ALBERTA
LAW REFORM
INSTITUTE

TRUSTEE INVESTMENT POWERS

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ALBERTA LAW REFORM INSTITUTE

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ACKNOWLEDGEMENTS

This consultation paper has been written by Rick Bowes, one of the Institute's counsel. Mr. Bowes has been greatly assisted by the members of an ad hoc project committee. The project committee consists of two other members of the Institute's legal staff – Janice Henderson-Lypkie (counsel) and Peter Lown, Q.C. (Director) – and the following external advisers who have graciously donated their time and expertise to assist the Institute in carrying out this project:

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Keith Stefanick, National Trust

PREFACE AND INVITATION TO COMMENT

In 1998 Alberta's Minister of Justice requested the Alberta Law Reform Institute to assist in considering whether Alberta should replace the "legal list" approach to trustee investment, embodied in section 5 of the *Trustee Act*, with the "prudent investor rule," which is now embodied in the trustee legislation of many other jurisdictions. The Institute agreed to do so.

Comments on this paper should reach the Institute on or before October 29, 1999

A person who creates a trust is entitled to give the trustees investment powers that are as broad or as narrow as the trust creator considers appropriate. If, however, the trust instrument does not deal specifically with the matter of trustee investments, or simply refers to investments authorized by the *Trustee Act*, the trustees' powers of investment are as provided in section 5 of the Act. A trust portfolio consisting only of assets identified in section 5 could best be described as extremely conservative; over the long term it is almost certain that the return on such a portfolio would be significantly lower than the return that an investor could realize by applying ordinary principles of long-term prudent investment.

Up until a few years ago, nearly every Canadian province as well as the United Kingdom, all the Australian states and New Zealand followed the legal list approach to default trustee investment powers. Most American states also followed an approach that had much the same practical effect as the legal list approach. Now, however, Alberta is one of a very small minority of jurisdictions that still follows the legal list approach. Most jurisdictions have now replaced the legal list approach with the prudent investor approach, in which trustees are not confined to investing in certain legislatively defined categories, but are required to invest in accordance with prudent investment practices.

This paper is circulated for the purpose of getting input on whether Alberta should replace the legal list approach with the prudent investor rule and on a number of subordinate issues that would arise if it is decided to do so. After we make some introductory remarks and provide some background information in Parts I and II, Part III states and describes alternative approaches to 19 separate issues relating to trustee investment. In each case, the discussion of each issue concludes either with a statement of the project committee's preferred alternative or a statement that the committee has not yet reached a consensus on the issue.

It should be noted that where the project committee states a preference for one of the suggested approaches to an issue, it is entirely possible that the committee could adopt a different view in light of further reflection after considering responses to this paper. It should also be noted that the views expressed herein reflect the consensus of the project committee, not the views of the Board of the Alberta Law Reform Institute. Ultimately, any recommendations that are made by the Institute in its final report will be determined by the Board, in light of its consideration of the views of the project committee as well as those who respond to this paper.

The Institute intends to issue a final report on this subject early in 2000. To this end, we request that readers who intend to provide comments do so by **October 29, 1999**. Comments in writing are preferred. Of course, any comments or suggestions are welcome, but we are particularly interested in comments on the specific issues discussed in Part III. Comments should be addressed to:

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CITATIONS AND ABBREVIATIONS

Statutes Cited

The following table gives the complete citation for statutes mentioned in the text.

Jurisdiction	Act Name	Additional Information
Alberta	*Condominium Property Act*	R.S.A. 1980, c. C-22
Alberta	*Dependent Adults Act*	R.S.A. 1980, c. D-32
Alberta	*Insurance Act*	R.S.A. 1980, c. I-5
Alberta	*Loan and Trust Corporations Act*	S.A. 1991, c. L-26.5
Alberta	*Power of Attorneys Act*	S.A. 1991, c. P-13.5
Alberta	*Public Trustee Act*	R.S.A. 1980, c. P-36
Alberta	*Trustee Act*	R.S.A. 1980, c. T-10
Manitoba	*The Trustee Act*	C.C.S.M., c. T160
New Brunswick	*Trustees Act*	R.S.N.B. 1973, c. T-15
New Zealand	*Trustee Act 1956*	As amended by *Trustee Amendment Act 1988*
Northwest Territories	*Trustee Act*	R.S.N.W.T. 1988, c. T-8
Nova Scotia	*Trustee Act*	R.S.N.S. 1989, c. 479, as am. by S.N.S. 1994-95, c. 19
Ontario	*Trustee Act*	R.S.O. 1990, c. T.23 as am. by S.O. 1998, c. 18
Prince Edward Island	*Trustee Act*	R.S.P.E.I. 1988, c. T-8, as am. by S.P.E.I. 1997, c. 51
Saskatchewan	*The Trustee Act*	R.S.S. 1978, c. T-23, as am. by S.S. 1998, c. 40
United Kingdom	*Trustee Investments Act, 1961*	9 & 10 Eliz. 2, c. 62

Jurisdiction	Act Name	Additional Information
Western Australia	*Trustees Act 1962*	As amended by *Trustees Amendment Act 1997*
Yukon	*Trustee Act*	R.S.Y. 1986, c. 173

Works Cited

Footnotes in this consultation memorandum cite articles, law reform proposals and other works using the abbreviated references in the left column of the following table.

Footnote Reference	Full Citation
ALRI 1993	Alberta Law Reform Institute, Report No. 67, *Transfers of Investment Securities* (Edmonton: ALRI, 1993)
BCLI 1998	British Columbia Law Institute Trustee Act Modernization Committee, *Consultation Paper on Trustee Investment Powers* (Vancouver: BCLI, 1998)
BCLI 1999	British Columbia Law Institute Trustee Act Modernization Committee, Report No. 6, *Trustee Investment Powers* (Vancouver: BCLI, 1999)
Haskell 1990	P. G. Haskell, "The Prudent Person rule for Trustee Investment and Modern Portfolio Theory (1990) 69 N.C.L. Rev. 87
LC & SLC 1999	U.K., Law Commission & Scottish Law Commission, *Trustees' Powers and Duties* (London: The Stationery Office, 1999)
Levy 1994	R. A. Levy, “The Prudent Investor Rule: Theories and Evidence” (1994) 1 Geo. Mason U.L. Review 1
LRC 1982	U.K., Law Reform Committee, Twenty-third Report, *The Powers and Duties of Trustees* (Cmnd. No. 8733) (London: Her Majesty's Stationery Office, 1982)

Footnote Reference	Full Citation
LRCBC 1996	Law Reform Commission of British Columbia, "Investment by Trustees: The Prudent Investor Rule Revisited" in *Proceedings of the Seventy-Eighth Annual Meeting of the Uniform Law Conference of Canada* (Ottawa: ULCC, 1996), Appendix N, online: Uniform Law Conference of Canada <http://www.law.ualberta.ca/alri/ulc/96pro/e96n.htm> (date accessed: September 17, 1999)
LRCS 1995	Law Reform Commission of Saskatchewan, Consultation on the Law of Trusts # 2, *The Investment Powers of Trustees* (Saskatoon: LRCS, 1995)
LRCWA 1984	Law Reform Commission of Western Australia, *Report on Trustees' Powers of Investment* (Perth: LRCWA, 1984)
MLRC 1982	Manitoba Law Reform Commission, *Report on Investment Provisions under "The Trustee Act"* (Winnipeg: MLRC, 1982)
MLRC 1999	Manitoba Law Reform Commission, Report # 101, *Trustee Investments: The Modern Portfolio Theory* (Winnipeg: MLRC, 1999)
McDermott 1996	P. M. McDermott, "Trustee Investment Law Reform" (1996), 70 Aust. L.J. 801
Waters 1984	D.W.M. Waters, *Law of Trusts in Canada*, 2nd ed. (Toronto: Carswell, 1984)
Waters 1998	D. Waters, *The Modern Portfolio Theory (or Prudent Investor Rule)*(Winnipeg: Manitoba Law Reform Commission, 1998)
UPIA	National Conference of Commissioners on Uniform State Laws, *Uniform Prudent Investor Act* (1994)
UTIA	Uniform Law Conference of Canada, *Uniform Trustee Investment Act, 1997*, online: ULCC, <http://www.law.ualberta.ca/alri/ulc/acts/etrust.htm> (date accessed: September 17, 1999)

Abbreviations Used in Text

(for abbreviations used in footnotes see "Works Cited" table)

BCLI	British Columbia Law Reform Institute (successor to LRCBC)
LRCBC	Law Reform Commission of British Columbia
LRCS	Law Reform Commission of Saskatchewan
LRCWA	Law Reform Commission of Western Australia
MLRC	Manitoba Law Reform Commission
MPT	modern portfolio theory
NCCUSL	National Conference of Commissioners on Uniform State Laws
ULCC	Uniform Law Conference of Canada
UPIA	Uniform Prudent Investor Act (NCCUSL)
UTIA	Uniform Trustee Investment Act, 1997 (ULCC)

LIST OF ISSUES

I Introduction

[1] The legal concept of a *trust* describes a situation in which one person – the *trustee* – is the legal owner of certain property but must exercise their rights and powers as legal owner for the benefit of another person or persons – the *beneficiaries* of the trust – rather than for their own benefit.[1] The situation in which the legal owner of property must exercise their legal rights and powers as owner for someone else's benefit is often characterized as a separation of *legal* title from *equitable* title. The trustee is the legal owner of the trust property but the beneficiaries are the equitable owners.

[2] Broadly speaking, there are two types of trust: (1) trusts deliberately created by someone who originally holds both the beneficial and legal title to property and wants to split them up; (2) trusts that arise by operation of law, that is, where by virtue of a statute or judicial decision the legal owner of property it on trust for someone else, even though the legal owner might have had no intention of being a trustee. In this paper we focus primarily on the former sort of trust: one created by a deliberate act. Lawyers usually refer to a person who creates a trust that comes into effect while they are still alive as a *settlor* and to a person who creates a trust that comes into effect upon their death as a *testator*, but this paper simply refers to the *creator* of a trust. Similarly, we refer to the document that evidences the trust creator's intention to create a trust and sets out the terms of the trust as the *trust instrument*.

[3] The law of trusts gives a trust creator great latitude in formulating the terms of the trust: the set of duties, powers, authorities and discretions that governs the trustee in dealing with the trust property. Subject to broad constraints dictated by considerations of public policy, what the trustee may do, must do or may not do with the trust property is determined by the trust creator's intentions, insofar as those intentions are revealed by the trust instrument. This proposition applies to the investment of trust funds as well as to other aspects of a trust's administration. The trust instrument could limit the trustee to investing only in a handful of specifically

[1] It is possible for one person to be both a trustee and a beneficiary. For example, *A* may hold property on trust for the benefit of *A* and *B*. This is but one of many subtleties of trust law that are largely ignored in this paper.

identified securities or in a somewhat broader but still limited range of assets. At the other extreme, the trust instrument could authorize the trustee to make any investment that the trustee considers appropriate. Insofar as the trust creator's intentions regarding the trustee's investment duties and powers are clearly expressed in the trust instrument, they will be enforced by the courts.

[4] The issues under consideration in this project arise primarily in the context of trusts created by trust instruments that do not expressly define the trustee's investment authority.[2] The law abhors a vacuum. Therefore, if the trust instrument does not specify the trustee's investment duties and powers, the courts or the legislature must supply a *default rule* that fills the gap. In Alberta the default rule is provided by section 5 of the *Trustee Act*. The default rule provided by section 5 takes what has come to be known as the *legal list* approach to trustee investment. Under this approach, in the absence of a broader investment authority in the trust instrument, the trustee is confined to investing trust funds in assets that fall within certain categories identified by the statute[3]

[5] The fundamental issue considered in this report is whether the *legal list* approach should be replaced with a more modern and flexible approach known as the *prudent investor* rule. Rather than categorizing certain forms of property as permitted trustee investments and prohibiting investment in other forms of property, the prudent investor rule focuses on the *process* by which a trustee makes investment decisions. The rule emphasizes the importance of establishing an investment strategy with risk and return objectives that reflect the nature of the trust and the circumstances of its beneficiaries. Whereas the legal list approach attempts to limit risk by prohibiting trustees from investing in forms of property that the legislature has determined to be inherently speculative or risky, the prudent investor rule focuses on *diversification* as the key to managing risk.

[6] If it is decided to replace the legal list approach with the prudent investor approach, a number of subordinate issues arise. The subordinate issues relate to

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[2] We say they arise "primarily" in the context of trust instruments that do not precisely define the ambit of the trustee's investment authority because we are concerned to some extent with trusts that arise by operation of law, where there is no trust instrument as such.

[3] See para. 9, below for a slightly more detailed explanation of the legal list approach.

such matters as how the prudent investor rule should be given legislative expression, and whether the legal list approach should be preserved in any contexts.

[7] This paper is being circulated for the purpose of soliciting input on the issues mentioned above. Input is being sought from individuals and organizations who we expect will have a particular interest in and knowledge of the subject of trustee investments. We assume that most readers will fall into one (or both) of two categories: (1) individuals who are very familiar with the legal rules and issues regarding trustees and trustee investments ("lawyers"); (2) individuals who are intimately familiar with the theory and practice of financial planning and investment management ("investment professionals"). This paper's discussion of legal rules and issues on the one hand, and investment theory on the other, is at a general level. We are confident, therefore, that investment professionals will have no difficulty in following the discussion of legal rules and issues and that lawyers will have no difficulty in following the discussion of investment theory.

II Background: Legal Lists and Prudent Investors

A. The "Legal List" Approach to Default Investment Powers

[8] As mentioned in the introduction, under the legal list approach to default trustee investment powers, in the absence of more liberal investment powers in the trust instrument trustees are authorized to invest only in property that meets criteria specified in the legislation. The range of investments permitted by a particular jurisdiction's version of the legal list could be very narrow or quite broad, depending on legislative policy-makers' views of what constitutes a safe trustee investment. Typically, the evolution of the legal list approach in a given jurisdiction consists of the gradual expansion of the range of permitted investments, reflecting an evolution in policy-makers' views of what sort property it is prudent for a trustee to invest in.

[9] The investments permitted by a legal list have traditionally reflected a premise that the principal duty of a trustee is to preserve the capital of the trust, and that their secondary duty is to obtain as much income as is consistent with preserving the capital. Accepting this premise – we refer to it as the *capital-preservation imperative* – does not lead inexorably to a legal list approach. What leads to the legal list approach is the capital-preservation imperative combined with three subordinate assumptions or premises. The first is an assumption that certain assets are inherently *low-risk*, in that someone who invests in such an asset runs little risk of actually losing money on the investment, while other assets are inherently *speculative* because there is a substantial risk that you could ultimately get back less than you invest (or nothing at all) in such an asset. The second assumption is that it is inconsistent with the capital preservation imperative for a trustee to invest in a speculative asset. The third assumption is that a legislature (or a regulator exercising delegated legislative authority) is capable of specifying criteria for distinguishing between low-risk and speculative investments. When the capital-preservation imperative is combined with these three assumptions, it seems perfectly logical for a legislature to set out a list of authorized (low risk, non-speculative) trustee investments.

[10] We have mentioned that over the years, the range of investments permitted by a particular jurisdiction's legal list tends to expand. This is true of Alberta, but the

legal list found in section 5 of the *Trustee Act* would still have to be regarded as highly conservative. The list is dominated by fixed income investment instruments upon which there is very little risk of default: securities issued or guaranteed by Canadian federal, provincial or municipal governments or certain foreign governments, well-secured mortgage loans, debt instruments of banks and the most solid non-financial corporations, and so on. Equities find their way onto the traditional legal list only under very stringent conditions. Thus, Alberta trustees subject to the legal list contemplating an investment in common stock would have to ponder the following conditions:

> fully paid common shares of a corporation incorporated in Canada or the United States of America that during a period of 5 years that ended less than one year before the date of investment has either
>
> (i) paid a dividend in each of those years on its common shares, or
>
> (ii) had earnings in each of those years available for the payment of a dividend on its common shares,
>
> of at least 4% of the average value at which the shares were carried in the capital stock account of the corporation during the year in which the dividend was paid or in which the corporation had earnings available for the payment of dividends, as the case may be.[4]

It may be noted in passing that, quite apart from any theoretical questions about the rationale for such a restrictive approach to investments in common stock, as a practical matter it would be extremely difficult to get the information necessary to determine whether a particular corporation meets these criteria.

B. Modern Portfolio Theory and the Prudent Investor Rule

[11] The prudent investor rule is a legal application of *modern portfolio theory* ("MPT"). A discussion of the intricacies of MPT is well beyond the scope of this paper. At the most general level, the central idea of MPT – managing risk through diversification – is expressed in an ancient aphorism: don't put all your eggs in one basket. To bring the old aphorism into line with all of the tenets of MPT, however, the former would require some elaboration.

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[4] *Trustee Act*, s. 5(k).

[12] Certainly, if you decide to invest in eggs, make sure they are not all in the same basket. But that is not an adequate diversification strategy. Even if you were concerned only with the risk of physical destruction of your eggs, putting them in different baskets would not really protect you from losing your total investment in eggs to one catastrophe. What if all your eggs, albeit in different baskets, are in the same semi-trailer whose refrigeration unit malfunctions in the middle of nowhere on a hot summer day? Insofar as physical risks to your investment in eggs is concerned, an effective diversification strategy must ensure that there is a negligible risk that one single calamity will wipe out all or a substantial proportion of your holding of eggs.

[13] Suppose that you have developed and applied a strategy for investing in eggs that ensures that no single calamity will destroy more than 5% of your eggs. You have invested all of the money that you have available for investment in eggs. The obvious problem with your diversification strategy is that it only addresses one sort of risk: physical destruction of your eggs. Your strategy does nothing to protect you from a dramatic decline in the price of eggs that might be brought about by a change in consumer tastes, a dramatic increase in the supply of eggs, or other market forces. Your total investment portfolio is subject to the risk of a decline in egg prices. To protect yourself against this sort of risk, you must diversify by spreading your investment dollars amongst assets whose prices are not highly *correlated.*

[14] A less whimsical, but still informal, description of MPT is provided in a recent report of the British Columbia Law Institute ("BCLI"):

> These rules [the legal list approach] tend to discourage trustees from applying investment strategies that make use of modern portfolio theory, which is based on reduction of overall risk to the portfolio as a whole by acquiring a wide range of investments. Those carrying higher return, and correspondingly greater risk, are balanced in a well-diversified fund by those carrying lower risk.[5] Portfolio

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[5] It is worth observing that reduction of risk is achieved not just by balancing high expected return, high risk assets with low expected return, low risk assets. Suppose that assets L1 and L2 are both relatively low risk investments, while assets H1 and H2 are relatively high risk investments. The return on asset L1 is highly correlated with the return on asset L2, but the return on asset H1 is only weakly correlated with the return on asset H2. Because of the high correlation between the returns on L1 and L2 and the low correlation between the returns on H1 and H2, the overall riskiness of a portfolio consisting of the two individually high risk assets might actually be lower than the riskiness

(continued...)

> theory recognizes the fact that concentration in a few securities means losses in those categories will magnify the proportional loss to the fund. It also recognizes that the probability of loss in a great number of categories at the same time is much smaller than the chance of loss in one category. In other words, modern portfolio theory favours *diversification*.[6]

[15] A somewhat more elaborate, but still not overly technical, description of MPT and its relationship to the prudent investor rule is provided in the following passage:

> This risk – sometimes labelled non-market or specific or unique risk – represents variability in rate of return that can be mitigated by proper diversification of the portfolio. . .
>
> Modern portfolio theory offers an instructive framework for separating risk into its market and non-market components. Systematic or market risk, for which the investor is compensated in the form of higher returns, is not inherently bad. Accordingly, the prudent investor rule does not establish an objective level of market risk that is unacceptable. There is recognition that the financial well-being of trust beneficiaries may be impaired by undue conservatism as well as by excessive risks.
>
> Investments such as real estate and venture capital, and techniques such as borrowing or futures transactions, are not *per se* prohibited. Rather they may be used to reduce overall portfolio risk, or to increase expected return without a disproportionate increase in risk. Restatement [of Trusts] (Third) permits a trustee to purchase volatile assets, even to structure an overall portfolio which is volatile – provided that the aggregate risk level is consistent with the beneficiary's objectives, and non-market risk has been minimized.
>
> As fiduciaries, trustees must seek the lowest level of portfolio risk for a particular level of expected return, or the highest return commensurate with anticipated risk. An optimal tradeoff between risk and return is usually reached by adequate diversification.[7]

[16] The author of the forgoing passage goes on to consider the technical aspects of MPT: the association of the risk of a particular investment with the variability of

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[5] (...continued)
of a portfolio comprised of the two low-risk assets. Levy 1994 at 19-20 gives a concrete example of how the addition of a "risky" asset to a conservative portfolio could actually lower the riskiness of the overall portfolio while increasing its expected return.

[6] BCLI 1999 at 6.

[7] Levy 1994 at 7.

the probability distribution of possible returns, the intricacies of determining the degree of correlation between the expected returns of different assets, and so on. For our purposes, however, it suffices to emphasize the following features of MPT and the prudent investor rule:

1. The goal of the prudent investor (or the trustee employing the prudent investor rule), is not simply to *minimize* risk; it is to *optimize* the risk-expected return relationship. Having determined a target rate of return, the objective is to choose a portfolio that minimizes risk while achieving that expected return. Conversely, having determined an acceptable level of risk, the objective is to select a portfolio with the highest expected return consistent with the accepted level of risk.

2. Risk is judged on a portfolio-wide basis, rather than an asset-by-asset basis. Investing a portion of the trust funds in highly volatile assets could be part of a prudent investment strategy. Indeed, adding a volatile (risky) asset to a portfolio might actually decrease the overall volatility (riskiness) of the portfolio, depending on the degree and direction (positive or negative) of correlation between the asset and the rest of portfolio.

3. The key to effective risk management is diversification, and the key to effective diversification is selecting assets whose expected returns are negatively correlated, uncorrelated, or at least only weakly correlated with each other.

C. Actual and Proposed Reforms Elsewhere

[17] There is an inherent tension between the underlying premises of a legal list approach and the underpinnings of MPT and the prudent investor approach. Even if a particular version of the legal list approach authorizes trustees to invest in fairly broad range of assets, it still rests on a judgment that certain types of asset are inherently unsuitable as trustee investments. The prudent investor approach, on the other hand, is based on the premise that the suitability of a particular type of asset for inclusion in a trust's portfolio can only be determined by considering how it would fit into the trustee's overall investment strategy. Moreover, while the legal list approach presumes that certain investments are inherently low-risk and therefore "safe," MPT assumes that too much of an ostensibly low-risk thing may

result in what is actually an unnecessarily high-risk portfolio, given its modest expected return. Finally, while the legal list approach seems to presume that beneficiaries as a whole will be better off if trustees are told by legislators what types of assets they can or cannot invest in, MPT and the prudent investor rule put more faith in the judgment of the person or persons to whom the trust creator has chosen to entrust the management of the trust funds. In recent years, legislature after legislature in jurisdictions that had for decades followed some version of the legal list approach has embraced MPT and the prudent investor rule.

1. The United States

[18] Most American states' default rule for trustee investments has long been what is known as the *prudent man* rule or *constrained prudent man* rule, which should not (but easily can be) confused with the modern prudent *investor* rule. Although this judge-made rule does not formally prohibit investment in certain types of asset, over the years prudence has been interpreted by courts in many American states so as effectively to preclude trustees from investing in certain types of "speculative" property. Investment in volatile assets was considered to be speculative and, thus, imprudent:

> Under modern portfolio theory, a volatile investment that varies in price, if its price movement is not correlated with other assets in the portfolio, may add to portfolio return without increasing portfolio risk. By contrast, under the constrained prudent man rule, volatile investments are forbidden, even if it can be shown that they reduce portfolio risk. The prudent man rule requires diversification, but only permits investment in non-speculative assets. For example, passive investment in an index fund would be prohibited because it would expose the beneficiary to the potentially speculative aspects of some stocks within the index.[8]

[19] Trustees who were subject to the constrained prudent man rule found that it was constraining them to accept lower returns on their trust portfolios than they could achieve by following conventional, prudent investment practices, without any commensurate reduction in the riskiness of their portfolios. Eventually, this led to reform of the law on a national scale. In 1974 the federal *Employee Retirement Income Security Act* moved some way towards the prudent investor standard from

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[8] *Ibid.* at 8.

the constrained prudent man rule.[9] In 1990 the American Law Institute adopted the Restatement (Third) of the Law of Trusts. The Restatement, an unofficial but highly authoritative statement of the law of trusts, unequivocally adopted the prudent investor rule.[10] Then in 1996 the National Conference of Commissioners on Uniform State Laws (NCCUSL) adopted the Uniform Prudent Investor Act ("UPIA"), which is intended to give legislative effect to the prudent investor rule. Approximately half of the States have adopted the UPIA, and other States have enacted their own version of the prudent investor rule.

2. Canada: Other Provinces

[20] Prior to 1970 all Canadian provinces followed the legal list approach, as did the uniform trustee investment provisions of the organization that is now known as the Uniform Law Conference of Canada ("ULCC")). In 1970 the ULCC adopted uniform investment provisions based on the American *prudent man* test. The 1970 uniform provisions were adopted by New Brunswick, the Northwest Territories and the Yukon.[11]

[21] Manitoba adopted a variation of the 1970 uniform trustee investment provisions in 1983. It did so in accordance with recommendations of the Manitoba Law Reform Commission ("MLRC").[12] As mentioned earlier, the main weakness of the prudent man rule from the perspective of MPT is that the former does not expressly incorporate the latter's tenet that risk is to be assessed on a portfolio-wide basis, rather than on an investment-by-investment basis. And the American experience with the prudent man rule was that courts tended to assess prudence on an investment-by-investment basis, rather than on a portfolio-wide basis. In its report the MLRC considered this weakness of the prudent man test and made the following recommendation to address it:

> . . . an additional section should be enacted stating that if a trustee is sued for imprudence, it shall be a defence for that trustee to show that while a particular investment viewed in isolation may have been speculative or imprudent, the

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[9] *Ibid.* at 3-4.

[10] *Ibid.* at 6.

[11] The relevant provisions are now found in sections 2 to 4 of each jurisdiction's *Trustee Act*.

[12] MLRC 1982.

> trustee nonetheless followed a prudent investment policy and that this total policy was not speculative and not imprudent.[13]

This recommendation was implemented by what is now section 79 of the Manitoba *Trustee Act.*

[22] In its 1994-95 session, Nova Scotia's Legislature amended its *Trustee Act* to replace the legal list with a prudential test that expressly measures prudence in the context of the overall portfolio of investments:

> Subject to Sections 4 and 5, a trustee may, for the sound and efficient administration of a trust, establish and adhere to investment policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments to avoid undue risk of loss and obtain a reasonable return.[14]

Section 4 provides for regulations that could authorize or prohibit investment in particular types of asset, but no such regulations have been made to date. Section 5 implements the principle that statutory trustee investment powers are merely *default* powers, which give way to a contrary intention expressed in the trust instrument.

[23] In 1997 the ULCC adopted the Uniform Trustee Investment Act ("UTIA") and recommended its adoption by all provinces and territories. The UTIA is based quite closely on the American UPIA. As such, it goes beyond the 1970 uniform investment provisions by expressly incorporating MPT's tenet that the prudence of any given investment must be evaluated in the context of the trustee's overall investment strategy. The UTIA has been adopted, with certain variations, by Prince Edward Island (1997), Saskatchewan (1998) and Ontario (1998).[15] The BCLI has recently issued a report that recommends that British Columbia adopt the prudent investor rule, without expressly recommending adoption of the UTIA.[16] And although Manitoba's Trustee Act has since 1983 incorporated certain aspects of portfolio

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[13] *Ibid.* at 27.

[14] *Trustee Act* (N.S.), s. 3.

[15] In force as of July 1 1999.

[16] BCLI 1999.

theory, the MLRC has recently issued a report that recommends incorporation of certain aspects of portfolio theory that are missing from the current statute.[17]

3. New Zealand and Australia

[24] New Zealand and the Australian states formerly followed the legal list approach to default trustee investment powers. In 1988 New Zealand replaced the legal list approach with the prudent investor rule.[18] The legal list approach survived somewhat longer in Australia. In 1995, however, South Australia, Victoria and the Northern Territory adopted the prudent investor rule[19], and the other states have since done so as well.[20]

4. The United Kingdom

[25] The default investment powers of trustees in the United Kingdom are set out in the *Trustee Investments Act 1961*, which is a version of the legal list approach. The basic structure of this Act was summarized in a 1982 report in the following terms:

> . . . its scheme is to divide permitted investments into two groups, the narrower-range and the wider-range investments. The former consist chiefly of gilt-edged and other fixed-interest securities such as National Savings Certificates, the latter chiefly of industrial equities. Some narrower-range and all wider-range investments may only be made after the trustees have taken advice . . . Trustees may invest the whole of the trust fund in the narrower-range, but their overriding duty to have regard to the need for diversification of investments will normally deter them from doing so. However, where they wish to invest in any wider-range securities they must divide the whole fund into two equal parts and they may then invest one but only one of those parts in the wider-range.[21]

[26] The report went on to observe that the majority of the committee's witnesses believed that the Act's provisions "were out of date and, where applicable, restricted sensible trust investment" and that "in the vast majority of cases the Act is either

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[17] MLRC 1999.

[18] *Trustee Amendment Act 1988* (1988, No. 119), s. 3.

[19] McDermott 1996 at 801.

[20] We are indebted to Mr. Peter Richards and Dr. Peter Handford for information regarding recent Australian developments.

[21] LRC 1982 at 15.

modified or wholly excluded in the trust instrument."[22] The report recommended that the scheme of the 1961 Act be abolished and replaced with one along the following lines:

> We think that investments should be divided into those which can be made without advice and those which can be made only with advice. We think that the former category should comprise those investments presently known as narrower-range securities and listed in Parts I and II of the 1961 Act. In addition, trustees should be empowered to invest in unit trusts and investment trusts [ie. mutual funds] . . . without the necessity of taking advice. The category of investments requiring advice should comprise any other investment quoted on the English stock exchange.

It will be noted that although the report's recommendations would have considerably widened trustee's investment powers, it would not have abandoned the legal list approach, since even the broader category of investments would have been limited to investments quoted on the English stock exchange.

[27] The Law Reform Committee's recommendations were not acted upon, and UK trustees' default investment powers are still determined by the 1961 Act.[23] The survival of the 1961 Act seems to owe more to legislative inertia than to enthusiasm for its approach to trustee investment. In 1996 the Treasury issued a consultation document that proposed that the 1961 Act be repealed and that trustees "have all the powers of an absolute owner in relation to the investment of trust assets."[24] In July of this year the two UK law reform commissions–the Law Commission and the Scottish Law Commission–issued a joint report that notes that "an overwhelming majority of those who responded to consultation were firmly in favour" of the Treasury's 1996 proposals, as well as to similar proposals in a consultation paper published by the Law Commission in 1997. Not surprisingly, the report reiterates the earlier recommendations:

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[22] *Ibid.* at 16.

[23] One recent change is that the permissible ratio of wider-range to narrower-range investments has been increased to 75:25: LC & SLC 1999 at 18 (para. 2.20).

[24] This summary of the Treasury proposals appears *ibid.* at 2 (para. 1.4).

> . . . the Trustee Investments Act 1961 should be repealed and replaced with a new statutory provision giving trustees power to make an investment of any kind as if they were absolutely (or beneficially) entitled to the assets of the trust.[25]

5. Alberta

[28] Although Alberta retains the legal list approach in the *Trustee Act*, the prudent investor rule is acknowledged in some Alberta legislation. The *Insurance Act* and the *Loan and Trust Corporations Act*, for example, require financial institutions to which they apply to invest their own funds (as opposed to funds held as trustees or in some other fiduciary capacity) in accordance with the standards of a prudent investor. Given actual and proposed reforms over the last decade or so in other Canadian provinces, the United States, New Zealand, Australia and the United Kingdom, as well as the recognition of the prudent investor approach in some existing Alberta legislation, at least one thing is clear. It would not at this time be particularly innovative or daring for Alberta to abandon the legal list approach in favour of the prudent investor rule as the default rule for trustee investments.

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[25] *Ibid.* at 9-10 (para. 1.3).

III Issues and Tentative Proposals

[29] This part of the paper briefly considers specific issues relating to trustees' default investment powers. We emphasize that we are discussing *default* investment powers: powers that apply only where the trust instrument does not deal specifically with the trustee's powers of investment.

[30] The presentation of each issue follows the same pattern. It begins with a brief statement of the issue. This statement is followed by the heading *Alternative Approaches*, under which is a brief description of two or more alternative approaches to the issue under consideration. In some cases the alternatives are starkly opposed; in others the alternatives represent slightly different routes to the same objective. After the statement of the alternatives is a section headed *Discussion*, which briefly describes and evaluates arguments for choosing one of the alternatives over the other(s).

[31] The last heading under each issue is *Project Committee's Preferred Alternative*, under which we indicate the preliminary consensus of the members of the project committee as to which alternative will best serve the objective of providing an effective set of default rules governing trustee investment. In a few cases no preference is stated, because the members of the committee have not yet reached a consensus as to which of the alternatives would best serve the objectives of the legislation. It goes without saying (but we say it anyway) that, whether the project committee expresses a preference for one of the alternatives or not, readers are invited and encouraged to provide their own views on which of the stated alternatives (or, perhaps, whether an unstated alternative) is likely to lead to the most effective set of *default* rules to govern trustee investment. In this regard, we remind readers that the consensus of the project committee on any given issue does not necessarily represent the views of the Board of the Alberta Law Reform Institute.

A. Legal List or Prudent Investor?

[32] This section begins by considering the fundamental issue whether the prudent investor rule should replace the legal list approach as the general default rule for trustee investments. The remaining issues in this section proceed from the

assumption that the prudent investor rule will indeed replace the legal list approach as the general default rule. Starting from that premise, they consider whether there are particular types of trust or particular circumstances where the legal list should be preserved, whether as the default rule or as an alternative "safe harbour" for trustees.

ISSUE No. 1
As a general matter, should the legal list approach be replaced by the prudent investor standard for the investment of trust funds where the trust instrument does not expressly define the trustee's investment powers?

Alternative Approaches

1. The legal list approach is retained as the general default rule for trustee investment. The legal list might be expanded and provision might be made for future expansion of the list by regulation.

2. The legal list approach is replaced by the prudent investor rule as the general default rule for trustee investment. The prudent investor rule would apply to a trust unless it is clearly inconsistent with the terms of the trust.

Discussion

[33] Whatever approach is taken – legal list or prudent investor – the statutory statement of trustee investment powers and duties serves merely as a default rule. A default rule of this sort can serve two related but distinct functions. The more obvious function is to provide direction for trustees where the trust's creator has simply not considered the question of how the trustees should invest the trust funds. The other function is to provide known rules for trustee investments that the creator of a trust who does consider the issue of trustee investments can either expressly incorporate by reference or implicitly adopt by saying nothing about the matter in the trust instrument.

[34] One perspective is that in providing a default rule the legislature should err on the side of caution by restricting trustees' default investment powers to a conservative list of safe investment instruments. Let trust creators who want to

allow trustees to speculate with the trust fund give them express permission to do so:

> The thrust of this Article is that the traditional [constrained] prudent person rule needs some retuning, but that for family trusts it remains essentially a sound rule. This conclusion is premised upon the ultra-conservative purposes of the typical family trust, which are to provide a satisfactory income flow, to preserve if possible the purchasing power of principal, and to minimize loss of value in the event of severe economic decline. If more flexibility is desired in the form of more risk-taking in exchange for the potential for greater gain, or in the form of expansive experimentation pursuant to portfolio theory, the dispositive instrument can provide for it.[26]

In response to the foregoing argument, it may be observed that the prudent investor rule does not sanction careless speculation; it sanctions an approach to investing in which each investment is evaluated by considering its impact on the risk and expected return of the total portfolio.

[35] It has long been the case that in jurisdictions that retain the legal list approach as the default rule, professionally drafted trust instruments routinely reject it in favour of more liberal trustee investment powers.[27] What inferences are to be drawn from this fact? One possible inference is that since most trust creators explicitly reject the statutory default rule, those who do not reject it must intend to adopt it:

> The majority of our witnesses took the view that its provisions [Trustee Investments Act 1961 (UK)] were out of date and, where applicable, restricted sensible trust investment. However, the evidence we received made it clear that in the vast majority of cases the Act is either modified or wholly excluded in the trust instrument . . . This led some of our witnesses to suggest that where it was not so excluded the settlor must have intended it to apply and to operate as a restriction on the trustee's power of investment.[28]

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[26] Haskell 1990 at 87-88.

[27] Waters 1984 at 766 notes that "Today some ninety percent of trusts authorize the trustees to invest as they in their discretion think best, or in some other language it is made clear that no restrictions are placed upon the trustees in their choice of investments." Similar statements are found in many other texts and reports. On the other hand, LRCS 1995 at 4 suggests that in Saskatchewan the proportion of trust instruments that give trustees more liberal invest powers than are provided by the statute may be lower than the figure mentioned by Waters, *ibid*.

[28] LRC 1982 at 15-16 (para. 3.16).

On the other hand, it is possible that a sizeable proportion of trust creators who fail to provide more ample powers than are provided by the *Trustee Act* are simply not aware of the need to consider the issue. Moreover, it can be argued that, all else being equal, the more appropriate of two possible default rules is the rule that demonstrably is chosen by most trust creators whose minds are directed to the issue. Why put the majority of trust creators, who want their trustees to have flexible investment powers, to the trouble and expense of "drafting around" a restrictive default rule, rather than leaving this task to the minority of trust creators who do not want their trustees to have flexible investment powers?[29]

[36] Supporters of some version of the legal list approach have sometimes argued that the list provides *guidance* to unsophisticated trustees that they would not otherwise have. For example, in 1995 the Law Reform Commission of Saskatchewan("LRCS") issued a consultation paper that rejected the "constrained prudent man" approach and argued for a refurbished version of the legal list approach.[30] The paper argued that the UK *Trustee Investment Act 1961*–

> ...embodies a more satisfactory policy in regard to trustee's investment than the prudent man rule. It provides guidance to trustees rather than merely enacting a criterion for judging their performance.[31]

[37] The paper acknowledged that Saskatchewan's then current version of the legal list approach was unsatisfactory but also considered that the prudent man approach was subject to serious criticism. In particular, the Commission thought that a vague statutory requirement to invest prudently could either lead Canadian courts to take the same restrictive approach as American courts have taken over the years in applying the prudent man test or leave unsophisticated trustees with no guidance as to appropriate investment strategies:

> If the prudent man rule is widely adopted in Canada, and content is given to it by referring to American precedent, very little will have been achieved [by way of allowing trustees to invest in accordance with MPT]. If, on the other hand, our courts do not turn to the American experience, we will be left with a virtual *tabula*

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[29] See Levy 1994 at 28.

[30] LRCS 1995.

[31] *Ibid*. at 7.

> *rasa* [blank slate]. In the worst case, the result would be *de facto* abandonment of any serious effort to provide guidance to trustees. Our courts might, of course, fill the void by evolving an appropriate interpretation of the rule that differs from the American model. In any event, adopting the prudent man rule would be less an exercise of law reform than a mechanism to pass the ball to the judiciary. Such a course of action could be justified only if no viable alternative exists.[32]

The LRCS paper goes on to recommend a legal list approach based on that recommended by the UK Law Reform Committee[33] some years before. There would be two lists: a narrow list consisting essentially of government-issued debt instruments; and a broader list ("all other publicly-traded securities and securities approved by Regulation").[34] Trustees would be permitted to invest in the broader list only after "obtaining the advice, in writing, of a recognized financial adviser."[35] The LRCS's recommended approach did not find favour with the Saskatchewan Legislature, which, as already noted, amended the *Trustee Act* in 1998 to adopt the prudent investor rule.

[38] Two propositions seem to be implicit in the LRCS's 1995 endorsement of a refurbished legal list approach: (1) that a legal list of authorized investments provides guidance to unsophisticated trustees; and (2) there is no better way to provide such guidance. A similar view was expressed by the Law Reform Commission of Western Australia ("LRCWA") in a 1984 report.[36] The reason given by the LRCWA for retaining the legal list approach is as follows:

> 2.13 Only one commentator on the working paper supported the adoption of the prudent man rule in Western Australia. The remainder were of the view that the list approach should be retained on the ground that it is desirable to give inexperienced trustees guidance on investment. However, they were generally of the opinion that the range of investments should be extended.

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[32] *Ibid.* at 16.

[33] LRC 1982. See above at para. 27.

[34] LRCS 1995 at 24.

[35] *Ibid.*

[36] LRCWA 1984.

> 2.14 The Commission agrees that it would not be desirable to abandon the concept of a statutory list in favour of a prudent man rule in Western Australia at this stage, for the reason advanced by the commentators.[37]

The LRCWA's recommendations were implemented in the *Trustee Amendment Act 1987*, but this was but a temporary reprieve for the legal list approach in Western Australia. It was replaced by the prudent investor rule in 1997.[38]

[39] One response to the sort of argument made by the LRCS and LRCWA is that a list of authorized investments does not necessarily provide an unsophisticated trustee with any effective guidance as to how they should invest trust property. Legal lists tend to be long and convoluted, and it is doubtful that the typical unsophisticated trustee would take much comfort or find much guidance from an examination of a provision such as section 5(k) of Alberta's *Trustee Act*, which was set out earlier in this paper.[39] To be sure, a legal list does tell trustees what types of property they can or cannot invest in. But it gives them no guidance as to how they should go about selecting from the types of securities that are identified in the list. And unless the list is so narrow as to effectively deny trustees access to assets with any potential for significant capital appreciation, it will necessarily be broad enough to allow the unsophisticated, unadvised trustee plenty of scope for getting into serious trouble.

[40] As an objection to the prudent investor rule, the "guidance" argument is not particularly persuasive. As will become clear when we examine detailed issues relating to implementation of the prudent investor rule, the rule does not simply direct trustees to invest prudently and then leave the trustee to figure out what that means. Although the prudent investor rule does not label particular investments as inherently prudent or imprudent, the legislative implementation of the rule can provide investors with a variety of guidelines and directions as to how to invest trust funds. The precise nature of these guidelines and directions may vary from one implementation of the prudent investor rule to the next, but it is

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[37] *Ibid.* at 18.

[38] *Trustees Act 1962* (WA), Part III, as am. by No. 1 of 1997, s. 6.

[39] See para. 11 above.

simply wrong to suggest that the prudent investor standard cannot provide trustees with guidance and direction.

[41] As noted above, the LRCS recommended a modified version of the legal list approach in which unsophisticated trustees who wanted to go beyond a narrow list of permitted investments would be required to obtain expert advice before investing in securities identified in a broader list. But assuming that unsophisticated trustees should be required to get investment advice at all, it is reasonable to ask why this requirement should not apply regardless of whether they are ostensibly investing in “risky” securities or not. It has been pointed out by many commentators that an unsophisticated trustee can cause considerable damage to the trust beneficiaries’ financial interest by taking an overly conservative approach: e.g. by investing all the funds of a long-term trust in “safe” money market instruments. Thus, to the extent there is a good argument for requiring certain trustees to act only after obtaining advice from qualified financial advisers, the argument would seem to apply whether such trustees are constrained to invest within the bounds of a legal list or not.

Project Committee’s Preferred Alternative

[42] The committee’s preference is for alternative 2: replacing the legal list with the prudent investor approach as the general default rule for trustee investments.

ISSUE No. 2
Should the legal list approach continue to be the default rule for certain trustees?

Alternative Approaches

1. Sophisticated trustees may invest in accordance with the prudent investor standard, but unsophisticated trustees must adhere to a legal list unless otherwise provided in the trust instrument.

2. All trustees are governed by the prudent investor standard, rather than a legal list, unless this is inconsistent with the terms of the trust instrument.

Discussion

[43] In its recent report on trustee investment powers, the BCLI noted that although those who responded to its consultation paper were predominantly in favour of abolishing the legal list, some"favoured restrictions on investment in the case of committeeships, small funds and trusts of minors' property," and that some respondents "expressed concern that financially unsophisticated trustees may be left without guidance if the legal list is repealed."[40] The report's response to these concerns was as follows:

> The Committee considered all of these submissions carefully, but is not persuaded that a statutory list of authorized investment categories provides a satisfactory solution to any of the difficulties faced by the trustee or other fiduciary in the cases suggested by some correspondents as ones in which the range of investments should be limited. The statutory list is equally likely to become a trap for an inexperienced trustee as a guide, since the trustee may not be aware of the legislation and unwittingly depart from the list, thereby committing a breach of trust. It is also undesirable to restrict any trustee or fiduciary to categories of investments that may cease to be safe or productive with change in market conditions. Flexibility to deal with altered circumstances is as important to a trustee of a small fund as a large one.[41]

[44] It might be reiterated that, to the extent that there is an issue about providing guidance to unsophisticated trustees, it is a separate issue from whether they should be constrained by a legal list. Whether unsophisticated trustees should be required to obtain expert advice in connection with investment decisions is considered in Issue 12, below.

Project Committee's Preferred Alternative

[45] The committee prefers the second alternative: the prudent investor rule would apply to all trusts by default.

ISSUE No. 3
How should the legislation deal with existing enactments that incorporate the investment provisions of the Trustee Act by reference?

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[40] BCLI 1999 at 8.

[41] *Ibid.*

Alternative Approaches

1. The existing enactment is read as incorporating the new prudent investor standard by reference. If the Legislature intends that an enactment that currently incorporates the investment provisions of the *Trustee Act* by reference will continue to require the legal list approach (or to apply any investment criteria other than the prudent investor standard), then specific legislative provision will have to be made.

2. An existing enactment that incorporates the *Trustee Act*'s investment criteria by reference is deemed to require adherence to the legal list approach. If the Legislature intends that such an enactment will incorporate the prudent investor standard, then specific legislative provision to that effect will have to be made.

Discussion

[46] In Alberta, as in other jurisdictions, many enactments create statutory trusts or impose fiduciary responsibilities on individuals who occupy positions that involve the administration of funds that belong to others. A question that will often arise is how such fiduciaries may invest the funds under their administration. Many enactments answer this question by stipulating that the fiduciary may invest those funds in accordance with the *Trustee Act*.

[47] Section 35 of the *Condominium Property Act*, for example, provides that "a [condominium] corporation may invest any funds not immediately required by it in those investments in which a trustee may invest under the *Trustee Act*." Similarly, the *Public Trustee Act* provides for the investment by the Public Trustee of money that is not "subject to any express trust or direction for the investment thereof" in a common fund[42] and then provides that the common fund "shall be invested in any of the investments authorized by the *Trustee Act* and not otherwise."[43] As a final example, section 29(b) of the *Dependent Adults Act* provides that a trustee of a dependent adult may invest "in investments in which trustees are authorized to invest trust money under the *Trustee Act*". Section 30 of the *Dependent Adults Act*

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[42] *Public Trustee Act*, s. 25(1).

[43] *Ibid.* s. 26(3).

empowers the Court, notwithstanding the *Trustee Act*, to authorize the trustee to "invest funds in any securities and assets that the court approves."

[48] Suppose that the *Trustee Act* were amended by replacing the legal list with the prudent investor rule. Under ordinary rules of statutory interpretation, provisions such as those mentioned in the preceding paragraph would be interpreted as referring to the *Trustee Act* in its amended form, rather than to the *Trustee Act* as it read when the referring provision was enacted.[44] In other words, the provision in the other enactment would now be read as requiring fiduciaries to invest in accordance with the prudent investor rule, rather than the legal list approach. If the Legislature is not comfortable with this result, it could include in the amended *Trustee Act* a provision along the lines of section 26 of Ontario's *Trustee Act*, as amended in 1998:

> If a provision of another Act or the regulations under another Act authorizes money or other property to be invested in property in which a trustee is authorized to invest and the provision came into force before [the prudent investor rule was incorporated in The Trustee Act] the provision shall be deemed to authorize investment in the property in which a trustee could invest immediately before the coming into force of section 16 of [the amending Act].

Under the Ontario approach, if it is intended that fiduciaries under an existing enactment that incorporates the *Trustee Act*'s investment powers by reference are to have the expanded investment powers of the prudent investor rule, that enactment must be amended to expressly adopt the new rule.

Project Committee's Preferred Alternative

[49] The committee prefers the first alternative, on the basis that the same considerations that make the prudent investor rule a better default rule for ordinary trustees make it a better default rule for trusts or other fiduciary relationships that arise by operation of statute. However, just as the creator of an ordinary trust might decide to impose specific limitations on trustees' powers of investment, we conceive that the Legislature or the government department responsible for administering a particular enactment might decide that the purposes of that enactment would be better served if fiduciaries subject to that enactment had less flexible investment powers that are provided by the prudent

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44 *Interpretation Act*, ss 27, 29.

investor rule. Therefore, we believe that government officials responsible for administering such enactments, in consultation with individuals and organizations affected by the enactments, should carefully consider what type of investment power will best serve the purposes of the enactment.

[50] We expect that in the great majority of cases, it will be determined that it is appropriate for the relevant fiduciaries to be governed by the prudent investor rule. In some cases, though, it may appear that the particular purposes of the relevant enactment – or the particular purpose for which the funds in question are held – will be better served by placing certain restrictions on the relevant fiduciaries' investment powers. In those instances it would be necessary to amend the relevant enactment to incorporate the desired restrictions.

ISSUE No. 4
Where a trust has come into existence or the trust instrument (e.g. a will) was executed before the prudent investor rule replaces the legal list, and the trustee's investment powers are determined by the *Trustee Act*, should the trustee's investment powers be determined by the prudent investor standard or the legal list approach?

Alternative Approaches

1. The trustee's investment powers are confined to the legal list if the trust instrument was executed before the *Trustee Act* is amended to incorporate the prudent investor standard, regardless of whether the trust had come into existence before the amendment or not.

2. The trustee's investment powers are confined to the legal list if the trust has come into existence before the *Trustee Act* is amended, but are determined in accordance with the prudent investor rule if the trust comes into existence after the Act is amended, regardless of when the trust instrument was executed.

3. The trustee's investment powers are determined by the prudent investor standard even if the trust has come into existence before the *Trustee Act* is

amended, unless this result would be clearly inconsistent with the terms of the trust instrument.

Discussion

[51] The recent report of the BCLI contains a concise elaboration of the issue under consideration here, as well as a brief argument in support of the third alternative mentioned above:

> The non-statutory rule of interpretation governing references to legislation in deeds and other documents is different [from that which applies to references in enactments], however. A reference in a trust instrument to a legislative provision or to the law affecting some act or matter is normally read as a reference to the provision or the general law as it stood at the time the document was executed, in the absence of a contrary intention on the part of the settlor. Thus, questions of interpretation will arise under instruments predating the introduction of the prudent investor rule as to the scope of powers to invest in "securities in which trustees are authorized by law to invest."
>
> These questions emerge in relation to the broader issue of whether the prudent investor rule, and other changes to the statutory powers under the *Trustee Act*, should apply to trusts created before the changes come into force. The Committee believes that the reformed statutory powers should apply to pre-existing trusts, unless they are actually inconsistent with the terms of those trusts. This would be in keeping with the purpose of the *Trustee Act*, namely to supply a basic framework of administrative powers that are not specifically conferred on the trustee by the actual terms of the trust, but which are essential under contemporary conditions.[45]

So far as we are able to determine, the approach favoured by the BCLI is the approach actually taken or recommended in other jurisdictions in which the prudent investor rule has replaced the legal list approach. It is perhaps noteworthy that this is true even in Ontario,[46] where, as noted above, the opposite approach was taken with respect to existing enactments that incorporate the *Trustee Act*'s investment powers by reference.

[52] An argument for not applying the prudent investor rule to preexisting trusts would be that the creators of many existing trusts apparently were content with the trustee investment powers of the *Trustee Act*. They must have intended to restrict

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[45] BCLI 1999 at 11-12.

[46] *Trustee Act* (ON), s. 30.

their trustees to the conservative investment policies set out in the Act as it read when they executed the trust instrument. To provide that the trustees of such trust have the broad investment powers provided by the prudent investor rule would be to undermine the intentions of the trust's creator.

[53] One possible reply to the foregoing argument is that most trust creators who were content to adopt the *Trustee Act*'s standard of prudent investment by trustees probably did not pay a whole lot of attention to the specific provisions of the Act as it existed at the time they executed the trust instrument. Rather, they intended to authorize their trustees to invest in a manner that meets trustee investment standards that are determined to be prudent by the Legislature from time to time. Indeed, failing to apply the prudent investor rule to preexisting trusts, many of which were created years ago when problems with the legal list approach were less evident, would deprive the amendment of much of its potential benefit.

Project Committee's Preferred Alternative

[54] The members of the committee prefer the third alternative: the prudent investor rule applies to all trusts, whether they are created or come into existence before or after the prudent investor rule replaces the legal list approach.

ISSUE No. 5
Given that trustees would be authorized to invest trust funds in any type of property in which a prudent investor might invest, should the legal list approach nevertheless be preserved to the extent of providing a "safe harbour" for trustees?

Alternative Approaches

1. The legal list is preserved as a figurative "safe harbour," in the sense that trustees who invest trust funds in property identified in a statutory list are presumed to have acted prudently with respect to the investment of those funds.

2. The legal list is not preserved even as a safe harbour for trustees. Any investment decision made by a trustee is subject to scrutiny in the light of the prudent investor standard.

[55] It has been argued that even if the legal list is done away with insofar as it imposes a *constraint* on trustee investments, it should be preserved as a safe harbour for trustees. That is, trustees who decide to venture beyond the confines of a legal list should be held to the standards of the prudent investor, but trustees who stay within its confines should be presumed to have acted prudently.

[56] One problem with the foregoing argument is that even under the existing legal list approach, the trustee's general duty of care and prudence is not suspended or presumed to have been met simply because the trustee stays within the confines of the legal list. A trustee who goes beyond the legal list (or the express investment powers set out in the trust instrument) is certainly guilty of a breach of trust. But a trustee who stays within the list has not necessarily satisfied the general duty of care and prudence. The point was put thus by the MLRC in its 1982 report:

> The Commission also noted that support for the legal list position seemed to be founded to a large extent on two misconceptions. The first misconception is that if a trustee follows the legal list he will be immune from being sued... Neither proposition can be supported in law...
>
> Dealing first with the question of immunity. Section 70(2) of "*The Trustee Act*" commences by saying "... if the investment is in all other respects reasonable and proper ...".[47] These words are a clear indication that the Legislature never intended to provide immunity to the trustee who merely followed the legal list; the trustee must still exercise reasonable care...[48]

The report then goes on to discuss case law supporting its contention that adherence to the legal list does not absolve a trustee from responsibility for acting prudently.

[57] Of course, the fact that, under the existing legal list approach, trustees who confine themselves to authorized investments are not automatically immunized from allegations of imprudence does not mean that an amended Act could not do so. For example, the Act could set out a list of "sale" investments and specify that

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[47] The ellipsis is in the original. The introductory part of section 5 of Alberta's *Trustee Act* contains the identical phrase.

[48] MLRC 1982 at 8-9.

investment of trust funds in any of those investments is deemed to be prudent.[49] However, while the provision of such a safe harbour might appeal to some trustees – and it is always open to a trust creator expressly to provide such a safe harbour – it could have unfortunate consequences for a trust's beneficiaries. Presumably, the provision of a list of investments that would act as a safe harbour would encourage trustees who wish to avoid potential liability to invest only in the conservative investments identified in the list. But the basic problem with a trust portfolio that is confined to conservative investments is that it will often condemn the beneficiaries to accepting unnecessarily modest returns from the trust's investments compared to the returns that could be realized from a diversified portfolio. In short, preserving the legal list (or some version of the legal list) as a safe harbour for trustees seems to put the interests of certain unsophisticated trustees ahead of the interests of the beneficiaries of the trust.

Project Committee's Preferred Alternative

[58] The members of the committee are of the view that the legal list should *not* be preserved as a safe harbour for trustees. All trustees should be held to the standard of a prudent investor.

B. Implementing the Prudent Investor Standard

[59] This section considers issues that arise in connection with the implementation of a prudent investor rule. Most of these issues concern the most appropriate technique for implementing an agreed policy, rather than to any controversy over the policy itself. For example, one of the issues considered in this section (Issue 7) is whether the statute should set out a non-exclusive list of criteria for making investment decisions in accordance with the prudent investor standard and, if it does, whether the statute should say that the trustee "must" or "may" consider the factors mentioned in the list. Given a decision to adopt the prudent investor rule, it is presumably uncontroversial that the considerations that might be mentioned in such a list should generally be considered in making investment decisions. What may be more controversial is whether it is useful to set out such factors in the statute and, if so, whether it should be mandatory for trustees to consider those factors in making investment decisions.

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[49] This approach is taken by Quebec's Civil Code, which restricts administrators to investing in a list of investments that are "presumed sound," and provides that an administrator who invests in accordance with the relevant section "is presumed to act prudently:" Arts. 1339 and 1343, C.C.Q.

1. Statutory Expression of the Prudent Investor Rule

[60] As discussed earlier, the basic ideas of the prudent investor rule are reasonably clear. The prudent investor begins by establishing clear objectives regarding return and risk, and then builds a diversified portfolio designed to meet those objectives. What is less clear is the optimal manner of giving legislative expression to these ideas. The issues under this heading relate to the translation of prudent investor principles into statutory provisions.

ISSUE No. 6
What is the preferable legislative expression of the general prudent investor standard?

Alternative Approaches

1. "A trustee may invest trust property in any form of property or security in which a prudent investor might invest . . . [and] in investing trust property, a trustee must exercise the care, skill, diligence and judgment that a prudent investor would exercise in making investments" [UTIA, ss 1(1), (2); PEI, Ontario and Saskatchewan very similar]

2. "A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill and caution. . . A trustee may invest in any kind of property or type of investment consistent with the standards of this Act. [UPIA, §2(a), (e)]

3. ". . . a trustee may invest in any kind of property, real, personal or mixed . . . in investing money for the benefit of another person, a trustee shall exercise the judgment and care that a person of prudence, discretion and intelligence would exercise in administering the property of others. [Manitoba *Trustee Act*, s. 68(1), (2); New Brunswick *Trustee Act*, s. 2]

4. ". . . a trustee may, for the sound and efficient management of a trust, establish and adhere to investment policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of

investments to avoid undue risk of loss and to obtain a reasonable return." [Nova Scotia *Trustee Act*, s. 3]

5. ". . . shall adhere to prudent investment standards in making investment decisions . . . prudent investment standards are those which, in the overall context of an investment portfolio, a reasonably prudent person would apply to investments made on behalf of another person with whom there exists a fiduciary relationship to make such investments without undue risk of loss or impairment and with a reasonable expectation of fair return or appreciation." [*Insurance Act*, s. 94(1), (2); *Loan and Trust Corporations Act*, s. 196(1), (2)]

Discussion

[61] The foregoing are but a few of the various ways in which the basic concept of the prudent investor rule might be expressed. This is an issue where five reasonable individuals who are in complete agreement as to the policy to be pursued by the legislation might prefer five different alternatives. Nevertheless, we think it is useful to comment briefly on some of the nuances of the alternatives and to invite comment from readers.

[62] The first alternative, the UTIA's formulation, might be regarded as the presumptive favorite simply because there is much to be said for having uniform wording in legislation across the country. However, the UTIA formulation might be criticized on a couple of grounds. The principal criticism is that it uses without defining the term "prudent investor" as if this term connoted a well-known legal concept, when in fact it does not. Although the UTIA does contain provisions that impose fairly specific requirements, or provide certain guidelines, for trustee investments, it does not expressly identify them as the hallmarks of a prudent investor. For example, although section 3 of the UTIA states that a trustee must diversify to an extent that is appropriate in the circumstances, it does not indicate whether this is part of what defines a prudent investor or is a separate requirement. In contrast, the formulations in the Nova Scotia *Trustee Act* and Alberta's *Insurance Act* and *Loan and Trust Corporations Act* eschew the term "prudent investor" but explicitly tie the concept of prudent investment into the idea of balancing risk and return on a portfolio-wide basis.

[63] Another possible criticism of the UTIA is that the phrase "may invest trust property in any form of property or security *in which a prudent investor might invest*" seems to invite courts to draw the conclusion that there are certain forms of property or security in which a prudent investor would not invest. In other words, it seems to imply that certain forms of property may be inherently unsuitable for trustee investment. As discussed earlier, however, under MPT, no form of property is inherently too risky to be included in the portfolio of a prudent trustee. What the prudent trustee must do is assess whether the expected return and risk associated with a particular proposed investment fits within the overall investment strategy and asset mix for the trust.

Project Committee's Preferred Alternative

[64] The committee has not yet reached a consensus on this issue.

ISSUE No. 7
Should the statute include a non-exclusive list of factors that either may be, or must be, considered by a trustee in making investment decisions.

Alternative Approaches

1. The statute sets out a list of factors that *must* be considered by the trustee in making investment decisions, in addition to others that may be relevant in the circumstances. [UPIA, Ontario, Saskatchewan]

2. The statute sets out a list of factors that *may* be considered by the trustee in making investment decisions, in addition to others that may be relevant in the circumstances. [UTIA, PEI]

3. The statute does not set out either a permissive or mandatory list of factors to be considered by trustees. [Recommended by BCLI]

Discussion

[65] A statute cannot aspire to identify and list all of the factors that it might be appropriate for a trustee to consider in making prudent investment decisions. On the other hand, it is possible for a statute to identify the factors that would generally be appropriate for a prudent trustee to consider in making investment

decisions. What is somewhat controversial is whether it is useful for a statute to identify certain factors that *must* or, alternatively, *may* be considered by a trustee in making investment decisions, in addition to any other factors that may be relevant in a particular case. The function of a permissive list would be simply to draw trustee's attention to factors that generally ought to be considered in making investment decisions. The UTIA takes the permissive list approach:

> (3) A trustee may have regard to the following criteria in planning the investment of trust property, in addition to any others that are relevant to the circumstances:
>
> (a) general economic conditions;
>
> (b) the possible effect of inflation or deflation;
>
> (c) the expected tax consequences of investment decisions or strategies;
>
> (d) the role that each investment or course of action plays within the overall trust portfolio;
>
> (e) the expected total return from income and the appreciation of capital;
>
> (f) other resources of the beneficiaries;
>
> (g) needs for liquidity, regularity of income and preservation or appreciation of capital;
>
> (h) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

The PEI statute takes the identical approach. The Saskatchewan and Ontario statutes have essentially the same list,[50] but state that the trustee *must* consider the factors in the list.

[66] The Western Australian Act takes the same approach as Saskatchewan and Ontario in *requiring* trustees to consider the factors mentioned in a statutory list. However, we think it is worthwhile to set out the Australian provision in full, because it contains some items for which there is no direct analogue in the UTIA list

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[50] Ontario omits the UTIA's clause (f).

20(1) Without limiting the matters that a trustee may take into account when exercising a power of investment, a trustee shall, so far as they are appropriate to the circumstances of the trust, have regard to —

(a) the purposes of the trust and the needs and circumstances of the beneficiaries;

[(a1) a duty to act impartially towards beneficiaries and between different classes of beneficiaries;][51]

(b) the desirability of diversifying trust investments;[52]

(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 length of the term of the proposed investment;

(i) the probable duration of the trust;

(j) the liquidity and marketability of the proposed investment during, and on the determination of, the term of the proposed investment;

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[51] The clause that we have numbered "(a1)" does not actually appear in subsection 20(1) of the Western Australian Act. Instead, it appears as clause (c) of subsection 19(1), which reads as follows:

> 19.(1)Any rules and principles of law or equity that impose a duty on a trustee exercising a power of investment including, without limiting the generality of those duties, rules and principles that impose —
> (a) a duty to exercise the power of a trust 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 hazardous;
> (c) a duty to act impartially towards beneficiaries and between different classes of beneficiaries; or
> (d) a duty to take advice,
> continue to apply except to the extent that they are inconsistent with this or any other Act or the instrument creating the trust.

We have inserted the duty to act impartially into the list for the purpose of inviting comment as to whether it would be an appropriate component in of a list factors that a trustee is directed to consider in making trust investments.

[52] The UTIA list of things to consider does not mention diversification, but the Act contains a separate section dealing with diversification.

(k) the aggregate value of the trust estate;

(l) the effect of the proposed investment in relation to the tax liability of the trust;

(m) the likelihood of inflation affecting the value of the proposed investment or other trust property;

(n) the costs (including commissions, fees, charges and duties payable) of making the proposed investment; and

(o) the results of a review of existing trust investments.

[67] A couple of items – (a1) and (b) – in the above list warrant special comment. Regardless of whether a list of "things to consider" includes a reference to a duty to act impartially as between beneficiaries or different classes of trustees in making investment decisions, such a duty is fundamental to the trustee's role (unless negated by the trust instrument). This duty might be relevant, for example, where one beneficiary of a trust is entitled to the income generated by the trust for life while another is entitled to the capital once the first beneficiary dies. In this context, an investment strategy that is entirely unobjectionable from the perspective of MPT, but which is heavily weighted to capital appreciation over income generation, may well violate the trustee's duty to "maintain an even hand" between the income and capital beneficiaries. Although the duty to maintain an even hand does not depend on its inclusion in a list of factors to be considered by trustees in making investment decisions, there is something to be said for including it in a list as a reminder to trustees that it needs to be considered, unless the duty is negated by the trust instrument.[53]

[68] Item (b) of the Western Australian list consists of a requirement (recall that the trustee *must* have regard to the items in the list, so far as they are relevant to the particular trust) to consider the desirability of diversification. The UTIA does not refer to diversification in its list of factors that a trustee *may* consider. Instead, it contains a separate provision, section 3, that reads as follows:

> A trustee must diversify the investment of trust property to an extent that is appropriate having regard to

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[53] See Waters 1998 at 39.

(a) the requirements of the trust, and

(b) general economic and investment market conditions.

As noted by Professor Waters in a paper prepared for the MLRC, a statute that says nothing at all about diversification of the trust's investments would fail to draw the attention of trustees to one of the most important aspects of MPT.[54] Given that the items in the Western Australian list *must* be considered by the trustee, so far as they are appropriate to the terms of the trust, it will be apparent that insofar as diversification is concerned, the UTIA and Australian provisions are to much the same effect.

[69] Should the statute provide a non-exclusive list of factors that either may be or must be considered by trustees in making investment decisions? The recent BCLI report noted that a few of the respondents to its consultation paper favoured optional guidelines and that none favoured a compulsory list of factors to be considered. The report then gave its reason for recommending that the legislation should not contain a list of investment criteria, whether compulsory or permissive:

> Over the course of time guidelines may be seen as a checklist that must be gone through in order for an investment decision to be considered prudent in a legal sense. The standard of "prudence" might thus become equivalent to a mechanical process of demonstrating compliance with the checklist rather than a careful analysis of risk and return in light of prevailing conditions. It is unlikely that less sophisticated trustees would be assisted to any great degree by the inclusion of guidelines such as those listed above, as they will require expert advice in any event in order to assess tax consequences and inflation. More sophisticated trustees will be aware that factors such as those listed in (a) to (h) above play a part in every well-considered investment decision. The Committee does not see guidelines as necessary or desirable, and we do not recommend their inclusion in the legislation.[55]

It might also be argued that the unsophisticated trustee is unlikely to derive much assistance from a checklist that contains no hint as to the prioritization of factors that may point in different directions. On the other hand, the supporter of a permissive list could say that it will do no harm and may be helpful to alert trustees to factors that they should take into account in making investment decisions.

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[54] *Ibid.* at 40.

[55] BCLI 1999 at 10.

Project Committee's Preferred Alternative

[70] The committee prefers the approach of *requiring* trustees to at least consider the factors mentioned in a statutory list: the approach followed by Saskatchewan, Ontario, the US UPIA and the Australian statutes. As the Western Australian statute puts it, the trustee's duty would be to have regard to the listed considerations, so far as they are appropriate to the terms of the trust. The committee's view is that, insofar as the prudent investor rule is founded on a presumption that there are certain factors that a trustee should generally take into account in making investment decisions, it would be odd if the statute did not require trustees to at least consider those factors in making investment decisions. The committee also believes that if the trustee *must* consider the factors mentioned in the list (insofar as they are applicable to the particular trust), and if the list mentions diversification, it would be unnecessary for the Act to contain a specific provision along the lines of UTIA section 3.

[71] In addition to commenting on whether the Act should set out a list of factors for trustees to consider in making investment decisions, readers are invited to comment on particular items that might be included in the list. In this regard, since the Western Australian list is more comprehensive than the UTIA list, we specifically invite comments on the items mentioned in the former.

ISSUE No. 8
How should statutory expression be given to the principle that investment decisions should be made by looking at the total portfolio, and by balancing risk and return objectives, rather than by looking at a particular component of the portfolio in isolation or by concentrating solely on minimizing risk?

Alternative Approaches

1. The statute says that a trustee is not liable for a loss to the trust arising from the investment of trust property if the conduct of the trustee that led to the loss conformed to a plan or strategy for the investment of the trust property, comprising reasonable assessments of risk and return, that a prudent investor could adopt under comparable circumstances. [UTIA]

2. The statute says that a trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an investment strategy having risk and return objectives reasonably suited to the trust. [UPIA]

Discussion

[72] The issue here is how to best give expression to the basic concepts of portfolio theory. Given the decision to adopt the prudent investor approach, it is not an issue that the legislation should give expression to the ideas of evaluating particular investment decisions in the context of the overall portfolio and of balancing risk and return objectives. The question is simply one of the best technique for expressing these ideas.

[73] In truth, there is probably not a lot of practical difference between the two alternatives. However, the first alternative, the approach taken by the UTIA, employs a statutory provision that comes into operation only when a loss has been suffered. One might argue that the provision is too litigation-oriented: the principles of MPT are presented negatively as a defence to an action for breach of trust. Given their central place in the prudent investor rule, it is arguable that the portfolio approach and the balancing of risk and return objectives should be stated in a positive manner, as in the American UPIA, rather than as a defence to an action resulting from a loss on a particular investment.

Project Committee's Preferred Alternative

[74] The committee prefers the second alternative.

ISSUE No. 9
To what extent, if at all, should the *Trustee Act* expressly abrogate the traditional "anti-netting" rule that governs the assessment of damages against trustees who have made imprudent investments?

1. The Act does not expressly abrogate the anti-netting rule.

2. The Act states that in assessing the damages for which a trustee is liable in respect of failure to conform to the standard of a prudent investor, the court may take into account the overall performance of the portfolio. [UTIA, PEI, Saskatchewan, Ontario]

3. The Act states that in assessing damages in respect of failure to conform to the standard of a prudent investor, damages are to be assessed based on the overall performance of the portfolio, except where a loss results from dishonesty on the part of the trustee. [BCLI]

[75] The "anti-netting" rule applies *only* where it has already been determined that a trustee has been guilty of a breach of trust in investing trust property. It relates to the assessment of damages for that breach. The rule is to the following effect, assuming that a legal list approach governs the trustee's investments. Suppose that the trustee invests trust funds in each of two unauthorized investments. One of the investments goes up $500 and the other goes down $500. The net result is neither a gain nor a loss to the trust. However, under the anti-netting rule traditionally applied by courts, no allowance would be made in the trustee's favour for the unauthorized investment that realized a gain for the trust. The trustee would be liable to the trust for the $500 loss, regardless of the fact that the other unauthorized investment resulted in a $500 gain.

[76] The rationale for the anti-netting rule is one of deterrence, and is concisely expressed in an American case cited by the MLRC in its 1983 report:

> It seems to me to be inconsistent to maintain that the consequences of one unauthorized act should be mitigated by the more fortunate results of another, and if we consider the case from the standpoint of public policy, on which all these principles ultimately rest, this conclusion is greatly strengthened, for if a trustee who has made an unauthorized and losing investment and knows that he may recoup the loss by better luck in another, he would certainly be tempted to embark on another enticing speculation, which as holding out a prospective profit, would be attended with further and perhaps, even greater risk to the trust fund.[56]

[56] *Cuyler's Estate* (1924), 5 Pa. D. and C. 317, quoted in MLRC 1982 at 25.

[77] The commentary to UTIA section 5 provides the following rationale for abrogating the anti-netting rule in conjunction with the adoption of the prudent investor rule:

> The present rule for assessing a trustee's liability for an investment-related breach of trust does not allow the netting of gains against losses. All gains may be enjoyed by the beneficiary, but the losses fall solely on the trustee. This much criticized "anti-netting" rule compels an investment-by-investment analysis that is inconsistent with the portfolio-based assessment of the trustee's conduct introduced by s. 04. S. 05 abrogates the "anti-netting rule" by making a trustee who breaches the standard of care of the prudent investor liable only for the net loss to the trust.

[78] It has been observed that even if the anti-netting rule is not expressly abrogated, the scope for it to operate will be greatly reduced by adoption of the portfolio approach.[57] The question of assessing damages only arises after it has been determined that there is a breach of trust. Under the prudent investor rule, that a particular investment has resulted in a loss does not in itself imply that there has been a breach of trust.

[79] Where a trustee is found to be in breach of trust under the prudent investor rule, the breach presumably will consist of failure to observe the standard of prudence in carrying out investment responsibilities. It will not consist of making an "unauthorized" investment, because no type of investment is unauthorized *per se*. Therefore, in assessing damages for such a breach, the Court presumably must compare the value of the portfolio that has resulted from the imprudent investment approach to the estimated value of a portfolio that would have resulted from a prudent investment strategy.[58] Such an approach to assessing damages necessarily involves "netting" of the investments that turned out well with those that did not.

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[57] BCLI 1999 at 14.

[58] Of course, there will always be many different portfolios that could have been assembled through a prudent investment strategy. So the Court will not be able to say that if the trustee had followed a prudent investment strategy, the trust portfolio *would* have consisted of assets A_1, A_2, A_3, . . . A_n, whose aggregate value *would* be $Y. However, with the assistance of expert evidence, the Court should be able to say that, given the terms of the trust, the circumstances of the beneficiaries and so on, a prudent trustee likely would have constructed a portfolio with characteristics such that the value of the portfolio would lie somewhere within the range between $X and $Z.

[80] We mentioned above that the rationale for the traditional anti-netting rule is deterrence. In its report the BCLI made the following observation about deterrence:

> The Committee still sees some value in retaining a deterrent, however, and favours retention [of the anti-netting rule] in cases where an investment loss is associated with a breach of trust involving dishonesty. The rule should not apply where an investment loss is attributable solely to bad judgment in investment matters.[59]

One might argue that a loss that results from dishonesty in investing trust property (e.g. receiving a secret commission to invest trust property in certain securities) has nothing to do with "imprudent" investing, so that it is unnecessary for a statute to carve out a specific exception for losses that result from dishonesty in investing. Nevertheless, there is something to be said for making it clear in the statute that where a trustee causes losses to the trust through dishonesty in investing trust property, the trustee will be liable for the full extent of those losses notwithstanding that other investments may have turned out favourably for the trust.

Project Committee's Preferred Alternative

[81] The committee prefers the third alternative, in which damages for imprudent investments are assessed by considering the performance of the portfolio as a whole, unless the losses are related to dishonest behaviour on the part of the trustee.

ISSUE No. 10
Should the *Trustee Act* expressly impose a higher standard of knowledge or skill on an expert trustee than on a lay trustee with respect to investment of trust assets.

Alternative Approaches

1. The Act imposes the same standard of skill on all trustees in making investments: to exercise the care, skill, diligence and judgment that a prudent investor would exercise in making investments. This leaves open the possibility that professional or expert trustees may implicitly be held to a higher standard by the courts. [UTIA]

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59 BCLI 1999 at 14.

2. The Act imposes on a trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, a duty to exercise those special skills or expertise. [UPIA]

3. The Act provides that, subject to the terms of the trust instrument,

   (a) a trustee whose profession, business or employment is or includes acting as a trustee or investing money on behalf of other persons must 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) a trustee who is not engaged in such a profession, business or employment, must exercise the care, diligence and skill that a prudent person would exercise in managing the affairs of other persons. [WA]

4. A trustee must exercise such care and skill as is reasonable in the circumstances, having regard in particular –

   (a) to any special knowledge or experience that the trustee has or holds themself out as having, and

   (b) if acting as a trustee in the course of a business or profession, to any special knowledge or experience that it is reasonable to expect of a person acting in the course of that kind of business or profession. [Law Commission Draft Bill]

[82] The Canadian UTIA's general statement of the prudent investor rule does not make a distinction between the standard of care and skill to be exercised by a professional trustee or by an unsophisticated trustee. The UTIA's approach[60] is to rely on judicial interpretation of the following provision of the *Trustee Act*:

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[60] The Commentary on UTIA s. 2 specifically refers to the discretionary relief provisions of Canadian trustee statutes and to the manner in which they have been interpreted by the courts.

> 41 If in any proceedings affecting trustees or trust property it appears to the court
>
> (a) that a trustee . . . is or might be personally liable for any breach . . . but
>
> (b) that the trustee has acted honestly and reasonably and ought fairly to be excused for the breach of trust . . .
>
> then the court may relieve the trustee either wholly or partly from personal liability for the breach of trust.

In *Fales v. Canada Permanent Trust* the Supreme Court of Canada applied this provision (actually, its British Columbia equivalent) so as to relieve a testator's widow of liability for bad investment decisions while refusing to grant relief to the widow's professional co-trustee. Although the court did not explicitly impose a higher standard of care or skill on the professional trustee, its treatment of the two trustees had the effect of doing so.

[83] The second and third alternatives represent more direct approaches to imposing a higher standard of care and skill on "experts." Alternative 2, which reflects the wording of the American UPIA, focuses on the expertise or purported expertise of trustees, requiring them to exercise the level of expertise that they have or purport to have. Alternative 3 is a close paraphrase of section 18(1) of the Western Australian *Trustee Act*. It is similar in effect to the UPIA's approach, but it focuses on the trustee's profession or business rather than referring specifically to the trustee's special skills or expertise. The duty of care provision in the English Law Commission's draft bill, of which Alternative 4 above is a close paraphrase, combines the UPIA and Western Australian approach, in that it refers both to expertise (actual or purported) and to the trustee's profession.[61]

[84] In its 1996 report to the ULCC on the prudent investor rule, the Law Reform Commission of British Columbia ("LRCBC") summarized the arguments for and against a dual standard briefly as follows:

> Arguments in favour of a dual standard of care focus on the fact that professional trustees hold themselves out as having special knowledge and skill,

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[61] It is worth noting that, in the view of the Law Commission, the draft bill would in essence be a statement of the common law position: see LC & SLC 1999 at 15-16 (paras 2.14 and 2.15).

> particularly in relation to investment. If professionals claim to be better at managing trust property than non-professional trustees by virtue of their special skills, should they not be expected to obtain better results? Against this is the argument that "prudence is prudence" and any attempt to distinguish between the degree of prudence that paid trustees would exhibit and the prudence of unpaid trustees is bound to be artificial.[62]

The report also noted that a dual standard might complicate the law unnecessarily, by creating problems of defining what sort of trustee is held to which standard, and complicate breach of trust actions by making it necessary to determine the operational differences between the two standards.[63] On the other hand, it seems that either the UPIA or Western Australian provision achieves a reasonably clear delineation between expert and non-expert trustees. Moreover, it may be thought that the problem of fleshing out the operational difference between the two standards in the context of court proceedings would be no more difficult than the sort of enquiry a court would have to make in deciding whether to exercise its discretion in favour of different trustees under section 41 of the *Trustee Act*.

Project Committee's Preferred Alternative

[85] The committee has not yet reached even a consensus on this issue. Some members believe that it is appropriate for the statute expressly to impose a more exacting standard of performance on trustees who have or purport to have special expertise, while others are content to leave this matter to be determined by the courts.

ISSUE No. 11
Should the *Trustee Act* expressly require trustees to establish and adhere to an investment strategy?

Alternative Approaches

1. The Act expressly requires trustees to establish and adhere to an investment strategy.

2. The Act does not expressly impose such a requirement.

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[62] LRCBC 1996 at 11 (para. 40).

[63] *Ibid.* paras 42-43.

Discussion

[86] Although the discussion of the prudent investor rule and its relationship to modern portfolio theory at the beginning of this paper is rather brief, we think it will be clear from that discussion that it is implicit in the concept of the prudent investor that such an investor will have some sort of plan or strategy in mind when making investment decisions. It is difficult to see how a trustee could be said to be investing in accordance with the tenets of the prudent investor doctrine if the trustee has not established certain objectives relating to risk and return by which the suitability of any investment may be measured. However, the question remains whether the Act should expressly impose on trustees a duty to establish an investment plan or strategy. The UTIA does not expressly impose such a requirement. The BCLI report makes the following observations about this issue:

> A question closely related to that of investment guidelines is whether trustees should be under a statutory obligation to establish an investment strategy. Some of our correspondents favoured imposition of such a duty. It may be noted that it is increasingly common for trustees to formulate and record the investment objectives for the funds they administer, partly in an effort to demonstrate that their later decisions are not taken on an ill-considered or capricious basis. The Committee nevertheless suspects that a duty to establish an investment strategy would be unenforceable in practice.[64]

Project Committee's Preferred Alternative

[87] The committee favours the second alternative: the Act does not expressly require trustees to establish an investment strategy. Given the committee's view that there should be a statutory requirement to consider certain factors in making investment decisions (see Issue 7, above), its view is that it is unnecessary to further stipulate that the trustee must establish an investment strategy.

ISSUE No. 12
Should the *Trustee Act* require certain trustees to obtain, or to consider obtaining, investment advice or provide that trustees may obtain and rely on investment advice.

Alternative Approaches

1. The Act is silent on the matter of investment advice.

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[64] BCLI 1999 at 10-11.

2. The Act expressly states that a trustee may obtain investment advice and rely upon such advice if a prudent investor would do so, but does not expressly require trustees to obtain investment advice. [UTIA]

3. The Act expressly requires non-professional or unsophisticated trustees (however defined) to obtain investment advice from qualified advisers (however defined).

4. The Act expressly requires trustees to consider whether they should get investment advice. [MLRC] This alternative could be combined with Alternative 2.

Discussion

[88] This issue could be broken down into to sub-issues, the first being whether it is necessary or useful for the statute to provide that trustee's may seek professional investment advice and, having obtained it, rely upon it. UTIA section 6 takes the approach described in Alternative 2, and the Commentary on that section provides the following rationale for doing so:

> Like other investors, individual trustees often require advice in order to maximize the return from trust property while holding risk to a tolerable level. General trust law assumes, however, that trustees will exercise their own judgment and discretion. Their ability to seek and rely upon investment advice without an express power to do so is in some doubt.

[89] Other commentators and law reform bodies, however, have questioned whether a provision along the lines of UTIA section 6 serves any purpose. Professor Waters, in his paper for the MLRC, suggests that there is no doubt that trustees can seek and rely upon expert investment advice.[65] Nevertheless, he argues that the UTIA provision is useful insofar as it stipulates that the trustee is entitled to rely on the advice *only* if a prudent investor would do so in comparable circumstances:

> In many trust instruments today a clause is introduced excusing trustees from any liability if they have relied upon advice received from a professional. This language is understood to have the effect of exempting them from liability even if the advice is subsequently held by a court to be that which a trustee should not have relied upon. Trustees not unnaturally take the position that if they have

[65] Waters 1998 at 42.

> sought advice for a fee from a reputable source, they should not be held liable if it is subsequently established that that advice, especially legal advice, was incorrect. Section 06(2) [of the UTIA] nevertheless takes the position that trustees may only rely if a prudent investor would have relied upon the advice obtained. That is important. It reintroduces the prudence that must underlie all trustee conduct. The trustees are not expected to 'second guess' professionals, but they are expected to recognize the advice that – for instance - is thin, poorly reasoned, or lacking in any apparent support.[66]

[90] In its recent report, the MLRC itself reiterates Professor Waters conclusion about the lack of any doubt that trustees can obtain investment advice.[67] However, unlike Professor Waters, the Commission takes the view that section 6(2) of the UTIA is unnecessary, insofar as it requires trustees to exercise prudence in dealing with the advice they have received:

> Nor does the existing law permit trustees to rely upon advice; the prudence they must demonstrate in the selection of agents is complemented by the prudence they must exhibit in assessing whether they should adopt or not follow the advice they have received. Subsections 06(1) and (2) state the present case law.[68]

The implication is that the MLRC believes that UTIA section 6 serves no purpose.

[91] In its consultation paper on trustee investments, the BCLI made the following observations regarding a statutory duty to obtain advice:

> The question whether the *Trustee Act* should impose a duty on non-professional trustees to obtain investment advice is more difficult. Such a change has been recommended in some other parts of the world, including some Canadian provinces. Yet the matter of qualifications for investment counsellors is highly unsettled. It may also be unrealistic to require the cost of obtaining investment advice to be borne by smaller trust funds.
>
> On balance, the Committee thinks that trustees should be required to obtain advice from an objective source before embarking on a course of investment decisions. In the absence of an established system of qualifications for investment counsellors, the most practical way of determining what sources of advice are appropriate seems to be to turn to the "prudent investor" standard.

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[66] *Ibid*. at 42-43.

[67] MLRC 1999 at 19-20.

[68] *Ibid*. at 20.

> If a prudent investor would rely upon a source of advice, then it should be considered proper for a trustee, who is bound to act as a prudent investor, to rely on it also.
>
> With respect to investment advice, the Committee's proposal then is:
>
> 2. Trustees, other than corporate trustees and other trustees engaged in the business of providing trusteeship services on a commercial fee basis, should be required by the Trustee Act to obtain investment advice from an objective and qualified source before investing trust property. A qualified source is one that would be relied upon by a prudent investor investing his or her own property.[69]

The BCLI apparently has changed its views on this subject, however, because its final report[70] does not contain a recommendation along the lines of the proposal in its consultation document. The considerations that led the Institute to change its view are not disclosed in the final report, as the issue is not discussed. It may well be that, after consultation and reflection, the BCLI put greater weight on the complexities involved in imposing a duty on certain trustees to obtain investment advice.

[92] In its recent report the MLRC has advanced a proposal that seems to avoid the principal disadvantages of imposing a statutory duty on certain trustees to obtain investment advice, while emphasizing the importance of getting advice when it is appropriate to do so. After stating why it thinks that a provision along the lines of UTIA section 6 is unnecessary, the report states what it considers to be the real issue and the Commission's proposed approach to the issue:

> In the Commission's opinion, the issue on the subject of investment advice is not whether advice can be obtained, but how stress can be placed by *The Trustee Act* upon the importance of advice in appropriate circumstances.
>
> In many circumstances the seeking of advice will be vital, while in others it is unnecessary (e.g., the trustee is corporate and has access to in-house skilled investment advice) or the cost of obtaining advice is not justifiable (e.g., the trust is small and payments to the beneficiary are frequent and significant).

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[69] BCLI 1998 at 7-8.

[70] BCLI 1999.

> The Commission is of the view that the trustee should be under a statutory duty to consider, in the particular circumstances, whether advice should be taken.[71]

[93] It will be noted that the MLRC's proposed duty is significantly different than the approach represented by Alternative 3, which imposes a duty on certain trustees to obtain investment advice. The MLRC's proposed duty is to consider whether advice should be obtained. This approach would seem to avoid such problems as defining the category of trustees who must obtain advice and the perhaps even thornier matter of defining from whom such advice must be obtained. On the other hand, it could be argued that imposing a statutory duty to consider whether to get investment advice is redundant, because such a requirement is implicit in the general requirement to act as prudent investor. A financially unsophisticated but prudent trustee who is administering anything but the smallest or most ephemeral of trusts will realize that they should consider whether they need expert investment advice.

Project Committee's Preferred Alternative

[94] As between the first three alternatives, the committee prefers Alternative 3. The committee was not aware of the MLRC's recommended approach when it met to consider this issue. Therefore, the committee does not express a preference as between Alternative 3 and Alternative 4.

2. Delegation Generally and in the Context of Mutual Funds

[95] The issues in this section are concerned with trustees' ability to delegate investment decisions to (presumably) expert agents, and the consequences of such delegation in terms of the trustee's (or agent's) duties to the trust's beneficiaries.

> **ISSUE No. 13**
> **To what extent, if at all, should the *Trustee Act* expressly empower trustees to delegate investment decisions to expert agents?**

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[71] MLRC 1999 at 20. The Commission's formal recommendation is that the Act should "provide that the trustees have a duty to consider whether in the particular circumstances they should obtain advice as to the investment of the trust property".

Alternative Approaches

1. The Act does not expressly authorize delegation of investment decisions to agents, leaving this to be determined by the ordinary principles that govern delegation by trustees. [Ontario]

2. The Act authorizes trustees to delegate to agents the degree of authority with respect to investment of trust property that a prudent investor might delegate in accordance with ordinary business practice. [UTIA, PEI, Saskatchewan, BCLI, MLRC]

[96] Traditional trust law draws a distinction between the delegation by a trustee of administrative or "ministerial" functions to agents and the delegation of decision-making by a trustee to an agent. For example, a distinction would be drawn between (1) directing a broker to buy shares of a certain company at a certain price, and giving the broker authority to do everything necessary to execute those instructions, and (2) giving a broker the authority to decide what shares should be purchased on behalf of the trust and to execute that decision. The former is permissible. The latter is viewed as an impermissible attempt to delegate authority that must be exercised personally by the trustee. Another distinction that is drawn is between (1) taking and giving serious consideration to expert advice in arriving at an investment decision and (2) abdicating responsibility for making investment decisions to experts. Again, on the traditional view of trustee responsibilities, the former is permissible; the latter is not.

[97] As in other areas, traditional trust doctrine's abhorrence of delegation of decision-making authority by trustees conflicts with the complicated realities of a modern-day trustee's investment responsibilities. Simply put, unless a particular individual trustee has an unusually sophisticated appreciation of the intricacies and pitfalls of investment, a trust's beneficiaries are likely to be better served if the trustee delegates day-to-day investment decisions to expert agents, rather than obtaining expert advice but then personally making all the investment decisions on the basis of that advice. A more realistic role for the average trustee is to exercise care in the selection of expert agents, to establish the objectives to which the agent's day-to-day investment activities should be directed, and to monitor the agent's activities with a view to ensuring that they are in accordance with the instructions the trustee has given to the agent.

Project Committee's Preferred Alternative

[98] The committee prefers the second alternative: allowing trustees to delegate all those functions that a prudent investor might delegate.

ISSUE No. 14
What duties should the trustee be under in selecting, instructing and monitoring expert agents?

Alternative Approaches

1. A trustee must exercise prudence in selecting an agent, in establishing the terms of the delegated authority and in monitoring the performance of the agent to ensure compliance with the terms of the delegation. [UTIA, PEI and Saskatchewan Acts]

2A A trustee must exercise prudence in selecting an agent and establishing the terms of the delegated authority *and must periodically review* the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation. [UPIA]

2B A trustee must exercise prudence in selecting an agent, establishing the terms of the delegated authority *and in reviewing* the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation. [modified UPIA]

[99] It will be noted that all three alternatives would require the trustee who delegates investment authority to an agent to exercise prudence in selecting the agent and establishing the terms of the delegated authority. This is assumed to be uncontroversial. It is also assumed to be uncontroversial that the trustee should be under a duty to exercise a degree of vigilance in monitoring the agent's performance. There is a question, however, of exactly how to express the trustee's duty in this latter regard.

[100] Professor Waters, in his paper for the MLRC, refers to the UTIA rule (Alternative 1) and poses the following questions:

> If trustees can delegate stock and bond selection to their agents, how do they carry out an appropriate act of supervision? Commonly trustees meet with their financial advisors on a quarterly basis. Suppose during a quarter the agent has purchased a stock which, like Bre-X, was flourishing during the period of acquisition but subsequently for any number of reasons plummeted in value. All this, we will suppose, happened within the quarter, and when the trustees look at the record of the past quarter they find the trust fund has suffered not insignificant loss. Have the trustees improperly carried out their task of supervision of their agent? Have they, in the words of [UTIA], "monitored" the performance of the agent in order to ensure compliance with the terms of the delegation? It is not only a question of a stock being acquired – an act in itself which perhaps was prudent – but possible delay in the sale of the stock once it began to fall. Are the trustees responsible for the delay which occurred withing the quarterly reporting period?[72]

It will be noticed that Alternative 2A, the formulation of the American UPIA, seems to provide a firmer basis for answering this question than does either of Alternatives 1 or 2B. Alternative 2A, refers specifically to a duty to *periodically* review the agent's action, which, if applied to Professor Waters' example, seems clearly to imply that they would *not* be liable for wrongful actions (or in action) of the agent during the period between reviews. Either of the other formulations (1 or 2B) leaves open the possibility that the trustee would be found to have been under a duty to monitor the agent's performance on a continuous basis.

[101] Leaving aside the difference between Alternatives 2A and 2B, there is a subtle difference between Alternative 1 and either version of Alternative 2. The former says that the trustee must monitor the agent's performance to ensure compliance with the terms of the delegation. Monitoring the agent's *performance* is for the purpose of ensuring *compliance* with the terms of the delegation. On the other hand, the UPIA formulation seems to require the trustee to monitor the agent's *actions* for two independent purposes: (1) monitoring the agent's performance, and (2) monitoring the agent's compliance with the terms of the delegation. It is readily conceivable that an agent who is assiduously adhering to the terms of the delegated authority is, nevertheless, not performing very well. Thus, one might argue that the UPIA formulation is preferable to the UTIA formulation in calling attention to the need to monitor performance for its own sake.

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[72] Waters 1998 at 45-46.

Project Committee's Preferred Alternative

[102] The committee has not reached a consensus on this issue. Some members of the committee prefer Alternative 2A while others prefer either Alternative 1 or 2B.

ISSUE No. 15
Should the *Trustee Act* provide that trustees who delegate authority to an agent are not liable for the agent's actions, if the trustees have discharged their duties as determined under Issue 13.

Alternative Approaches

1. The Act is silent. [MLRC report]

2. The Act provides that trustees who have delegated authority to an agent are not liable for the latter's decisions or actions if the trustees have discharged their duties relating to selecting, instructing and monitoring the agent. [UPIA, UTIA, Saskatchewan, PEI]

[103] If the Act authorizes trustees to delegate authority to agents and imposes certain "oversight" obligations on the trustees, this seems to entail a conclusion that the trustees will not be personally liable to the beneficiaries for wrongful actions of the agent, if the trustees have properly discharged their oversight obligations. What would be the point of providing trustees with authority to delegate decision-making authority if the trustee remained vicariously liable for all decisions and actions of the agent?

[104] The UTIA, following the American UPIA, and those provinces whose Acts provide for delegation of investment authority (Ontario's does not), expressly provides that trustees who properly fulfill their oversight responsibilities are not liable for decisions or actions of the agent. In his paper for the MLRC, Professor Waters does not take issue with this policy, but argues that it is unnecessary for the

statute to contain an exculpatory clause because this merely restates the common law,[73] and this is also the position taken in the MLRC report.[74]

Project Committee's Preferred Alternative

[105] The committee prefers the second alternative: providing expressly that the trustee is not liable for the agent's decisions or actions.

ISSUE No. 16
What, if anything, should the *Trustee Act* say with respect to the duties of an agent exercising delegated authority?

1. The Act is silent. [MLRC report]

2A The Act provides that the agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation. [UPIA, UTIA, PEI]

2B The Act provides that the agent owes a duty to the trustee and to the beneficiaries to exercise reasonable care to comply with the terms of the delegation. [Saskatchewan]

3. The Act provides that an agent's liability for breach of contract with a trustee may be enforced in an action by the trustee or, if the trustee fails to bring an action, in an action by the beneficiaries.

[106] Section 7(4) of the UTIA, adopting the precise language of section 9(b) of the American UPIA, expressly imposes a duty of care on the agent in favour of "the trust." Saskatchewan's implementation of the UTIA states that the duty of care is owed to the trustee and the beneficiaries.[75] In its recent report the MLRC observes that in substituting "the trustee" for "the trust," the Saskatchewan provision

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[73] *Ibid*. at 46.

[74] MLRC 1999 at 22.

[75] *Trustee Act* (SK), s. 44(4).

reflects "the true legal nature of the trust."[76] What the Manitoba Commission seems to have in mind with this observation is that under Canadian law a trust (unlike, a corporation) is not a legal person. So the idea of an agent owing a duty to *a trust*, as distinguished from the trustee or the beneficiaries, is somewhat akin to the concept of someone owing a duty to *a contract*, as distinguished from the party to a contract.

[107] With respect to the Saskatchewan Act's statement that the agent owes a duty to the beneficiaries, the MLRC report explains that this statement was added "supposedly because this appears to be the Uniform Law Conference's intended meaning in subsection (4)."[77] The reference to the *supposed* reason for the precise wording of the Saskatchewan provision, as an interpretation of the *apparently* intended meaning of UTIA section 7(4) demonstrates that the purpose and intended effect of the section is not altogether obvious. The commentaries on UPIA section 9(b) and UTIA section 7(4) shed little light on the matter. The commentary on the former is as follows:

> Although subsection [9](c) [UTIA s. 7(5)] of the Act exonerates the trustee from personal responsibility for the agent's conduct when the delegation satisfies the standards of subsection 9(a) [UTIA s. 7(3)], subsection 9(b) makes the agent responsible to the trust. The beneficiaries of the trust can, therefore, rely upon the trustee to enforce the terms of the delegation.

For its part, the commentary on UTIA section 7(4) says simply that it "is identical to s. 9(b) of [the UPIA]," without explaining what its intended purpose might be.

[108] In its 1996 report to the ULCC that preceded the latter's adoption of the UTIA in 1997, the LRCBC made the following observation about the intent of UPIA section 9(b), and the possible effect of its adoption in Canada:

> Paragraph 9(b) creates a direct obligation owed by the agent to the trust, which the trustee may enforce despite being personally exonerated from liability for the agent's breach by paragraph 9(c)... It might confer on the beneficiaries a direct right of action against the agent, regardless of whether or not the agent is or ought to be aware of the nature of the trust terms or even that trust property is

[76] MLRC 1999 at 22.

[77] *Ibid.*

> involved. If so, it would be a significant widening of the responsibility of a trustee's agent in the common law provinces. An agent may attract trustee liability by knowingly effecting or assisting in a breach of trust or by interfering with the administration of a trust, but otherwise owes only a contractual obligation towards the trustee as principal. . . The direct obligation to the trust contemplated by paragraph 9(b) of the *Uniform Prudent Investor Act* would unquestionably improve the position of the beneficiaries and put beyond doubt the ability of any subsequent trustee to pursue the agent, but would also put business relationships between financial agents like brokers and investment managers, and the people who employ them, on a considerably different footing. It is a change that should only be made after carefully considering the effect it would have on those business relationships.[78]

The LRCBC report recommended that the ULCC adopt the UPIA's delegation powers without adopting either section 9(b) [agent's duty to trust] or section 9(c) [insulation of trustee from liability for agent's acts].[79] The concerns expressed by the LRCBC regarding the ramifications of imposing on agents a direct duty of care in favour of trust beneficiaries are reflected in Professor Waters paper for the MLRC as well as the latter's own report, which recommends that Manitoba's *Trustee Act* say nothing about the issue of the agent's liability to the trust (or to the trustee or the beneficiaries).[80]

[109] It should be readily apparent from the foregoing that there is considerable doubt as to the purpose of UTIA section 7(4) and as to its probable effect. To the extent that it might be construed to give beneficiaries substantive rights against the agent, there is a concern that it may be opening a can of worms that should not be opened without a great deal of prior reflection. On the other hand, it is possible that the purpose of section 7(4) is much more modest and merely procedural. Professor Waters discusses this possible purpose and indicates why, in his view, it is a purpose that does not need to be served by the statute:

> A trustee exculpated from personal liability for the agent's wrongdoing continues to hold in trust his contractual right of action to seek compensation from the agent because of the latter's breach. . . If for whatever reason the trustee refuses to bring action, the trust beneficiaries can sue the trustee, and in my opinion join the breaching agent as co-defendant . . .

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[78] LRCBC 1996 at 14-15 (para. 53).

[79] *Ibid.* at 15 (para. 53).

[80] Waters 1998 at 28-30, 46-48; MLRC 1999 at 22-23.

> The [ULCC] would appear to have had some doubt as to whether such a joining is possible. The association between the trustee and the agent is contractual, so that they alone – it may have been thought – are party and privy to that contract. In the writer's opinion the privity of contract rule would not apply, because a trust beneficiary has an equitable proprietary interest in the trustee's right of contractual action against the third party.[81]

[110] Let us suppose that the whole purpose of UTIA section 7(4), rather than being to create a substantive duty of care to beneficiaries, is simply to remove a technical difficulty that might or might not lie in the way of enforcement of a contractual claim that would exist apart from the section. If this is what the section is intended to achieve, then there would seem to be a more direct and less ambiguous method of achieving this purpose. This is the gist of Alternative 3, above. Rather than speaking in terms of the trustee owing a duty of care to the trust (as in the UTIA) or to the trustee and the beneficiaries (as in the Saskatchewan Act), the statute would simply provide that an agent's liability for breach of a contract with a trustee can be enforced in an action by the trustee or by the beneficiaries, if the trustee fails to bring an action. This sort of provision would not be open to the possible objection that it imposes duties on the agent beyond those which it has accepted under the contract. On the other hand, it might also be regarded as an unnecessary restatement of the existing law.

[111] Before leaving this topic we address one last point. Suppose that the statute does not impose a duty of care in favour of the beneficiaries, so the beneficiaries rights against the agent ultimately depend upon the latter's contractual obligations to the trustee. It is legitimate to ask, "What happens if trustees have entered into a contract that severely restricts the agent's duties or the trustees' (and by implication the beneficiaries') remedies for breach of those duties?" If the trustees are not liable (because the statute says they are not liable) and the agent is not liable (because the contract says so), the beneficiaries could be without a remedy. An answer to this question is provided in the Commentary to UPIA section 9, upon which the UTIA delegation provision is based:

> The trustee's duties of care, skill, and caution in framing the terms of the delegation should protect the beneficiary against overbroad delegation. For example, a trustee could not prudently agree to an investment management agreement containing an exculpation clause that leaves the trust without

[81] Waters 1998 at 46-47.

> recourse against reckless mismanagement. Leaving one's beneficiaries remediless against willful wrongdoing is inconsistent with the duty to use care and caution in formulating the terms of the delegation.

We observe that although the foregoing passage refers to an exculpation clause that leaves the trust without recourse against "reckless mismanagement," it might also be imprudent for a trustee to enter into a contract that leaves the beneficiaries remediless in the face of negligent mismanagement.

Project Committee's Preferred Alternative

[112] The committee has not yet reached consensus on this issue.

ISSUE No. 17
Should the *Trustee Act* expressly provide that trustees may invest trust property in mutual funds and stipulate that such an investment does not amount to a delegation of authority by the trustee to the fund managers?

Alternative Approaches

1. The Act does not expressly deal with mutual funds, relying instead on the general prudent investor rule.

2. The Act specifically authorizes trustees to invest in mutual funds. [UTIA, s. 1(1)]

3. The Act stipulates that purchase of units in a mutual fund does not amount to a delegation of investment authority. [UTIA, s. 7(7)]

Discussion

[113] Under existing law there are two reasons why trustees cannot invest in mutual funds unless expressly authorized by the trust instrument to do so. The first is that mutual funds are not mentioned in section 5 of the *Trustee Act*. The second is that there is authority to the effect that, since selection of the underlying securities of a mutual fund is entrusted to the fund managers, trustees who invested in a

mutual fund would be making an unauthorized delegation of investment authority to the fund managers.[82]

[114] We believe it is uncontroversial that, under the prudent investor approach, a trustee should be able to invest in mutual funds. Moreover, we suspect that it is unnecessary to say anything specifically about mutual funds for it to be clear that a trustee acting in accordance with the prudent investor rule could invest in this form of property. Certainly, mutual funds are a form of property in which many prudent investors routinely invest, so mutual funds would come within the general prudent investor test. Section 1(1) of the UTIA says that a trustee "may invest in any form of property or security in which a prudent investor might invest *including a security issued by a mutual fund.*" Although there is perhaps no harm in specifically referring to mutual funds, the specific reference to mutual funds raises a question about other "exotic" forms of property, such as option contracts, that are not specifically referred to in the section.

[115] Section 7(7) of the UTIA states that investing in a mutual fund is not a delegation of authority by the trustee. This provision has more utility than the reference to mutual funds in section 1(1). In one sense, section 7(7) is unnecessary, presuming that trustees are given general authority to delegate decision-making to agents. If trustees may delegate decision-making authority to agents, investment in mutual funds would be permissible even if it amounts to a delegation of authority to the fund's managers. However, if investing in mutual funds is viewed as an act of delegation, this would give rise to the trustee's duties with respect to selection and oversight of an agent exercising delegated authority. Rather than regarding the purchase of units of a mutual fund as delegation of investment authority, it seems more logical to treat it as an investment decision that must be evaluated in accordance with the standards of prudence that would apply to any other investment decision.

Project Committee's Preferred Alternative

[116] The committee prefers Alternative 3, stipulating that investing in a mutual fund does not constitute delegation of investment authority.

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82 *Haslam v. Haslam* (1994) 114 D.L.R. (4th) 562 (Ont. Gen. Div.).

3. Other Issues

[117] This section considers some incidental issues that are conveniently considered in conjunction with the prudent investor rule.

a. Registration of Securities

ISSUE No. 18
Should section 9 of the *Trustee Act*, which requires securities to be registered in the name of the trustee, be repealed or modified?

Alternative Approaches

1. Section 9 is retained.

2. Section 9 is repealed.

3. Section 9 is modified. The modified version would require trustees to ensure, so far as it is possible to do so, that any record evidencing the trustees' ownership of securities indicates their status as trustees, without presuming that the record will necessarily be an entry in the securities register of the issuer.

Discussion

[118] Section 9(1) of the *Trustee Act* reads as follows:

> Except in the case of a security that cannot be registered, a trustee who invests in securities shall require the securities to be registered in his name as the trustee for the particular trust for which the securities are held, and the securities may be transferred only on the books of the corporation in his name as trustee for that trust estate.

Insofar as this section requires that a trustee be shown as the registered owner of a security on the books of the issuer, it is clearly inconsistent with the modern reality of how securities are held and transferred. The latter subject is dealt with in great detail in the Alberta Law Reform Institute report, *Transfers of*

Investment Securities.[83] For present purposes, it suffices to observe that, nowadays, when an issuer (generally but not necessarily a corporation) issues securities to the public, the registered owner of the securities as shown in the records of the issuer is likely to be a *depository* (or its nominee). The *depository*, in turn, will maintain accounts on behalf of various *intermediaries*, such as securities brokers and financial institutions. The records of the depository will show the proportion of the securities that are held for it on behalf of different intermediaries. The records of the intermediaries, in turn, will show the proportion of the securities owned by particular clients of the intermediary. Under this system, it is only at the level of the intermediary's records where it is possible to indicate a typical trustee's ownership of securities.

[119] In its recent report the BCLI makes the following recommendation regarding the BC equivalent of section 9:

> Section 20 of the Trustee Act, which requires all trust securities capable of registration to be registered in the trustee's name as trustee for the particular trust, should be repealed to allow investment of trust property to be carried out through contemporary exchange trading methods, subject to a requirement that the holdings of the trust be identifiable at any given time.

We expect that it will be uncontroversial that trustees should not be burdened with impractical registration requirements.

[120] However, dispensing with the notion that the trustee must be shown as the registered owner of securities on the books of the issuer does not necessarily entail dispensing with the requirement that the trustee's status as trustee be shown on those records that do indicate the trustee's ownership of securities. For example, where securities are held for a trustee by a broker, the requirement of section 9 could be translated into a requirement that the trustee require the broker's records to indicate that the securities are held by the dealer for the trustee as trustee of the X trust.

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[83] ALRI 1993.

Project Committee's Preferred Alternative

[121] The committee prefers Alternative 3: trustees are required to ensure, where possible, that any record of their ownership of securities indicates their status as trustees.

b. Interface with Powers of Attorney Act

> **ISSUE No. 19**
> **Should the *Powers of Attorney Act* be amended to provide that, subject to the terms of the instrument, an attorney under an enduring power of attorney has the same duties as a trustee under the (amended) *Trustee* with respect to the investment of the property to which the power relates.**

Alternative Approaches

1. No change is made to the *Powers of Attorney Act.*

2. The *Powers of Attorney Act* is amended to include a provision that makes it clear that, unless the instrument that creates the power of attorney provides otherwise, a person exercising investment powers under an enduring power of attorney is subject to the same duties as a trustee under the *Trustee Act.*

[122] Section 7 of the *Powers of Attorney Act* provides:

> Subject to this Act and any terms contained in an enduring power of attorney, an attorney
>
> (a) has authority to do anything on behalf of the donor that the donor may lawfully do by an attorney.

So far as investment *powers* are concerned, this would seem to provide an attorney with investment powers that are at least as ample as those that would be provided to a trustee under the prudent investor rule. The question arises, though, whether an attorney under an enduring power of attorney should be subject to the same standard of prudence in investing to which a trustee would be subject under an amended *Trustee Act.*

Project Committee's Preferred Alternative

[123] The committee has not yet reached a consensus on this issue.

APPENDIX 1

UNIFORM TRUSTEE INVESTMENT ACT, 1997

Investment of trust property

01.(1) A trustee may invest trust property in any form of property or security in which a prudent investor might invest including a security issued by a mutual fund as defined in the [name of statute in jurisdiction regulating securities].

(2) Subsection (1) does not authorize a trustee to invest in a manner that is inconsistent with the trust.

(3) A trustee may have regard to the following criteria in planning the investment of trust property, in addition to any others that are relevant to the circumstances:

(a) general economic conditions;

(b) the possible effect of inflation or deflation;

(c) the expected tax consequences of investment decisions or strategies;

(d) the role that each investment or course of action plays within the overall trust portfolio;

(e) the expected total return from income and the appreciation of capital;

(f) other resources of the beneficiaries;

(g) needs for liquidity, regularity of income and preservation or appreciation of capital;

(h) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

Standard of care

02. In investing trust property, a trustee must exercise the care, skill, diligence and judgment that a prudent investor would exercise in making investments.

Diversification

03. A trustee must diversify the investment of trust property to an extent that is appropriate having regard to

(a) the requirements of the trust, and

(b) general economic and investment market conditions.

Trustee not liable if overall investment strategy prudent

04. A trustee is not liable for a loss to the trust arising from the investment of trust property if the conduct of the trustee that led to the loss conformed to a plan or strategy for the investment of the trust property, comprising reasonable assessments of risk and return, that a prudent investor could adopt under comparable circumstances.

Quantification of trustee's liability when investment strategy imprudent

05. A court assessing the damages payable by a trustee for a loss to the trust arising from the investment of trust property may take into account the overall performance of the investments.

Investment advice

06.(1)A trustee may obtain advice in relation to the investment of trust property.

(2) It is not a breach of trust for a trustee to rely upon advice obtained under subsection (1) if a prudent investor would rely upon the advice under comparable circumstances.

Delegation of authority with respect to investment

07.(1) In this section, "agent" includes a stockbroker, investment dealer, investment counsel and any other person to whom investment responsibility is delegated by a trustee.

(2) A trustee may delegate to an agent the degree of authority with respect to the investment of trust property that a prudent investor might delegate in accordance with ordinary business practice.

(3) A trustee who delegates authority under subsection (2) must exercise prudence in

(a) selecting the agent,

(b) establishing the terms of the authority delegated, and

(c) monitoring the performance of the agent to ensure compliance with the terms of the delegation.

(4) In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.

(5) A trustee who complies with the requirements of subsection (3) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.

(6) This section does not authorize a trustee to delegate authority under circumstances in which the trust requires the trustee to act personally.

(7) Investment in a security issued by a mutual fund as defined in [name of statute in jurisdiction regulating securities] or in a similar investment is not a delegation of authority with respect to the investment of trust property.