in fixed-interest securities to the exclusion of equities constituted a breach of trust in the circumstances of this case." On behalf of the defendant trustees, expert evidence was given that their investment policy had been "in line with the then current thinking and practice."[107] That evidence may have evoked in the mind of the court the celebrated comment by Bowen LJ[108] that "Bona fides cannot be the sole test, otherwise you might have a lunatic conducting the affairs of the company, and paying away its money with both hands in a manner perfectly bona fide yet perfectly irrational." At all events, the court found the trustees to have been in breach of duty by not having ensured that, by 1972, the estate had been invested in equities to the extent of 40% [or $43,200] of the fund:[109]

> Investment at that level would have enabled the purchase of a reasonable spread of blue-chip shares, whereas the options would have been limited with any appreciably lower level of investment. A reason-able spread would have comprised about ten shares, selected on the basis of performance and with long-term retention in mind. Other considerations would also have been at play. In 1972 the rate of inflation was of the order of 10 per cent and the trend in relation to mortgage interest rates was upwards. These factors would have underscored the need for a decisive move into the sharemarket.

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[105] Ibid, 505.
[106] Ibid, 507.
[107] Ibid, 497.
[108] *Hutton v West Cork Railway Co* (1883) 23 Ch D 654, 672-673.
[109] [1998] 1 NZLR 481, 509.

A fund of only $43,000 was never going to be enough to construct and manage a fully index-matched portfolio. The trustees would have to have made choices:[110]

> Turning to the question of whether the assumed estate portfolio would have increased in value in line with the Barclays Index, the Court was again confronted with conflicting evidence. On the one hand Mr Nisbet ventured the confident opinion that a suitable mix of blue-chip shares would have outperformed the index. He justified this opinion on the basis that the estate would have been advised to pick the six to ten best stocks out of the 40 that comprised the then Barclays Index. At the other end of the spectrum was the final witness Mr Irvine called for the second defendants. He considered that although the index was probably the most suitable available benchmark, it did not provide a valid base for measuring the performance of a fairly modest portfolio of a private trust. He supported this contention by reference to various factors. The index comprises a basket of shares. An estate could not hope to 'buy the Index'. The spread of investment over 40 shares would provide, he considered, a lower risk profile than investment in a limited number of shares. In addition, he characterised the index as a 'winners' measure. By this Mr Irvine meant that profitable growing companies become part of the index, while declining companies drop out. Accordingly for an estate to match the index, would require a considerable level of trading; conduct inconsistent with that to be expected of trustees committed to the purchase of blue-chip shares on a long-term basis. He pointed as well to the costs involved in acquiring and selling shares, namely commission and duty. It was therefore Mr Irvine's view that in using the index as a benchmark in the present context, a discount factor of 50 per cent should be applied.
>
> I considered Mr Irvine to be an impressive witness. Largely on the basis of his evidence it is my view that the identified contingencies do require the application of a discount factor, but not at the level suggested. I consider a discount of one-quarter would be appropriate. Mr Irvine's views were expressed on the footing that the estate would hold a narrow portfolio of two or three shares. I regard that as unlikely. With an investment of $43,200 in 1972 a portfolio of perhaps ten shares would have been obtained. I consider this holding would have been retained intact and would, on the probabilities, have increased in value to the extent of 75 per cent of the growth in the index.

From there, the court was driven to conclude that the $43,200 would have increased to $170,640, and effectively to surcharge the trust company with the difference between these figures.

This is not to say that the Trustees can, or must, adopt fixed percentages, or rules of thumb. As the US District Court, Maryland, held in *Meyer v Berkshire Life Insurance Company*[111] held:

> the duty to diversify investments cannot be stated as a fixed percentage, because a prudent fiduciary must consider the facts and circumstances of each case."

[110] Ibid, 510.
[111] 250 F Supp 2d 544, 565 (2003).

BALANCE MEDIATES BETWEEN RISK AND RETURN: PORTFOLIO THEORY[112]

As Hoffmann J has put it,[113] trustees now are to "be judged by the standards of current portfolio theory". And in the United States, the Association for Investment Management and Research has declared that:[114]

> The investment profession has long recognized that the combination of several different investments is likely to provide a more acceptable level of risk exposure than having all funds in a single investment."

For the larger trust estate, "buying the index" may be feasible and desirable. For the smaller estate, as in *Re Mulligan*[115] as few as ten stocks may suffice. The important thing is that they are truly diverse in the sense of being minimally correlated. Stocks are not relevantly diverse if they are "co-variant"—that is, if they all are likely to go belly-up at once.

Justice Richard Posner's of the US Court of Appeals for the Seventh Circuit, writes extensively of portfolio design in his *Economic Analysis of Law*.[116] His comments include these basics [for ease of reference, I have inserted sub-headings, and have incorporated the footnotes into the text]:

> *[Risk and expected return]*
> A security has two dimensions: risk and expected return. The expected return is constructed by multiplying every possible return by the probability of its being the actual return, and then adding the results of the multiplication. Thus, if there is a 50 percent probability that a particular stock that sells for $10 today will be worth $12 one year from now, a 40 percent probability that it will be worth $15, and a 10 percent probability that it will be worth nothing, its expected return is $2 [(.5 x $2) + (.4 x $5) – (.1 x $0)] [The expected value is $12 [(.5 x $12) + (.4 x $15) + (.1 x $0)], and the current price is $10. To simplify analysis, it is assumed that no dividends will be paid. The expected return of a stock includes, of course, both appreciation and dividends.]

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[112] See Ian Shipway's clear explanation in "Modern Portfolio Theory", and Christopher Mc Call's "A Fine Romance: the Union of Prudence and Risk" [2009] *Trusts & Trustees* Issue 2.

As for pension fund investment, see Lee, "Modern Portfolio Theory and the Investment of Pension Funds" in Finn (ed) *Equity and Commercial Relationships* (1987) 284, and Ellison, *Pension Fund Investment Law* (2008): bearing in mind what Staughton LJ said in the Court of Appeal in *Nestle v National Westminster Bank plc* [1993] 1 WLR 1260, 1277 (CA):

> There is in my opinion a better answer to this comparison. Life assurance companies and pension funds have as their primary duty an obligation to pay at some future date a sum that is fixed in monetary terms. No doubt they offer profits, or an increase on the promised pension; and it may be that even in 1959 there was competition between companies by reference to their past records of success. But I am convinced that they could be expected to follow a policy of considerable caution in order to ensure that, come what may, their minimum obligations in monetary terms were fulfilled. I do not regard them as a reliable guide to what would have been done by private investors, or should have been done by trustees of a private family trust.

[113] *Nestle v National Westminster Bank plc* [2000] WTLR 795, 797; affd [1993] 1 WLR 1260.

[114] *The Standards of Practice Handbook* 8th edn (1999).

[115] [1998] 1 NZLR 481, 510.

[116] 7th edn (2007) 465-466.

[Usual preference is for the lower risk for the same return]
Although the expected return of a 100 percent chance of obtaining $10 is the same ($10) as the expected return of a 50 percent chance of obtaining $20 or a 1 percent chance of obtaining $1,000, we know that people are not indifferent to the various ways of combining uncertainty and outcomes to yield the same expected return. In choosing among securities that have identical expected returns, the risk-averse investor will choose the one having the least uncertainty unless the prices of the others fall, thereby increasing their expected returns, to the point where he feels adequately compensated for bearing greater risk.

The prevalence of risk aversion in investing is illustrated by the normally lower rate of return on bonds compared to the common stock of the same company. Suppose that the expected return (dividends plus appreciation) on a company's common stock is 10 percent. Risk-neutral investors would demand 10 percent interest on the company's bonds as well. Although there is less risk to being a bondholder, since he has the cushion of the equity shareholders, who would have to be wiped out completely before he could lose his interest, his additional safety is offset in an expected-return sense by the fact that he cannot earn more than the interest rate specified in the bond. The difference between a company's bond interest rate and the (higher) expected return to owners of the common stock is compensation to the stockholders for the extra risk they bear. [(There) is one risk that bondholders bear that shareholders do not (to the same extent). (It is, of course, inflation.)]

[Negatively correlated risks can cancel each other out]
It follows that there should also be a systematic difference among the expected returns of common stocks that differ in their riskiness; but this point is subject to an important qualification. Suppose the expected per-share returns of two stocks (A and B) are the same, $2, but the expected return of A combines a 50 percent probability of no return with a 50 percent probability of a $4 return, while that of B combines a 50 percent probability of a –$6 return with an equal probability of a $10 return. B is the riskier stock. Let there be a third stock © that, like B, has an expected return of $2 resulting from a combination of a 50 percent probability of a –$6 return with the same probability of a $10 return— only the fortunes of C and B are reciprocal, so that when B does well C does poorly and vice versa. [That is, there is a 50 percent probability that B will yield a –$6 return and C a $10 return, and a 50 percent probability that B will yield a $10 return and C a –$6 return.] Then a portfolio composed of B and C will be less risky than one composed solely of A, even though A, considered in isolation, is less risky than either B or C. The investor will not insist on a risk premium for holding B and C in his portfolio. Their risks cancel; the portfolio itself is risk free.[117]

[117] Grinblatt and Titman, *Financial Markets and Corporate Strategy* 106-107 (1998) add a vital qualification as to co-variance:

> *Diversification*, the holding of many securities to lessen risk, is the most important concept introduced in this chapter. It means that portfolio managers or individual investors balance their investments among several securities to lessen risk. As a portfolio manager or individual investor adds more stocks to his portfolio, the additional stocks *diversify* the portfolio if they do not co-vary (ie, move together) too much in concordance with other stocks in the portfolio. Because stocks from similar geographic regions and industries tend to move together, a portfolio is diversified if it contains stocks from a variety of regions and industries.
> …

[Portfolio design proceeds accordingly]
This illustrates the fundamental point that portfolio design can alter the risk characteristics of securities considered individually. And in a world in which the risks of different common stocks were negatively correlated, as in the preceding example, there would be few if any differential risk premiums among common stocks. Less obviously, this would also be true if the risks of common stocks, instead of being negatively correlated, were uncorrelated, ie, random; for in a portfolio consisting of many different common stocks, the randomly distributed risks of the securities in the portfolio would tend to cancel out. By way of analogy, observe that while the riskiness of every individual life in this country is nonnegligible, the country's death rate—the performance of the 'portfolio' of all individuals—is extremely stable. It is, in fact, much more stable than the stock market. This suggests that the risks of different common stocks are neither negatively correlated nor random but in fact have a strong positive correlation. This in turn makes it necessary in portfolio design to distinguish between two components of risk. One is the component that is positively correlated with the risk of the whole flock of securities, the market, and therefore cannot be eliminated simply by adding more and more securities. The other component is risk that is negatively correlated, or uncorrelated, with the risk of the market as a whole, and therefore can be diversified away. Diversification is an important goal of portfolio design because it allows the investor to get rid of a form of risk that is uncompensated (precisely because it can be eliminated at slight cost, through diversification) and is therefore a deadweight loss to the investor who is risk averse. But diversification does not eliminate all risk; some risk, as we have seen, is undiversifiable, and to bear that risk the risk averse investor will insist on compensation. Because systematic risk—the risk component that is positively correlated with the risk of the market as a whole—is also compensated risk, the portfolio manager who wants to reduce it must be prepared to pay a price in the form of a lower expected return. [Stocks that differ in systematic risk have been found empirically to differ in expected return, and the correlation between systematic risk and return has been found to be positive as expected. The evidence is summarized in James H Lorie & Mary T Hamilton, *The Stock Market: Theories and Evidence,* chs 11-12 (1973), but remains controversial. Compare Eugene F Fama & Kenneth R French, "Common Risk Factors in the Returns on Stocks and Bonds," 33 *J Fin Econ* 3 (1993), with Fischer Black, Beta and Return, *J Portfolio Mgmt,* Fall 1993, p 8.]

TRUSTEE RELIANCE ON FUNDS[118]

To that end—following the discussion of basic portfolio theory, in his *Economic Analysis of Law*[119] cited above, and a discussion of leverage as a, risky, means of increasing portfolio returns—[120] Justice Posner canvasses the considerations bearing on whether this duty requires the trustees to engage in constant attempts to "beat the market" by identifying and purchasing undervalued shares, and by identifying and selling overvalued

While the principle of diversification is well known, even by students new to finance, implementing mean-variance analysis—for example, coming up with the weights of portfolios with desirable properties, such as a portfolio with the lowest variance—requires some work.

118 See Martin Day and Fiona Duggan "Common Investment Funds" [2009] *Trusts & Trustees* Issue 2.

119 7th edn (2007).

120 Ibid 468-469.

shares, and thus maximizing the return to the trust estate.[121] His view is that the game is not worth the candle. Research is expensive. Transaction costs are high. Much expensive trustee time is consumed. Above all, the public availability of the information, on which assessments of under and over valuation fall to be made, entails a sufficient degree of market efficiency to frustrate the attempt to beat it.[122]

So what about managed funds? The trustee thinking in that direction would need, also, to heed Justice Posner's pessimism whether fund managers, and their specialist analysts, are any better than analysts in general[123] when it comes to beating the market:[124]

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[121] Ibid 471-473.

[122] *Ibid* 472:

> It may seem virtually self-evident that a skilled investor, who conducts careful research into the conditions and prospects of particular companies and of the economy as a whole, will earn a higher return (always correcting for differences in systematic risk) than the investor who simply buys the market, blindly investing in the entire stock market list and never selling a stock when its prospects begin to sour. But since the value of a stock is a function of its anticipated earnings and therefore depends largely on events occurring in the future, it will often be impossible to determine whether a stock is undervalued at its current price without knowledge of what the future holds, and very few people are good at predicting the future. Although a stock may be undervalued because of some characteristic of the company (or of its competitors, suppliers, customers, political environment, etc) that exists today but is not widely known or correctly understood, the problem here is that the underlying information is in the public domain,2 meaning that it is equally available to all security analysts. The only way to make money from such information is to interpret it better than other analysts do. This is not a promising method of outperforming the market. It requires both that the analyst interpret publicly available information differently from the average opinion of the analyst community and that his deviant interpretations be correct substantially more often than they are incorrect … .

[123] Langbein "The Uniform Prudent Investor Act and the Future of Trust Investing," 81 *Iowa L Rev* 641, 656-658 (1966) points out why:

> Why have the professional investment managers performed so poorly? Modern Portfolio Theory supplies a crisp answer to that question. In a nutshell, the insight is that the professional portfolio managers are not incompetent bunglers, indeed, just the opposite. They are so good at what they do that they effectively cancel each other out.
>
> To understand why, start with the basics. The price of a security represents the present discounted value of its future earnings. Further, for every buyer there must be a seller—someone who has formed an opposite judgment about the value of that future earnings stream at the security's current price. If all investors agreed that a particular security was a bargain at its current price, no one who owned the security would sell it at that price. Only an increase in price would induce sellers to sell. This is why we can say that, presumptively, any security is correctly priced at its current trading level.
>
> To outperform the market—that is, consistently to identify undervalued or overvalued securities in advance of other investors —an investor must predict future earnings with superior speed and accuracy. But here the task becomes daunting. New information about individual companies is disseminated rapidly as a result of modern communications systems. The securities laws have largely choked off inside information as a source of advantage in trading. Economic developments, technological innovation, foreign affairs, political events, social changes—all profoundly affect the prices of securities, yet these phenomena are notoriously difficult to foresee.
>
> Professional securities analysts are thus largely limited to interpreting information already in the public domain and available to other analysts. In order to outperform the market the portfolio manager has to be consistently better at making such interpretations than the thousands of competing professionals who are interpreting the same data. The theory of efficient markets posits that everything that is known or knowable about the price of a publicly traded security is already fully reflected in its price. The securities markets are so efficient in discounting information and pricing securities that not even the professionals can consistently identify undervalued and overvalued securities before other investors get there. The indifferent performance record of professional investment managers is, therefore, 'exactly what we should expect in an efficient market.

[124] *Economic Analysis of Law* 7th edn (2007) 472-473.

> … empirical studies have found that mutual funds, despite their employment of security analysts and portfolio managers for the purpose of outperforming the market, fail to do [The early studies are summarized in Lorie & Hamilton, *The Stock Market: Theories and Evidence* at ch 4. See also Burton G Malkiel, "Reflections on the Efficient Market Hypothesis: 30 Years Later," 40 Fin. Rev 1 (2005); RA Brealey, *An Introduction to Risk and Return from Common Stocks*, ch 3 (2d ed 1983); Richard A Ippolito, *Efficiency with Costly Information: A Study of Mutual Fund Performance, 1965-1984*, 104 *QJ Econ* 1 (1989). The empirical research has concentrated on mutual funds because they are required by federal law to report in detail on their performance; but all indications are that common trust funds, pension funds, and other institutional investors likewise fail to systematically outperform the market portfolio.] They do no better than the blind market portfolio.
>
> Although it has been argued that the proper comparison is not between all mutual funds and the market but between the most successful mutual funds and the market, the studies suggest that there are no consistently successful mutual funds. Some enjoy shorter or longer runs of success, but generally the degree of success observed is no greater than one would expect if luck, not skill, indeed the only factor determining the fund's performance.

In *Nestle v National Westminster Bank*[125] Dillon LJ noted in the Court of Appeal that:

> as Hoffmann J pointed out,[126] that the evidence showed that if the BZW Equity Index was applied over the period from July 1974 to December 1986 to 'growth' unit trusts (as opposed to 'income' unit trusts) it appeared that 12 of the 'growth' trusts had done better than the index, but 21 had done worse.

So is the solution for the hapless trustee to go passive; to run with *Underhill and Hayton's* advice on the alternative to the *Re Mulligan*[127] approach, and[128] "bear in mind the possibility of investing small trust estates in 'tracker finds' which track and reflect the index, so obviating the need for a discount based on the size of the fund in question"? Here Justice Posner is more positive:[129]

> The studies support an even stronger conclusion: When brokerage costs and management fees are taken into account, the average mutual or common trust fund yields a lower net return than a broadly based market index such as the S&P 500. This comparison was long derided on the ground that the S&P 500 is a hypothetical fund and hence has no administrative costs. Now that there are, and indeed for some years have been, real market-matching funds in operation … , it is possible to evaluate—and reject—this criticism. The administrative costs of a market fund turn out to be so low (on a $500 million portfolio, perhaps 10 percent of the costs of conventional management) that the expected return of a market fund is only trivially different from that of the S&P 500.
>
> …

[125] *Nestle v National Westminster Bank plc* [1993] 1 WLR 1260, 1267 (CA).
[126] *Nestle v National Westminster Bank plc* [2000] WTLR 795.
[127] [1998] 1 NZLR 481, 510.
[128] Hayton et al, *Underhill & Hayton: Law Relating to Trusts and Trustees* (2006) 17th edn 89.42.
[129] *Economic Analysis of Law* 7th edn (2007) 473, 479.

> In a dramatic sign of the changing legal environment, trustees will now even invest portions of the funds entrusted to them in index funds. A typical index fund buys and holds a 200 to 500 stock portfolio designed to match the performance of the New York Stock Exchange (or perhaps some weighted average of domestic and foreign securities markets), performing no securities analysis and trading only insofar as necessary to maintain diversification, handle redemptions, and invest its shareholders' cash. It epitomizes passive investment—thus raising such questions as what if every investor adopted the passive strategy implied by the concept? Then the market would cease to be efficient … . But long before this happened, some investors would abandon the passive strategy to take advantage of the opportunities, which today are rare, for obtaining positive profits from securities analysis and active trading. How many active traders are necessary to keep the market efficient is a difficult question (need it be answered?). But observation of other markets, for example the housing market, where transactions are relatively infrequent and the products traded are heterogeneous (no two houses are as alike as two shares of the same class of the same company's stock), suggests that the stock market would remain efficient even if most investors were passive.

Professor Langbein adds his own weight to this:[130]

> One response to the lesson that you cannot beat the market is that you might make a considered judgment to cease attempting it, especially if you can pocket the savings from not trying. A vast proportion of all fiduciary investing is now conducted 'passively,' in so-called index or market funds. These funds undertake simply to replicate the performance of the broad market indexes. In the mid-1970s when market funds first appeared, they attracted only a few hundred million dollars, most of it from the AT&T pension funds. Today, hundreds of billions of dollars in American equities are indexed.
>
> Modern Portfolio Theory has taught us that the game of stock picking is costly and futile for most investors, especially small investors, while emphasizing the large and essentially costless gains that are to be had from maximizing diversification. These twin insights point the fiduciary investor —that is, the prudent investor—strongly toward the use of pooled investment vehicles that are large enough to achieve high levels of diversification at reasonable cost. The investment path of the future for trusts, especially smaller trusts, is the mutual fund or the bank common trust fund."

But while an investor of another person's money could prudently invest in a tracker fund in theory, it is clear that such an investment might not automatically be prudent in practice.[131]

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[130] Langbein "The Uniform Prudent Investor Act and the Future of Trust Investing," 81 Iowa L Rev 641, 656-658 (1966).

[131] Cf Womack, "When tracker funds go off the rails," *Mail on Sunday*, 14 January 2008:

> Tracker funds are supposed to take the guesswork out of investing. But a saver who five years ago picked the wrong UK tracker for their £10,000 investment would today be more than £8,000 worse off than someone who chose the top tracker.
>
> These funds aim to reproduce the gains, or losses, of a stock market index by holding a representative mix of the shares that make up the index. The process is largely automated, with no room for the human judgment calls made by the high-earning fund managers who run active funds.
>
> In theory, savers can invest in a tracker and expect it to give them returns in line with their target index. But in reality the funds deliver widely varying returns with differences in charges and

Apart from anything else, a prudent trustee would not simply hand the relevant part of the fund over to the tracker fund manager, without considering, and regularly verifying, for example, the basis on which it proposed to maintain diversification.

Nor would a prudent trustee necessarily and always concentrate on stocks and bonds, but ignore land[132] as a harbour in which to invest some of the trust estate.

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management styles leaving investors in some funds 17% behind others who were aiming for the same target.

Someone who invested five years ago in both St James's Place Tracker and Fidelity Moneybuilder UK Index would expect the same return from both funds. This is because both track the FTSE All-Share Index. But while Fidelity Moneybuilder has generated a return of 101.1%, St James's Place Tracker has delivered just 83.8%.

Worryingly for savers, no tracker fund was able to keep pace with its target index over the past five years. All were index laggers rather than index trackers.

Charges and fees explain most of the differences in performance between funds tracking the same index. The cheapest trackers, such as Fidelity's Moneybuilder, have annual charges of just 0.1%. But others-such as St James's Place Tracker, charge 1.25% a year - 12 and a half times as much.

Ben Willis, head of research at financial adviser Whitechurch Securities in Bristol who compiled the figures for Financial Mail, says:

> 'Over time initial charges and annual management fees will eat away at returns and it is only to be expected that most trackers will lag some way behind the index.'

132 For example, the American Law Institute's authoritative *Restatement of the Law, Trusts—Prudent Investor Rule* (1992) 54-55 lays down that:

Because of its importance as a part of the country's capital markets, real estate is a potentially valuable ingredient of a diversification strategy, especially in light of its limited covariance with publicly traded equity and debt securities. Historically, land has also tended to provide long-term protection against inflation. In addition, diversified real estate holdings have tended to offer, with less apparent volatility, returns comparable to those of a diversified portfolio of marketable securities. Furthermore, with thoughtful selection of properties or structuring of owner-ship positions, a trustee can organize the elements of the return toward the enhancement of either income productivity or principal appreciation, as might be desired for a particular trust portfolio.

Despite the potential advantages of investing in real estate, it would not be prudent for a trustee to disregard the complexities, burdens, and special risks associated with a decision to commit a portion of the trust estate to such investments. High transaction costs are to be expected. In addition, the absence of regulated and efficient central markets that deal in largely uniform assets creates specialized problems and significant extra risks. Inefficiencies in pricing inevitably cut both ways. This is especially so given the hazards of appraisal. Also, risk as well as opportunity for gain results from the array of uncertainties that relate to location, such as demography and land-use patterns, trends, and regulation.

Furthermore, important differences in the potential for gain enhancement and risk exposure turn on the specifics of the structure, terms, and circumstances of each real estate investment. Variations may involve matters ranging from financing arrangements to operating form to tax consequences of the diverse interests potentially involved. Some trust investments in real estate are likely to present challenging, ongoing management requirements. In addition, efforts to achieve diversification within the affected portion of the trust estate will be complicated by the combination of high unit costs typically associated with land and the general desirability of diversifying real estate investments by both geography and property type when practical.

Thus, problems are likely to be presented by the concern many trustees will have, especially trustees of smaller trusts, over diversification objectives; problems are also likely to be presented by a need for the technical competence that is so vital to success in a specialized field. These problems invite cautious, informed consideration of the opportunities of acquiring real estate limited partnership interests or publicly traded shares of real estate investment trusts and other real estate pooling devices. Investing through real estate pools may also alleviate liquidity problems, transaction costs, and inefficient pricing that are normally associated with investments in land.

…

In brief, a trustee contemplating the investment of trust funds in real estate has the usual fiduciary duty to make, with care, skill, and caution, an analysis of the role the property is to play in

RETAINING AN INVESTMENT IS "INVESTING": THE NECESSITY FOR REVIEW

The ready comparability of funds exposes the trustee who has not been diligent to being classed as a defaulting fiduciary: saddling him with the uncomfortable onus of showing that his actions had been prudent:[133]

> Consider, therefore, a simple case. Suppose that a trustee determines to invest twenty percent of the trust in an intermediate-term bond fund. Suppose, further, that the particular intermediate bond fund that the trustee chooses persistently underperforms other intermediate-term bond funds on account of drastically higher expense ratios. In view of the trustee's duty to monitor, the burden will more easily shift to the trustee to explain why the trustee chose that particular fund. Under the prudence standard, the comparability of increasingly standardized fund types will allow trustees (and the courts who oversee trustees when beneficiaries are unhappy) greater precision in examining investment performance. The point is not that a disappointing fund or fund year is ipso facto imprudent—far from it. The point is that the growing comparability of fund types provides a more precise and objective benchmark for evaluating claims that a certain fund is so manifestly inferior to competitors that investing in it, or retaining it, is imprudent.

Trustees must always be prepared and able to point to a diversified investment strategy; must be able to explain how it was developed for this Trust, and why they considered it to be prudent under the circumstances; and, where those circumstances have changed from time to time, how they adjusted the strategy to meet those new circumstances, or why they considered that no adjustments were necessary on the particular occasion.

It is challenging enough to find an answer to the question "what would be a properly-balanced portfolio in the light of, among other things, the state of the domestic and international economies; inflation or deflation prospects; the taxation matrix; the balance of special beneficiary income needs; and capital appreciation or at least capital protection?"[134] But finding an answer is only the beginning, not an end, of the challenge. The answer will require constant review.[135]

In *Estate of Rodney B Janes*,[136] the New York Surrogate Judge held that, as well as keeping under surveillance "the risks of a portfolio, the marketability of the holdings, its volatility, and the market conditions then and there prevailing," a trustee must consider whether, in the circumstances, he has:

> invested in or maintained an unusually large proportion of the fund in a single type of security. … Generally allied with the consideration of an unusually large portion

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> the trust's overall portfolio and strategy, and also an analysis of the risk-reward tradeoffs involved. In addition, the trustee must recognize that special sensitivity and attention will be required either in selecting shares of suitable real estate investment pools or in dealing with the competence and delegation issues that are virtually inherent in holding real estate directly as a part of the trust corpus. Accordingly, special care is required in making the choice between these two divergent approaches to a program of real estate investment.

[133] Langbein, "The Uniform Prudent Investor Act and the Future of Trust Investing," 81 Iowa L Rev 641, 662-663 (1966).

[134] Cf Hayton, "English Fiduciary Standards and Trust Law (The Rise of the International Trust)" 32 *Vanderbilt Journal of Transnational Law* 555, 558 (1999).

[135] *Nestle v National Westminster Bank plc* [1993] 1 WLR 1260; [2000] WTLR 795; *Clarke v Clarke's Trusts* 1925 SC 693, 711.

[136] 214 NYLJ 31 (5 July 1995).

> retained in a single security which may be termed a concentration (to be developed later in this decision) is the issue of diversification. In that respect it is clear that the failure to diversify by itself is not an act of imprudence. … Courts have tended to apply a different (more relaxed) standard when the fiduciary retains assets owned by the decedent as distinct from those that the fiduciary has acquired. … Such retention, however, does not exempt the fiduciary from the Prudent Man Rule, so where a fiduciary retains assets it must exercise prudence in doing so.

Where the trust estate does include assets derived from the settlor, the "more relaxed" attitude will extend only so far as to treating them as authorised. There will be no relaxation in the standard of vigilance required to ensure their retention does not become imprudent.[137]

Because, as Berry V-C held, in the Court of Chancery of New Jersey, in *Dickerson v Camden Trust Co*,[138] "retaining investments is in effect making them," review is not an end in itself. Thus, in *Estate of Rodney B Janes*,[139] the New York Surrogate Judge held also that:

> Notwithstanding turbulent worldwide economic conditions including an OPEC oil,embargo, all of which resulted in a monumental and precipitous decline in the stock market during the 1973-74 period, the bank's position continued to be one to retain the Eastman Kodak stock in its concentrated form. In that one year the EK stock dropped from approximately $115 a share to about $60 a share. In summary, the Bank's position in demonstrating prudence is that the retention of the EK was part of a conscious and studied investment plan. In reality, the Bank's responsveness to the admittedly turbulent and precipitous tenor of the times (1973) was to do nothing. To assert that mere review, analysis, and monitoring satisfies the standard of due care by a prudent person where action and activity are indicated, tests the Court's sense of reason and logic and more importantly flies in the face of the surcharge cases heretofore cited.

Writing extra-curially,[140] Lord Nicholls of Birkenhead came down firmly against the convenience of inertia:

> Trustees' problems with investments are not over once they have formulated their strategy and acquired their portfolio. Shares carry rights, and part of the duty of trustees is to decide how to exercise the voting and other rights attached to the trust fund securities. The proper discharge of this duty today by trustees of large funds must require more than deciding how to vote on routine resolutions put before shareholders at annual general meetings by the directors. *Inertia is a comfortable pillow, but it is not available to trustees.*

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[137] See the discussion under WHERE THE SETTLOR WANTS ALL THE TRUST EGGS IN ONE BASKET, THE TRUSTEE HAD BETTER WATCH THE BASKET CLOSELY at p 20 above.

[138] 140 NJ Eq 34, 42; A 2d 225, 231 (1947).

[139] 214 NYLJ 31 (5 July 1995).

[140] "Trustees and their Broader Community: Where Duty, Morality and Ethics Converge" (1996) *Australian LJ* 205, 214,

EACH TRUSTEE CARRIES *FULL* RESPONSIBILITY

Each Trustee must consider the matter and make up his or her mind. "A fiduciary's *independent* investigation of the merits of a particular investment is at the heart of the prudent person standard."[141] So, in *Re Mulligan*,[142] the New Zealand High Court held that:

> upon entering office *each individual trustee has a separate responsibility* to ensure the the terms of the trust are carried out. It is not open for one trustee to defer to the wishes of another trustee in the absence of proper reasons for doing so.

As the decision in that case compellingly illustrates, there cannot be a "proper reason" for minority trustees to permit the majority to make decisions "at which no reasonable body of trustees could arrive". Just as "getting along, by going along" is fiduciary anathema, resignation to clear a path for a breach of trust is itself a breach of trust.[143] It is not an option for the minority.

The safer course for the Trustees, or for those of them on either side of the disagreement, is to apply to the court for directions as in *In the Matter of Repus Trust and Trustcorp Ltd*.[144]

As Professor Waters has put it with characteristic lucidity:[145]

> If under the terms of the trust the opinion of a majority of the trustees, or of one particular trustee (for instance, the spouse of the testator or settlor), is to prevail in the event of a difference between the trustees, the minority or the co-trustees in the case of the particular trustee have a duty to bring the matter before the court if they reasonably entertain the view that the contemplated action or inaction of the majority, or of the particular trustee, constitutes a breach of trust. At this point, of course, we are essentially concerned with administrative powers, but breach will not always exist. If the minority trustees merely cannot agree with a decision that is both authorized by the instrument and is within the range of what is reasonable, they are required to lend their formal approval to necessary documentation and other procedural requirements for the carrying out of the decision. In any minutes of meetings they may also have their dissent recorded.
>
> It is in this way that the case law introduces a balance between the stalemate in decision-making that might otherwise occur, possibly to the injury of the beneficiaries, and the danger that the substance of the disagreement involves action or inaction that in fact constitutes breach. Again, breach may cause injury and loss to the trust beneficiaries. The role of the minority or of the co-trustees when it is a particular trustee who has the exclusive power is to ensure that decisions dictated to them are those which a court would permit trustees to take, whatever the court itself might have decided in the circumstances. …

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[141] 250 F Supp 2d 544, 566 (2003).

[142] [1998] 1 NZLR 481, 502.

[143] Retirement itself is an act done by a trustee, as trustee. If done without due regard for the safety of the trust estate, the resigning trustee will be liable for any loss the trust may suffer as a result: cf *Head v Gould* [1898] Ch 250, 268-269.

[144] Jersey Royal Court, Samedi Division, [2005] JRC 081,15 June 2005. Considered under WHERE THE SETTLOR WANTS ALL THE TRUST EGGS IN ONE BASKET, THE TRUSTEE HAD BETTER WATCH THE BASKET CLOSELY at page 20 above.

[145] Waters, "The Protector: New Wine in Old Bottles?" in Oakley (ed) *Trends in Contemporary Trust Law* (1996) 63, 84-85

The paramount duty of the trustee remains that, if he cannot prevent by his vote what he understands to be breach or possible breach, he applies to the court for advice and directions. If conduct is about to be perpetrated that will imperil the beneficiaries' best interests, he does not think first how he can avoid any blame.
