

# Trustee Investing: Homes and Hedges

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## Introduction: The New Regime for the Investment of Trust Funds

Within the last five years all Australian jurisdictions, following a New Zealand lead, have abolished the old statutory list of authorised trustee investments and have given trustees an unlimited investment power.<sup>1</sup> In England s 3 of the *Trustee Act 2000* provides that “a trustee may make any kind of investment that he could make if he were absolutely entitled to the assets of the trust”. The power is made subject to duties of care.

The new Australasian legislation provides that:

A trustee may, unless expressly prohibited by the instrument creating the trust –

- (a) invest trust funds in any form of investment; and
- (b) at any time, vary an investment.

In New Zealand the wording of (a) is “in any property”.

There is also a specific power enabling trustees to purchase a dwelling house as a residence for a beneficiary.<sup>2</sup>

As well as liberating trustees with respect to their investment powers the legislation places significant constraints upon them.

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<sup>1</sup> Australian Capital Territory (*Trustee Amendment Act No 28 of 1999*); New South Wales (*Trustee Amendment (Discretionary Investments) Act No 102 of 1997*); the Northern Territory (*Trustee Amendment (No 2) Act No 60 of 1995*); Queensland (*Trustee (Investments) Amendment Act No 69 of 1999*); South Australia (*Trustee (Investment Powers) Act 1995*); Tasmania: *Trustee Amendment (Investment Powers) Act 1997*; Victoria: *Trustee and Trustee Companies (Amendment) Act 1995 (No 104/1995)*; and Western Australia: *Trustees Amendment Act 1997*; New Zealand *Trustee Amendment Act 1988*, No 119.

<sup>2</sup> ACT s 14E; NSW s 14DA; NT s 10A Qld s 28; Tas s 5; Vic s 11; WA s 4.

## The Prudent Person Test

The legislation imposes a standard of conduct on trustees when investing in the following terms.

- (1) Subject to the instrument creating the trust, a trustee must, in exercising a power of investment -
  - (a) if the trustee's profession, business or employment is or includes acting as a trustee or investing money on behalf of other persons, exercise the care, diligence and skill that a prudent person engaged in that profession, business or employment would exercise in managing the affairs of other persons; or
  - (b) if the trustee is not engaged in such a profession, business or employment, exercise the care, diligence and skill that a prudent person would exercise in managing the affairs of other persons.
- (2) A trustee must exercise a power of investment in accordance with any provision of the instrument creating the trust that is binding on the trustee and requires the obtaining of any consent or approval with respect to trust investments.
- (3) Subject to the instrument creating the trust, a trustee must, at least once in each year, review the performance (individually and as a whole) of trust investments.<sup>3</sup>

The prudent person test has a long comparative jurisprudential history.

### *The Prudent Person Test – A Comparative Background*

In the United States in 1830 in *Harvard College v Amory*,<sup>4</sup> the Massachusetts Court had to decide whether to follow the lead of the English courts and specify what investments trustees might and might not make, or whether to adopt a generalised approach. The court ruled as follows:

All that can be required of a trustee to invest is that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of capital to be invested.

This classic statement is recognised as the first authoritative explication of the “prudent person” rule for the investment of trust funds.

However as time went by the courts applied the rule in a manner that restricted its flexibility and attracted criticism on a number of grounds. It was said that the courts in the United States:

<sup>3</sup> ACT s 14A; NSW s 14A; NT s 6; Qld s 22; Tas s 7; Vic s 6; WA s18; NZ s 13B.

<sup>4</sup> 26 Mass (9 Pick) 446.

- (a) focussed on individual assets rather than the trust portfolio as a whole – known as “anti-netting”;
- (b) confined its attention to voluntary trusts, and in particular trusts for successive beneficiaries, i.e. capital and income trusts, sidelining commercial trusts;
- (c) failed to develop rules for the purpose of protecting the purchasing power of the trust fund;
- (d) developed an artificial distinction between “prudent” and imprudent or “speculative” investments;
- (e) allowed “safe”, that is list style, low risk investing without scrutiny; and
- (f) prohibited the delegation of investment decisions.

Academic writings about the law of trusts, both in the United States – the work of Austin Wakeman Scott – and in England – the work of Underhill, Keeton and Pettit – also focussed on voluntary family trusts and ignored the growing market for commercial trusts.

These criticisms only emerged after the phenomenon of inflation undermined the economic assumptions upon which financial theory had relied during the nineteenth and early twentieth centuries.

The *Restatement (Second) of Trusts*, s 227 (1959) reflected and was in part responsible for the approach of the courts. The section provided:

*Investments Which a Trustee Can Properly Make*

In making investments of trust funds, the trustee is under a duty to the beneficiary (a) in the absence of provisions in the terms of the trust or of a statute otherwise providing, to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived.

The focus of this formulation remained upon voluntary trusts requiring the separation of the capital and income accounts and the needs of beneficiaries having successive interests.

Spurred on by the revelations of investment theorists of the post-war, inflationary era, American jurists secured adoption in 1992 of a new s 227 in *Restatement of Trusts (Third)* the purpose of which was a change of focus. It provides that the trustee is under a duty:

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.

Of this new formulation Edward C Halbach said:

Accordingly, the prudent investor rule is intended to liberate expert trustees to pursue challenging, rewarding, non-traditional strategies when appropriate to a particular trust. It is also designed to provide unsophisticated trustees

with reasonably clear guidance to practical courses of investment that are readily identifiable, expectedly rewarding and broadly adaptable.<sup>5</sup>

The distinction between the old “prudent person” and the new “prudent investor” is regarded as crucial.

In Australia and New Zealand the “prudent person” test of the *Restatement (Second) of Trusts*, s 227 of 1959 has been adopted and not the “prudent investor” test of the *Restatement (Third) of Trusts* of 1992. To that extent the legislation is backward looking.

The Australian and New Zealand legislation also imposes on trustees:

- (a) a duty to exercise the powers of a trustee in the best interests of all present and future beneficiaries of the trust;
- (b) a duty to invest trust funds in investments that are not speculative (or, in Western Australia, hazardous);
- (c) a duty to act impartially towards beneficiaries and between different classes of beneficiaries; and
- (d) a duty to take (in Queensland to obtain) advice.<sup>6</sup>

These provisions, too, are redolent of earlier law. They still evince concern with capital and income accounting in trusts for successive beneficial interests; and they maintain an arguably artificial distinction between prudent and speculative investments.

### **Matters to Which Trustees Must Have Regard in Investing**

Despite the retention of the conservative prudent person test, there are also to be found in the legislation significant allusions to the findings of modern investment theory that underlie the Third Restatement. Although these allusions when coupled with the prudent person test may be seen as jurisprudentially ambiguous, they clearly empower trustees to take advantage of the theoretical findings. These allusions to modern investment theory are to be found in provisions that require trustees to have regard to 15 specific matters when investing.<sup>7</sup> They are as follows:

- (a) The purposes of the trust and the needs and circumstances of the beneficiaries;
- (b) The desirability of diversifying trust investments;
- (c) The nature of and risk associated with existing trust investments and other trust property;
- (d) The need to maintain the real value of the capital or income of the trust;
- (e) The risk of capital or income loss or depreciation;
- (f) The potential for capital appreciation;
- (g) The likely income return and the timing of income return;
- (h) The probable duration of the trust;

<sup>5</sup> E C Halbach, ‘Trust Investment Law in the Third Restatement’ [1992] 77 *Iowa Law Review* at 1155.

<sup>6</sup> ACT s 14B; NSW s 14B; NT s 7; Qld s 23; SA s 8; Tas s 9; Vic s 7; WA s 19; NZ s 13F.

<sup>7</sup> ACT s 14C; NSW s 14C; NT s 8; Qld s 24; SA s 9; Tas s 8; Vic s 8; WA s 20; NZ s 13E.

- (i) The liquidity and marketability of the proposed investment during, and on the determination of, the term of the proposed investment;
- (j) The aggregate value of the trust estate;
- (k) The effect of the proposed investment in relation to the tax liability of the trust;
- (l) The likelihood of inflation affecting the value of the proposed investment or other trust property;
- (m) (except in New Zealand) The costs (including commissions, fees, charges and duties payable) in making the proposed investment.

It is within these highly significant provisions that trustees can find justification for pursuing rewarding, non-traditional investment strategies, when appropriate to a particular trust.

### **Modern Investment Theory**

One main purpose of this lecture is to consider whether the findings of modern investment theory can assist trustees. A starting point would seem to be to consider two key phrases used by investment theorists. One is *the efficient market hypothesis* and the other *modern portfolio theory*. Do these phrases really mean anything?

#### ***The Efficient Market Hypothesis***

The Efficient Market Hypothesis evolved in the 1960s from the Ph.D. dissertation of Eugene Fama. Fama argued that in an active market that includes many well-informed and intelligent investors, securities will be appropriately priced and reflect all available information. To the extent that a market is efficient, no amount of information or analysis can guarantee to the investor returns better than an average benchmark. Associated with the efficient market hypothesis is the random walk theory. That theory asserts that price movements will not follow any patterns or trends and that past price movements cannot be used to predict future price movements.<sup>8</sup> Consumer protection laws now require some financial services providers to include this proposition in advertisements soliciting business.

The phrase efficient market is usually left undefined in literature about the efficient market hypothesis: it is taken for granted. What it is that makes a market efficient? It is submitted that indicia of an efficient market include the following:

- (a) It provides easily accessible venues to vendors and purchasers for the transaction of business.
- (b) It enables vendors and purchasers to transact business quickly.
- (c) It is capable of handling small as well as large volumes of business.
- (d) It offers price transparency.
- (e) It offers low or at least transparent transaction costs.
- (f) It offers a minimum of intermediacy between vendor and purchaser.
- (g) It offers a minimum requirement of paperwork.
- (h) It is free of transfer taxes.

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<sup>8</sup> E F Fama, 'Random Walks in Stock Market Prices' (1965) *Financial Analysts Journal*.

There may be further indicia. Writings that discuss the efficient market hypothesis seem to assume that it applies only to such investments as meet all or most of these indicia. In applying these indicia one form of property most capable of efficient marketing would appear to be commercial choses in action, in particular shares in publicly listed companies. The markets for trading in such forms of property are more accessible than ever before; price and transaction costs are transparent and they can handle virtually all the business required of them at immense speed, sometimes at the speed of light. There is a minimum of intermediacy and paperwork and in Australia no transfer taxes. These characteristics attract large numbers of investors, many of them well informed, to financial markets and must inevitably attract trustees.

Let us probe the efficient market theory further. Consider what happens when an investor in an efficient market – for instance the share market – decides to act: that is, to buy or to sell.

First of all, however expert and informed the investor is, or however foolish and ignorant, it is the market that dictates the day's price, not the investor. A very large investor's decision to buy or to sell may affect the market price. But the ordinary investor must accept the day's price or exit the market.

Secondly, pricing represents the combined judgment of both sellers and buyers; and is sustained by volume trading. Since one cannot appraise the judgment of an investor according to the outcome of the investment<sup>9</sup> one can never say that either the investor who buys or the investor who sells, at the price set by the market on the day, has made a mistake. It is suggested that the vocabulary of right and wrong, or smart or foolish, does not belong here. Price in an efficient market is skill neutral.

Thirdly, there are forms of price sensitive information that can never be factored into the market analyst's calculations. For instance the analyst can never know how many buyers and sellers will want to deal on any given day; or whether there are far more buyers than sellers or vice versa. Nor can the analyst know for what reasons, other than reasons based on objective market analysis, an investor may decide to buy or to sell. Many investors enter the market for purely personal reasons; and an important, though not exclusive, factor in a decision to buy is the hope of gain; and an important factor in a decision to sell is the fear of loss. If the efficient market hypothesis includes such imponderables in its ratiocination, it is not a hypothesis that can assist trustees who wish to invest. But that is not its *raison d'être*. Its *raison d'être* is to demonstrate that making costly enquiries when investing is not cost effective. Its value for trustees is that they cannot be charged with negligence merely for having bought or sold an investment at a price supported by volume trading in an efficient market.

Where a market is inefficient, however, knowledge and skill can make all the difference. So extensive enquiries are justifiable. As an example of a less efficient market I would suggest the real estate market. Unlike financial investments it is often impossible to compare one piece of realty with another, because usually each parcel of realty is unique. For vendors and purchasers of realty, knowledge of such things as future developments in transport infra structure, in environmental and planning policy and in demographics will place the skilled investor at an advantage, as will civil

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<sup>9</sup> *Nestlé v National Westminster Bank Plc* [1993] 1 WLR 1260 (CA) per Staughton LJ at 1276.

engineering expertise and a knowledge of the law. Without expertise however, the investor is hampered by lack of transparency as to prices which is clouded by a real estate industry the reputability of which has been compromised by rogue elements and deterred by such matters as the impact of estate agents' commission, and high legal and transaction costs.

As another example one might suggest that the art and antiques markets are relatively inefficient. The ability to differentiate between the paintings of a master and those of a master's school and even skilled forgeries is sometimes not available even in the world's most prestigious auction houses; and very few people can identify the provenance of unmarked antique porcelain, pottery or glass. Those who can are at an advantage.

Is our comprehension of the efficient market hypothesis assisted by the expertise of the financial press and the advertisements of the finance management industry? It is worth considering what substance there is in some of the phrases that crop up in financial journalism. One is: "profit takers were out in force today". Another is: "bargain hunters came into the market today"; another is "financial markets welcomed (or failed to respond to) the news" and another is "the market made a technical correction". It is difficult to find any illumination in such phrases. As for profit takers, that is vendors, one may well ask: who were the purchasers? And of bargain hunters, that is purchasers, one may well ask: who were the vendors? The financial press, in using these expressions, seems sometimes to be making unjustifiable value judgments. It seems to be suggesting that the profit takers and the bargain hunters are smarter than those they have dealt with. If this is so the phrases endorse the decisions of the vendors in the one case and the purchasers in the other. Why should they? And as for news, for instance of take-overs or mergers, or management changes affecting prices, all one can say is that it is impossible to know whether the news is good or bad, or even what the outcome will be. Furthermore, how can one tell that it is that news, and not other factors, that made the difference, or no difference, to the day's price? It is to be doubted whether this has any real meaning. If the phrase "the market made a technical correction" is redolent of a belief in some sort of mystical omniscience of "the market", it is not illuminating. The efficient market hypothesis counters the belief that some individuals can always "beat the market"; that is, it accepts the market as the ultimate arbiter.

As for the finance management industry we do know that financial services providers accumulate wealth by using other people's money rather than their own. Other people's money is their business. Self-interest dictates that financial services providers reject the all-inclusive view embraced by the efficient market hypothesis. Financial services providers necessarily take a narrower, self-determined view. In doing so the industry utters some strange pronouncements. For example a very large financial services provider, in a half page advertisement in *The Australian* newspaper for 23 August 2000, in a series described as 'Insights for Investors', informed the investing public that Mount Kosciusko is not Australia's highest mountain: Big Ben is. Big Ben, if you read the rest of the long advertisement, is in Heard Island, part of Australia's Antarctic Territories; and a picture of it can be viewed on a web site. The site reveals that very few people have ever seen the summit of Big Ben because it is always shrouded in clouds. It is also Australia's only active volcano. One wonders whether Big Ben is a metaphor for the fund management industry.

The advertisement having pronounced that Equity markets reveal “truths with ruthless efficiency”- doffing its cap to the efficient market hypothesis - goes on to say:

And there’s always the odd market truth, as remote and clouded as Big Ben, waiting to be revealed. Once it is True Value’s assigned, and the stock’s marked up or marked down before the average investor can say boo.

One wonders whether True Value is an attempt at a Platonic hypostasis or an allusion to a chain of hardware outlets. It can hardly be the former because True Value, in the share market, itself changes before you can say boo. The advertisement also advises us to note the con in conventional wisdom. Our financial services provider has teams of experts “working in a collegiate style that fosters cross pollination and encourages critique.” One can commend the advertisement as a masterpiece of persuasion. But one may legitimately ask whether the exercise is cost effective for the investing clients of the financial services provider.

One should affirm, however, that in the case of efficient markets, the valuable contribution of a portfolio manager consists of analysing and investing appropriately, based on the personal profile of the investor and having regard to such factors such as age, tax bracket, risk aversion, employment pension eligibility and so on. It is in this context that expert financial advice can be crucial. The role of the portfolio manager in an efficient market is to tailor a portfolio to those needs, rather than to beat the market.

### *The Random Walk Theory*

Associated with the efficient market hypothesis is the random walk theory. That theory asserts that price movements do not follow any patterns or trends and that past price movements cannot be used to predict future price movements. Consumer protection laws now require some financial service providers to include this proposition in advertisements soliciting business.

### ***Modern Portfolio Theory***

In essence modern portfolio theory demonstrates the advantages of diversification. The advantages include the minimisation of risk and administrative costs. Risk is minimised because diversification averages profits and losses. Administrative costs are minimised because the efficient market hypothesis demonstrates that trustees cannot obtain better than average returns by making expensive enquiries in an attempt to forecast price movements. Trustees who decide to invest an appropriate proportion of the trust fund in a diversified portfolio of, say, shares may be referred to the findings of the United States author R A Brearley in his work *An Introduction to Risk and Return from Common Stocks*.<sup>10</sup> He estimated<sup>11</sup> that as few as ten well selected stocks can achieve 87% diversification; 20 such stocks, 93%; 50 such, 97% and 100 such, 98%.<sup>12</sup> A portfolio that attempts to mirror the market as a whole is called index linked, or an index tracker. It reflects rises and falls in the market it tracks but it cannot avoid systemic variations of

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<sup>10</sup> R A Brearley, *An Introduction to Risk and Return from Common Stocks*, 2<sup>nd</sup> edn 1983.

<sup>11</sup> *Ibid* at 112.

<sup>12</sup> Cited in Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing* [1996] 81 Iowa LR 641-669.

value. Systemic variations are flattened by following a policy of holding the portfolio and of investing regularly.

Modern portfolio theory is highly persuasive and many financial services providers index link. This is not to say that trustees must index link rigidly. It is not appropriate for trustees to set a policy, in advance, that if changes in share prices have the effect that a portfolio in management ceases to reflect the list precisely, shares that have fallen in value must be sold, and shares that have risen in value purchased, although some financial services providers do that. It is a policy that bucks the random walk theory and is usually commission driven. It might also have the effect of fettering the future exercise of the trustees' discretion in investing. It is arguable that modern portfolio theory justifies investors to respond to volatility storms, sometimes caused by fraudulent price manipulation, in the same way as to systemic price fluctuations, that is, to ride them out.

### **Can Trustees “Play the Markets”?**

The answer to this is YES – IF that is the purpose of the trust, or if the needs and circumstances of the beneficiaries require it. But there is a fundamental objection to trustees playing the market – that is buying and selling - as a matter of general administration of every trust. Although trustee legislation now permits trustees to invest in any form of investment and to vary investments at any time, except in the case where the trustees wish to buy or sell a residence, it is submitted that it is difficult for trustees to justify selling an investment solely for the purpose of purchasing some other investment, that is for the purpose of adding value to the trust fund. One reason for this is that playing the markets is an inherently speculative or hazardous activity. It stands to reason that if trustees sell asset A for \$20,000 for the purpose of acquiring asset B and the \$20,000 is then used to acquire asset B, the value of the trust fund has not changed - asset B is worth the same as asset A. The trustees may well believe that asset A will fall in value and asset B will rise in value, but it is unlikely that that belief is shared by the purchaser of asset A or the vendor of asset B. Trustees cannot assume that their belief is always right. In any case the costs of the sale and purchase have been irretrievably lost. A practice of swapping investments, marketed as good practice by some financial services providers, is usually commission-driven. Known as “churning” in the United States and Canada, it is incompatible with efficient financial management. Another reason limiting the extent to which trustees can justify playing the markets is that if they have regard to the matters they are required to have regard to in investing, they will usually find that there is no justification for trading. For example the author heard of a case where a testator left his estate to a trustee to pay the income of the estate to his widow for life and at her death to distribute the capital amongst their children. The trouble was that the entire income of the trust was being absorbed as trustees' fees and expenses. The trustees argued that they were benefiting the capital of the fund by their expertise in investing and their fees were deserved. They were in breach of trust. In the first place they were ignoring the main purpose of the trust, which was to secure a reasonable income for the life tenant. Playing the market was inconsistent with that purpose. Secondly in appropriating remuneration and management expenses from the income account they were in breach of trust because remuneration for activities directed to improving the capital of the fund should have been charged to capital. Thirdly, if indeed the value of the capital account had risen as a result of the trustees' efforts, a portion of the capital should have been set aside to meet the needs of the widow. If their

efforts had not resulted in benefit to the capital account, they might properly be required to repay remuneration appropriated from the fund on the grounds that it had not been properly earned.

The conclusion is that when trustees buy or sell, they must do so for a reason connected with the conduct of the trust as such, not because of some imagined benefit to be gained from trading.

On the other hand, sometimes a trustee is expected to play the markets. Suppose that an investor, diffident about trading in the market personally, decides to employ a financial services provider to invest as it thinks fit. The investor admires the financial expertise of the provider and believes that it will ensure an above average return for the investment. The provider maintains a trust account as part of its investing structure. Aside from any statutory provisions governing how financial services providers must operate, the contract between the investor and the provider expressly authorises the provider to buy and sell investments. It is the purpose of the contract and of the trust envisaged by it if not embedded in it. But the investor is a competent adult with contractual rights, who authorises the provider to take risks. Like any beneficiary who authorises a trustee to act in a certain manner, the investor cannot complain of the outcome of the provider's investing activities.

### **Homes and Hedges**

The new legislation specifically authorises trustees to purchase residences for beneficiaries. This is not a rejection of diversification theory. It recognises a particular feature of the Australian tax system that confers benefits on homeowners. A trust estate that consists solely of four residences for four beneficiaries could not be described as pursuing a goal of diversification; but it might well be far more advantageous to each of the beneficiaries than investment in a diversified portfolio producing only taxable income; and it can be justified by the specific power conferred on trustees by the legislation.

As for hedge funds, trustees will be entirely justified in using them occasionally for the purpose for which they are intended. For instance a trustee with an obligation to pay a large sum in a nominated overseas currency at a future date may well decide to insure the obligation against a fall in value of the Australian dollar vis-à-vis the nominated currency. Out of such context, however, a trustee would be justified in investing in a hedge fund only an appropriate fraction of the fund under investment, that is a fraction justified by a disciplined diversification policy. Similar remarks would apply to other investment markets such as the futures or derivatives markets.

### **Guidelines for Protection Against Fraud**

Trustees of large funds must be constantly on their guard against criminal intrusion. Sophisticated misconduct has not been absent from the Australian financial scene and trustees of large funds should assume that they will be targeted by criminal elements and that legislation designed to protect investors is ineffective. The lack of financial experience of elected trustees and the sense of power that control of huge sums of money imparts may make some trustees of large funds vulnerable to commit fraud. There are warning signs. There are strategies that can deter the criminal. There follow

some very elementary, but by no means always followed, prudential safeguards to protect against fraud.

### ***Maintenance of Separate Accounts***

A common indication of negligent and dishonest trust management is that the trustee fails to keep trust property separate from the trustee's own property.

### ***Diversification***

The advantages of diversification in terms of risk and cost minimisation have been briefly described. Except where the purposes of the trust or the needs of the beneficiaries justify the maintenance of an under-diversified portfolio, failure to diversify is a first sign of mismanagement. Serious criminals will not attempt to suborn trustees of a \$100m pension fund who, in pursuance of a disciplined policy of diversification, usually do not acquire any investment costing more than \$500,000. The prize would not be large enough.

### ***Investing in Efficient Markets***

The advantages of investing in an efficient market have been described.

### ***Selling to Buy***

Decisions to buy are governed by principles very different from decisions to sell. In the case of a pension fund trust where contributions are being received regularly the trustees must adopt an investment strategy that will ensure immediate short-term investment of contributions. This can be achieved by placing contributions in interest-bearing deposit accounts at a bank. In the case of more sophisticated longer term investing, trustees who cannot achieve a high level of diversification must ensure that they obtain proper advice in investing.

Selling an investment requires justification. For instance if an investment consists of an older building a decision to sell or renovate may have to be made. Making that decision will involve a consideration not only of the profitability implications of the decision but also of the availability of other investments, the balance of the portfolio, any need for liquidity and so on. Another reason for selling might be that there is a purchaser willing to pay what is clearly an above market price, for instance a purchaser whose ownership of adjacent property gives access to development potential not accessible to the trustees or anyone else. Another reason for selling is that the purposes of the trust and the needs and circumstances of the beneficiaries require it. Selling in a difficult market to meet a liquidity need should rarely be necessary for trustees of large funds because they should anticipate the need and have sufficient investments in an easily realisable form.

The value of playing the market has already been considered.

### ***Completing Transactions***

When trustees agree to acquire an investment, they must not part with the purchase moneys without at the same time receiving the title, or the means of acquiring the title,

to the property purchased. When they sell trust property they must not part with the title deeds and transfer documents without at the same time receiving the purchase moneys.

### ***Documentation***

The reliability and the genuineness of documentation supporting an investment proposal should always be carefully checked and, if in doubt, professional and independent advice obtained. For example, according to a press report on page 38 of *The Australian* newspaper dated 12 July 2000, a \$100 million dollar loan fraud which was successfully perpetrated against three major banks had just been revealed. The loans were supposedly secured by the sale of a non-existent cargo of prawns, to be transported from Brisbane to Japan on a non-existent ship. Several vital documents produced to secure the loans were forged. These included falsified supplier invoices, invalid bills of lading, bogus purchaser invoices, discrepancies in letters of credit making them invalid and phoney export insurance policies. Some of the forgeries were obvious. The perpetrator of the fraud was said to be bankrupt and the liquidator was reported as having failed to trace any of the moneys lent. But it is submitted that the criminal intent of the borrower is not the really important issue. It is the failure of bank officers to check the documentation. One must not make inferences from a mere press report, but every case of this kind constitutes a warning to all to check documentation when buying or selling and to refrain from assuming that large financial institutions are immune from infiltration by organised crime.

It is elementary safeguards such as these that are routinely ignored by negligent or fraudulent trustees.

### **Financial Advisers and Financial Services Providers**

There is no doubt that trustees may employ financial advisers to assist them in investing. Indeed the new legislation specifically authorises them to do so. If one considers how trustees should approach a financial adviser many thoughts come to mind. The trustees would indicate to the adviser that they are trustees, what the extent of the fund is, what its purposes are and the needs and circumstances of the beneficiaries. They could hardly do less. The financial adviser would then be circumscribed by the trustees' duties because the trustees are not investing on their own account. The trustees should also indicate to the adviser those matters which trustee legislation requires them to take into consideration, and if appropriate invite the adviser to maintain the relationship prescribed as an ongoing responsibility, and to advise the trustees should circumstances require reconsideration of policy or investment. It is not a far step from that to allow the adviser to take over the actual management of the trust assets or part of them.

In England the *Trustee Act 2000* has addressed the question of trustees employing persons to manage trust funds. It provides, in s 15, that the contract between the trustees and the manager must be in writing and that the trustees must prepare "a statement that gives guidance as to how the functions should be exercised ('a policy statement')". "The trustees must formulate the guidance given in the policy statement with a view to ensuring that the functions will be exercised in the best interests of the trust." (s 15(3)). They must keep these arrangements under review (s 22).

## A Comparative Perspective

The law of Quebec, a jurisdiction which has experience in both common and civil law concepts, provides illumination in our attempt to clarify the relationship which the law should allow trustees to enter into with financial experts. In the recent case of *Placements Armand Laflamme Inc. v Prudential-Bache Commodities Canada Ltd*<sup>13</sup> Armand Laflamme, a person with little or no knowledge of financial affairs, entrusted a fund to the management of Roy, a securities broker. The broker indulged in risky adventures, ignored the needs and circumstances of the beneficiaries, as well as certain instructions of his client and lost the fund. The Supreme Court of Canada described the nature and scope of the Quebec institution of the fiduciary mandate.

23 A securities dealer may perform a variety of functions. First, in his most common role, the dealer is an intermediary. He buys and sells securities on behalf of his client, in accordance with the client's instructions. The dealer is in no way involved in the management of his client's portfolio and has no discretion regarding its content and the transactions to be carried out. In this situation, the client's account is sometimes referred to as 'non-discretionary'.

24 Second, a dealer may also be responsible for managing the portfolio. In addition to his function as a dealer, he is also a portfolio manager with responsibility for making decisions with respect to the management and make up of the portfolio...This kind of account is referred to as a 'discretionary account'. While in the case at the bar Roy was both dealer and manager, these functions may sometimes be performed by different persons...

25 The functions of a manager and the powers granted to the manager may be quite extensive. Lise Beaudoin, (*Le contrat de gestion de portefeuille de valeurs mobilières* (1994) describes them as follows at pp 25-26:

'Authorised management of a portfolio results from delegation by the client of his decision-making authority. The task covers the intellectual, tactical and strategic activities performed in respect of a portfolio. The manager acts in accordance with the investments objectives set with the client. His decisions are essentially guided by the concept of maximising return on the portfolio, having regard to the risks that this involves. The manager determines the portfolio's make up and the investments to make...'

26 Thus the manager makes most of the decisions relating to the portfolio and the make up of the portfolio. The scope of his management authority and the exercise of his discretion will, however, depend on any restrictions that are imposed by law or agreement. In particular, the agreement may expressly circumscribe the manager's authority and discretion, for instance by giving the client the option of confirming certain transactions. Such limitations may also be implicit in the client's investment objectives or circumstances...

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<sup>13</sup> (2000) SCC 26 (Supreme Court of Canada 3 May 2000).

28 As in the case of any mandate, the mandate between a manager and his client is imbued with the concept of trust, since the client places trust in the manager - the mandatory - to manage his affairs... This element of trust explains, for instance the mandator's authority to revoke the mandate at any time (art. 1756 Civil Code of Lower Canada; art 2176 Civil Code of Quebec). This spirit of trust is reflected in the weight of the obligations that rest on the manager, which will be heavier where the mandator is vulnerable, lacks a specialised knowledge, is dependent on the mandatory, and where the mandate is important. The corresponding requirements of fair dealing, good faith and diligence on the part of the manager in relation to his client will thus be more stringent.

These remarks might well be regarded as pertinent to trustees who employ a financial adviser, but they are also pertinent to a person contracting with a trustee in the creation of an inter vivos trust. Increasingly the relationship between the settlor and the trustees arises in the context of a legal contract. In that case it is the contract that governs the relationship. It is unwise, particularly in Australia, to assume that financial advisers undertake fiduciary duties unless they are prescribed within the context of an enforceable relationship. This is because whereas the Canadian perception of the fiduciary allows the courts sometimes to impose *prescriptive* duties on fiduciaries, in Australia the courts limit themselves to the imposition of *proscriptive* duties.<sup>14</sup>

So in employing financial advisers to advise them or financial services providers to invest for them trustees must take great care in framing the terms of the contract between them.

Where trustees employ financial advisers, it is for the trustees to decide what action to take having considered the advice received. Investments undertaken following advice will be made in the names of the trustees.

But where trustees consider employing a financial services provider to invest trust funds in the provider's name, leaving the trustees with only a contract binding them to the provider, different considerations arise. In particular there arises the question of whether the trustees may be seen as delegating to the services provider decisions that only the trustees may take.

### **Delegation and Agency**

The law has failed to make a clear distinction between matters that trustees may not delegate and matters for which they may employ agents.

It is arguable that the no delegation rule has been assumed to be much broader than it should be and that it has imposed an unjustifiable fetter on the law that has always given trustees a wide general power to employ agents. Professor John Langbein has described the rule as "murky" and "overbroad".<sup>15</sup> It is time for the courts to give

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<sup>14</sup> *Breen v Williams* (1996) 186 CLR 71 per Gaudron and McHugh JJ at 113; *National Mutual Property Services (Australia) Pty Limited v Citibank Savings Limited* (1998) (unrep) FCA No NG 765 of 1994 (Lindgren J).

<sup>15</sup> J Langbein, 'The Uniform Prudent Investor Act and the Future of Trust Investing' [1996] 81 *Iowa LR* at 650-651.

consideration to the boundary between the restrictive rule preventing delegation and the broad power to employ agents.

There are, of course, provisions in trustee legislation to enable a delegate to attend meetings where a trustee cannot.<sup>16</sup> In England amendments to s 25 of the 1925 *Trustee Act* (the original version of which still makes better sense than its amendments) have brought confusion to this distinction that has not necessarily been exorcised by the *Trustee Act* 2000, s 11(2) of which provides:

In the case of a trust other than a charitable trust, the trustees' delegable functions consist of any function other than –

- (a) any function relating to whether or in what way any assets of the trust should be distributed,
- (b) any power to decide whether any fees or other payment due to be made out of the trust funds should be made out of income or capital,
- (c) any power to appoint a person to be a trustee of the trust, or
- (d) any power conferred by any other enactment or the trust instrument which permits the trustees to delegate any of their functions or to appoint a person to act as a nominee or custodian.

With respect it is clear that this provision does not have as its purpose to distinguish between those powers that trustees cannot delegate and those that they can. For instance it is hard to say that this provision could enable trustees to delegate to others such practical matters as when and where the next meeting of the trustees should take place, or what matters should be placed on the agenda papers. Neither, it should seem, could it enable trustees to delegate to others the composition of guidance leading to a “policy statement” in the context of employing agents to manage trust property.

To address the more general issue it is submitted that the only decisions of trustees that cannot be delegated, or entrusted to agents, are decisions that relate to the conduct of the trust *as such*. As an obvious starting place it is clear, for example, that only the trustees can decide upon the time and place of meetings of trustees or what items should be placed on the agenda for such a meeting. Until recently no general guidance has been furnished by case law as to what are matters concerning the conduct of the trust as such. Surprisingly, however, it is submitted that the new investment legislation, almost providentially, gives that guidance in requiring trustees, when investing, to have regard to the matters listed in the statute and detailed earlier in this article. Most if not all of these matters undoubtedly appertain to the conduct of the trust as such. At the top of the list are the purposes of the trust and the needs and circumstances of the beneficiaries and the desirability of diversifying trust investments. In any case, apart from the question of whether these matters appertain to the conduct of the trust as such, agents cannot be employed to “have regard” to these matters because the statute requires the trustees to do that. Trustees may need to employ advisers to advise them with respect to these matters in which case their duty is to consider that when having regard to the matters. They cannot leave it to their advisers or follow their advice blindly.

<sup>16</sup> ACT s 64; NSW s 64; NT s 3; Qld s 56; SA s 17; Tas s 25AA; Vic s 30 and *Instruments (Powers of Attorney) Act* No 9421 (1980) ss 2, 5; WA s 54; NZ s 31.

On the other hand, if it is prudent for investors to use the services of financial service providers, it is arguable that trustees should not be excluded from acting prudently by a doubtful doctrine of the law of trusts dating from long before the recent revelations of financial theory.<sup>17</sup> In *Jones v AMP Perpetual Trustee Co NZ Ltd*<sup>18</sup> trustees invested in a life insurance policy the premiums of which were invested in a unit style trust fund that fell in value. The Court of Appeal rejected an argument that the trustee had improperly delegated its investment power, because investment in insurance policies was specifically authorised by the trust instrument saying:

Express authorisation of this kind means that Perpetual was doing what it was entitled to do, and that cannot be an improper delegation of authority.<sup>19</sup>

After quoting these words Professor Philip Manns observes:

Further, the court reiterated its conclusions when the trustee's actions were measured against the "prudent person" rule of s 13B; consequently a decision to invest in managed funds is not a wrongful delegation under either pre-1988 law or the post 1988 prudent person law.<sup>20</sup>

In addition it may be argued that by authorising trustees to invest in "any form of investment", investment in the "products" of financial services providers are within the meaning of the legislation; and that it is unduly restrictive to deny trustees access to the very expertise, in financial services providers, the availability of which has generated law reform.

It is submitted that the problem is not that trustees may not invest in products offered by financial services providers but that it may be difficult for them to find products that are suitable to the purposes of the particular trust and the needs and circumstances of the particular beneficiaries. Not all financial services providers' products are appropriate as vehicles for the investment of trust funds. Some products appeal to the owner investor rather than to trustees. A product that requires commitment by the investor to a long-term contract and to reinvestment of income for the duration of the contract may be unsuitable for a trustee who has a duty to distribute the income or capital of the trust on a regular basis, or who has a power, often found these days, to terminate the trust. A product that does not offer transparency to the investor with respect to such matters as the realisable capital value of the product from time to time or its annual realisable income return may also be more suitable for the owner investor than the trustee. Furthermore it is submitted, for reasons already given, that a trustee cannot impose fiduciary duties with respect to the conduct of the trust as such upon a manager, even if a manager could be persuaded to assume them. Efficiencies of scale require financial services providers to offer a generalised product to a great number of owner investors, rather than a product tailored to the needs of a trust. To put it another way, using the language of the English *Trustee Act 2000*, a fund manager might not

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<sup>17</sup> See *Restatement (Third) of Trusts* s 227, comment j.

<sup>18</sup> [1994] 1 NZLR 690.

<sup>19</sup> *Ibid* at 705.

<sup>20</sup> P Manns, 'New Zealand Trustee Investing: Reflecting on Modern Portfolio Practice and the Ancient Distinction of Capital and Income' (1998) *Victoria University of Wellington Law Review* 611 at 625.

wish to enter into a contract with trustees who furnish it with a “policy statement” for guidance, the purpose of which is to protect the trust.

On the other hand, there is one type of trust that does have a long temporal reach and requires the reinvestment of income, namely the superannuation trust fund. Trustees of such funds may find products of financial services providers suitable for their needs, subject to the juggernaut of Australian superannuation fund legislation.

But other concerns must deter the trustee minded to invest trust funds with commercial financial services providers. Clearly financial services providers are in business to make money for themselves. To a certain extent this purpose places them in conflict with their clients. Financial services providers must engage in risk taking activities if they are to secure better than average returns to their clients having remunerated themselves appropriately and met all their administrative expenses. Administration expenses can themselves be enormous. For instance the Bankers Trust website, in a report in 1998 indicated that updating its computer systems for the new millennium would cost as much as \$260m. Advertising expenses that managers must assume to keep their products in the public eye must also be very considerable. Whilst such considerations may be insignificant to trustees of very large funds minded to acquire financial services providers’ products, they may be a deterrent to trustees of small funds.

## **The Current State of the Law of Trusts**

### **(1) *Liability for Negligence***

In some ways the new investment powers, while freeing trustees of the tyranny of the old list of authorised trustee investments, place a greater burden upon them. They are now obliged to take responsibility themselves for their conduct in investing. It is not surprising in this context that trustees nowadays ordinarily expect to be indemnified from loss caused by negligence, and that the Courts have expressed willingness to give full effect to indemnifying provisions in trust instruments and contracts.<sup>21</sup> This development in the law substantially diminishes the reliance that can be placed on the trust as a property management device.

### **(2) *Trustees’ Remuneration***

In the last fifty years trusteeship has become highly remunerated. Trustees no longer act gratuitously or for very low fees, as family solicitors used to. The level of remuneration to which trustees are entitled may eventually be seen as a deterrent to the creation of small trusts. For example s 21(1) of the *Victorian Trustee Companies Act 1968* provides as follows:

In respect of an estate committed (whether before or after the commencement of this section) to the administration of a trustee company as executor, administrator, trustee or as a sole guarantor or surety or as guardian of any minor or in any other capacity, the trustee company shall be entitled to receive out of the estate, in addition to all moneys properly expended by the

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<sup>21</sup> *Armitage v Nurse* [1997] 3 WLR 1046.

trustee company and chargeable against the estate, a commission to be fixed from time to time by the directors of the trustee company but not in any case exceeding –

- (a) \$5 for every \$100 of the gross value of the estate; and
- (b) \$6 for every \$100 of income received by the trustee company on account of the estate.

In New South Wales the *Trustee Companies Regulation* 2000 came into effect on the 1<sup>st</sup> September 2000. It details the services for which management fees may be charged by trustee companies. But the law must be the same for other trustees. It is an exhaustive list and includes such matters as keeping books of accounts, forming and restructuring companies, and carrying on a business as well as attending to the usual duties of managing trust property.

Concerns about levels of trustees' remuneration and disbursements may also be expressed in relation to the management of some charitable trusts. The Industries Commission Report on Charitable Organisations<sup>22</sup> revealed that some high profile Australian charities admitted that administration expenses absorbed over 48% of their income. The problem seems to be insoluble. Concern is justifiable where the purpose of the charity is the relief of poverty, but the officers and employees of the charity enjoy large commission style remuneration and substantial expense accounts. Members of the public are often unaware of this, and their immense generosity to these charities could be at risk, which would be a national disaster. The States and the Commonwealth, which makes a huge contribution to these charities through tax exemptions, should address this issue. In particular, all charities that enjoy any form of taxation relief should be required to make all their accounts available to the relevant Attorney-General who should be empowered to publish them on the Internet.

### (3) *Trustees' Discretions*

Many trusts these days empower trustees to make discretionary payments to beneficiaries. Indeed such trusts are usually called discretionary trusts. The law of discretionary trusts is that the discretions are conferred upon the trustees and no one else. Ordinarily this means that neither the courts nor any beneficiaries can interfere with their proper exercise. Discretions conferred upon trustees vary enormously not only as to the extent of their operation, but also as to the kind of consideration the trustees should give to their exercise. It is when trustees exceed their powers or fail to give the required consideration to their exercise that the courts will intervene. Since these cases are decided largely on questions of fact, namely the intention of the settlor and the circumstances and manner of exercise of the discretion, their value as precedents can be limited.

The discretionary nature of trustees' powers often inhibits the courts from using the word "must". Nevertheless a discretion given to trustees cannot be entirely unfettered. That would be inconsistent with the trustees' fiduciary duty to exercise an active and informed discretion, and would jeopardise the supervisory jurisdiction of the courts.

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<sup>22</sup> September 1995.

The trouble is that some trustees may believe that the discretions conferred upon them virtually relieve them of accountability for their actions and manage the trust as if it were a private fiefdom. In *Attorney-General v Breckler*<sup>23</sup> Gleeson CJ, Gaudron, McHugh, Gummow, Haynes and Callinan JJ said:

Where a trustee exercises a discretion, it may be impugned on a number of different bases such as that it was exercised in bad faith, arbitrarily, capriciously, wantonly, irresponsibly, mischievously or irrelevantly to any sensible expectation of the settlor, or without giving real or genuine consideration to the exercise of the discretion.<sup>24</sup>

So trustees' discretions are never unfettered. But judicial pronouncements, such as that quoted, are usually expressed in negative terms. Many trustees do not know whether they are giving adequate consideration to the exercise of their discretions. Because this poses a perennial practical difficulty for trustees, the following submission is made that it is hoped will assist them in practice. When trustees meet to decide to allocate payments of trust funds to discretionary beneficiaries, they should ensure that they are fully informed as to the intention of the settlor in conferring the discretion and as to the circumstances prevailing at the time of exercise of the discretion. One way of doing this is by imagining that the creator of the trust is present at the meeting when the discretion is being exercised. The trustees should ask themselves whether that ghostly personage would whole-heartedly and unequivocally endorse their decisions. If they feel unanimously that that is the case, it is unlikely that they will make decisions that anyone will subsequently wish to contest. It is their duty to seek relevant information and they may do so from sources outside the trust instrument.<sup>25</sup>

The law of trusts has changed enormously in the last fifty years. The high cost of managing a trust fund, and ensuring that trustees perform their duties, means that in some ways it is less able to deal with what is required of it. Nevertheless if the law can continue to ensure accountability in trustees, the institution will remain a significant achievement of our jurisprudence.

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<sup>23</sup> (1999) 197 CLR 83.

<sup>24</sup> *Ibid* at para 7.

<sup>25</sup> *Hitch v Leworthy* (1842) 2 Hare 200; 67 ER 83 per Sir James Wigram V-C at 207; *Maciejewski v Telstra Super P/L* (1998) 44 NSWLR 601.