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CHAPTER 1

INTRODUCTION

A. OVERVIEW

The law of trusts has historically measured the prudence of fiduciaries in carrying out their investment functions with reference solely to financial and financially-related criteria such as rate of income return, degree of capital appreciation, security of the principal investment, minimization of income tax consequences and other similar considerations. Hence, "prudent investors" have traditionally been concerned strictly with profitability and financial gains.

However, in recent years, trustees have increasingly found themselves to be stewards for beneficiaries who, whether for social, religious, moral, political or other philosophical reasons, are concerned about how their money is used or see investment as an instrument for the implementation of social policy. Some of these beneficiaries may wish to manifest this concern by avoiding certain investments as a matter of principle. Others may be prepared to accept a lesser monetary return on a portion of their investment portfolios in exchange for other benefits, both material and non-material. Indeed, the trustees themselves may have personal convictions which may lead them to shun certain investments and to favour others as a result of such "ethical" considerations.

The heightened profile in recent years of these non-financial criteria has resulted from a variety of factors including increased beneficiary awareness and concern in relation to environmental and social issues in the modern world, the proliferation of large multi-beneficiary pension funds and mutual or unit trusts where there may be a considerable diversity of non-financial objectives and the establishment of several large "ethical funds" which enshrine selected ethical criteria in the constitutional documents of the trust itself.

Having regard to the fact that, as a practical matter, ethical considerations are increasingly forming a part of the criteria by which the trustees of at least certain trusts are formulating investment policy and making investment decisions, a question arises as to whether the present law in Manitoba permits this practice and whether there is a need for legal reform. We consider these issues in this Report.

B. THE REPORT

In Chapter 2 of this Report, we provide a brief overview of ethical investing, its meaning, extent and relationship to the law of trusts generally. Chapter 3 attempts to place the issue of ethical investment in a historical context, reviewing the development of the law governing the investment of trust monies; *The Trustee Act* of Manitoba and its genesis will also be examined. Chapter 4 summarizes the case law which has developed in this area; since the Canadian courts have essentially been silent on this issue, we consider English and American authorities. Finally, in Chapter 5, we offer our analysis of the present state of the law and consider whether it is possible in law to apply other than strictly financial objectives and criteria in making investment

decisions. We conclude with a discussion of the need for reform and finally with our recommendations.

An Executive Summary of this Report appears on page 45.

C. ACKNOWLEDGEMENTS

This Report is one of a series in the Commission's project on the law of trusts which was made possible by a grant from the Manitoba Law Foundation. The Foundation has, through its grants to the Manitoba Law Reform Commission, made a significant contribution to the promotion of law reform in Manitoba and to the improvement of the laws of the province. The Manitoba Law Reform Commission has been a recipient of grants from the Foundation since its inception in 1986 and we gratefully acknowledge their important support of this and other projects.

The Commission would also like to thank Dr. Donovan Waters of the Faculty of Law, University of Victoria, and Mr. Shael Wilder, private practitioner in Vancouver, for their invaluable advice and assistance throughout this project. Of course, the Commission itself is solely responsible for the contents of this Report and its recommendations.

CHAPTER 2

AN OVERVIEW OF ETHICAL INVESTING

A. WHAT IS ETHICAL INVESTMENT?

A policy of ethical investment may take a number of forms. There is, first of all, the passive avoidance approach which involves excluding as potential candidates for investment going concerns which offend or otherwise fail to meet certain specified criteria. In most cases, the argument for the avoidance approach is less to draw attention to something than it is to refuse to profit by investment in companies whose goods, services or manner of conducting business are in some way objectionable.[1] A second and more proactive form of ethical investment entails making positive choices to invest in enterprises whose products, services, employment practices or other contributions to the community are regarded as valuable and deserving of support. Thirdly, there is the shareholder activist approach to ethical investment which advocates investing in companies with a view to changing their policies and practices through the exercise of shareholder or ownership rights.

Other sources categorize the phenomenon of ethical investment somewhat differently. For example, the following approaches have been identified:

(1) totally neutral investment policies which focus on the financial aspects of investment alternatives and then within this frame of reference analyze whether labour-relation practices, compliance with environmental or safety standards or other policies could affect the financial stability and profitability of a company;

(2) socially sensitive investment policies which begin with an analysis of conventional investment criteria and then proceed to a selection among financially comparable alternatives based upon other factors; and

(3) socially dictated investment policies which either permit the sacrifice of safety, return, diversification or marketability, or are undertaken to serve some objective that cannot be related to the pecuniary interests of the investor.[2]

Other authors prefer to speak of:

(1) targeted investments, which are designed to benefit a target community or geographical region;

(2) concessionary investments, which relinquish part of the expected return or desired safety in concession to a social goal;

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[1]A.L. Domini and P.D. Kinder, *Ethical Investing* (1986) 3.

[2]J.D. Hutchinson and C.G. Cole, "Legal Standards Governing Investment of Pension Assets for Social and Political Goals" (1980), 128 U. Pa. L. Rev. 1340 at 1344-1346.

(3) subsidized or "social" investments, which are subsidized by the other, superior-yielding investments in a portfolio; and

(4) social bonus investments, which yield a social benefit or "bonus" in addition to being profitable and safe.[3]

Hence ethical investment may be oriented towards the pursuit of profit, subsidization of particular social goals or, indeed, both of these ends. In addition, the return on an ethical investment may be measured in terms of financial and/or non-financial benefits which may be either direct and/or indirect.

Apart from these considerations are complex issues related to the matter of the ethical judgments which must inevitably be associated with the application of ethical criteria. For example, if the law is to recognize ethical considerations as having a legitimate role in the exercise of investment discretion, must any particular criterion satisfy some basic measure to qualify as a proper "ethical consideration" or would it be sufficient to characterize ethical criteria as merely those broadly falling into such rubrics as social, political, religious, environmental, etc. issues? At what point in time are these criteria measured? Is it exclusively the ethical objectives of the beneficiaries which are relevant or may those of the trustees form the basis for ethical investment? There is obviously a very significant element of subjectivity, value judgment and individual morality inherent in the notion of "ethical criteria" and this greatly complicates any balanced approach which the law might take in validating the consideration of non-financial matters.

The matter is further complicated by the relatively recent phenomenon of multi-beneficiary pensions, trusts, mutual and unit funds which commonly have thousands of beneficiaries. It is inevitable that a divergence of ethical objectives will exist among such beneficiaries and, indeed, it is likely that, at least in some instances, division would exist among the trustees themselves as to the appropriate ethical judgments. As is discussed later in this Report, these issues are considerably simplified where the trust documents expressly deal with the role which ethical criteria are to have in the development by trustees of investment policy and the exercise by them of investment discretion. In such cases, beneficiaries will often have the threshold decisions as to whether to invest in the mutual or unit trust initially or not, having regard to the ethical criteria which are stipulated. Moreover, the trustees will have specific guidance as to the nature of and extent to which ethical considerations should play a role in the discharge of their investment function. However, absent such express provisions, these complex issues relating to the definition and application of ethical criteria assume much greater significance.

B. EXTENT OF ETHICAL INVESTING

The issue of ethical investments by trustees is not without importance. At present, there are more than 4,000 trusteed pension plans in Canada,[4] and this number is likely to increase in the future. Between 1978 and 1982, the book value of assets administered by trusteed pension funds increased from $35.5 to $72 billion dollars.[5] Just one year later (1983), trusteed pension

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[3] B.R. Campbell and W. Josephson, "Public Pension Trustees' Pursuit of Social Goals" (1983), 24 Wash. U.J. Urb. & Contemp. L. 43.

[4] A. Finlayson, *Whose Money Is It Anyway? The Showdown on Pensions* (1988) 181.

[5] L. Kryzanowski and V. Jog, "Equity Eligibility Rules and Private Pension Fund Investment: Some Canadian Evidence" (1986), 4 Can. J. Ins. L. 90.

funds accounted for $84.6 billion or 43% of total Canadian pension assets.[6] By 1986, the market value of Canadian trusteed pension-fund assets had grown to $138 billion and, according to Statistics Canada, the book value of assets in trusteed pension funds as at December 31, 1987 was $142.9 billion, up 12.3% from the previous year.[7] This rapid growth has assured trusteed pension funds a dominant role in the economy of Canada. Indeed, today trusteed pension funds have surpassed insurance companies and the chartered banks as the largest institutional investors in Canada.[8] The importance of these funds takes on even greater significance when one takes into account the billions of dollars channelled through trustees for investment by religious institutions, universities, foundations and other charitable organizations.

In a few cases, the power to consider ethical factors is expressly included in the documents creating trusts or investment funds. In 1988, there were four ethical funds or groups of funds available to Canadian investors;[9] a further three ethical funds restricted their clientele to institutional investors.[10]

> The largest fund employing social criteria in investments, the Quebec Federation of Labour Solidarity Fund, had assets of nearly $210 million in June 1988. But it was dwarfed by the largest of the conventional equity funds, Industrial Growth, which stood at about $1.7 billion. Still, these funds are growing quickly. For example, as recently as 1987, Solidarity Fund had assets of only $95 million. Ethical Growth Fund had assets of $21.2 million in June 1988, up from $16 million a year earlier. And Investors Summa Fund, another ethical investment fund, grew from $26 million in April 1987 to $40.2 million a year later.[11]

Vancouver City Savings Credit Union, which launched the Ethical Growth Fund that has consistently ranked among the top performing Canadian equity funds since it was launched in 1986, recently announced the formation of a new group of ethical mutual funds to be marketed by credit unions across Canada. Ethical Funds Inc. will sell the funds that invest only in companies meeting certain ethical standards. Ethical Funds Inc. will control approximately $120 million worth of mutual funds and will invest in Canadian companies that practise progressive industrial relations, do business in countries that provide racial equality and are environmentally responsible and will avoid companies that manufacture military weapons, tobacco products or produce nuclear power, among other things.

However, the vast majority of trusts and pension funds are not governed by any express validation of the use of ethical criteria in making investment decisions. They are simply governed by the general law of trusts. As a result, in an age increasingly conscious of environmental, moral, political and other such concerns, the issue of the legal significance of such factors is growing in importance.

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[6]Science Council of Canada, *Pension Funds and Venture Capital: The Critical Links between Savings, Investment, Technology, and Jobs* (Discussion Paper) by M. Macdonald and J. Perry (1985) 39.

[7]Finlayson, *supra* n. 4, at 133.

[8]Finlayson, *supra* n. 4, at 182.

[9]All-Canadian Environmental Investment Fund/International Environmental Investment Fund; Ethical Growth Fund; Investors Summa Fund Ltd.; Le fonds de solidarité des travailleurs du Québec (Québec Federation of Labour Solidarity Fund).

[10]Canadian Alternative Investment Co-operative; Canadian Ethical Dynamic and Responsible Balanced Fund (CEDAR); Crown Commitment Fund.

[11]E. Ellmen, *The 1989 Canadian Guide to Profitable Ethical Investing* (1989) 54.

C. RELATION TO TRUST LAW

Although we must turn to the law of trusts to find the rules which govern the investment of monies on behalf of others, we note at the outset that the general law of trusts does not fit comfortably with the more modern invention of the pension fund.

A trust has been defined as:

> . . . the relationship which arises wherever a person (called the trustee) is compelled in equity to hold property, whether real or personal, and whether by legal or equitable title, for the benefit of some persons (of whom he may be one and who are termed beneficiaries) or for some object permitted by law, in such a way that the real benefit of the property accrues, not to the trustees, but to the beneficiaries or other objects of the trust.[12]

Hence trust arrangements create a duality of ownership whereby one person holds the legal title to property, while another has the right to the enjoyment of that property.

Historically, the principles and safeguards of trust law have been adapted primarily to facilitate the efficient management and transmission of private wealth. The typical private express trust, for example, has an identifiable creator (settlor or testator), income beneficiaries and capital beneficiaries. Moreover, this kind of trust usually involves a gratuitous transfer of wealth from the creator of the trust (the donor) to the beneficiaries (the donees). However, many institutional funds held in the nature of a trust involve more public or social forms of wealth, the ownership of which is not always clearly settled in law. The creation of a trusteed pension plan is essentially a business transaction, regardless of who actually initiates and sponsors the scheme. It may be settled or created by one employer, several employers, a union, an association of employees, various levels of government or, indeed, a combination of these parties. There is no gratuitous transfer of wealth involved in the creation of a pension trust. Rather, the plan is funded principally by the participants themselves. In the case of "contributory" plans, employees are required to contribute directly to the fund through payroll deductions. In the case of "non-contributory" plans, although all contributions to the pension fund are made by the employer, those sums represent deferred wages owing to employees. Finally, although pension trusts, like the typical private trust, have "income beneficiaries", as long as a pension trust endures, there are no capital beneficiaries to whom the trust capital must ultimately be distributed.[13]

To complicate matters even further, the list of parties that may claim a beneficial ownership in a pension trust is not at all settled. While it is obvious that pensioners or retirees have a vested interest in a pension fund, they are by no means its sole beneficiaries. Depending upon the context and the nature of the plan in question, other interested parties may include plan members and their dependants, sponsoring employers, shareholders, government, and perhaps even the taxpayers who ultimately fund public pension schemes. Hence pension funds are, at least in some cases, neither clearly privately owned nor publicly owned, but rather represent a relatively unique form of ownership which falls somewhere in the middle.

Nevertheless, despite these conceptual issues, in Canada private trust law principles continue to be routinely applied to the management of both traditional trust funds and these institutional funds. In the next Chapter, we turn to a review of these principles.

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[12] L.A. Sheridan and G.W. Keeton, *The Law of Trusts* (11th ed., 1983) 2.

[13] Different considerations may apply in cases where a pension plan is terminated.

CHAPTER 3

HISTORY AND STATUTE LAW

A. HISTORY OF TRUSTEE INVESTMENTS

The history of the law of trusts discloses that the rules respecting investments by trustees are continually evolving. Indeed, ". . . the permissible scope of trustees' investment powers has often been a function of the economic and financial conditions of the time."[1]

In 17th century England, there were no statutory and few judicial limits on the investment powers of trustees. In fact, the only investment duty of trustees was to act as prudent persons. Subsequent colonization in previously unknown parts of the world facilitated the growth of commerce and, by the 18th century, investment in new commercial ventures was generally regarded as sound policy.

Then followed the "burst of the South Sea Bubble" in the mid-18th century. The South Sea Company, like the Hudson's Bay Company and the East India Company, had been founded to explore areas of the new world. Many people, including both private investors and trustees, had invested huge sums of money in the South Sea venture. When, without warning, the company suddenly went bankrupt, a great many trust beneficiaries were completely impoverished. The effect of that bankruptcy was comparable to the "Wall Street Crash" of 1929. This episode, in conjunction with a subsequent series of financial disasters, ultimately persuaded the English Court of Chancery that investment in commercial enterprises was tantamount to speculation and, furthermore, that no trustee had the right to speculate with another person's money. Rather, the duty of trustees was to place the funds under their control in stable and well-secured investments. Consequently, when shortly thereafter government stock began to appear on the scene, secured as it was by government revenues, it immediately became the preferred option for trustee investment.

> In this way the Court of Chancery invested moneys under its own control on behalf of beneficiaries, and appeals to the Court for advise [sic] resulted in the commendation of the same practice to trustees. Trustees who were held liable for losses discovered or confirmed in accounting actions were told that, if they had followed the Court's practice, either the loss would not have occurred or, if there had been loss, they could not have been accused of a lack of due and proper care. Then came the Napoleonic Wars of the early nineteenth century, and with regard to commercial enterprises the bankruptcies which were the outcome of the economic strains of that struggle. Courts and trustees were confirmed in their belief that government stocks, and not commerce, were the proper place for trust funds.[2]

There can be no doubt that the license given to trustees to invest in government stock was a powerful stabilizing factor during the 18th and early 19th centuries and made it possible for governments to issue successive national loans with the reasonable expectation that they would be fully taken up.[3]

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[1]Ontario Law Reform Commission, *The Law of Trusts*, vol. 1 (Report, 1984) 212.

[2]D.W.M. Waters, *Law of Trusts in Canada* (2d ed., 1984) 767.

[3]G.W. Keeton, *Modern Developments in the Law of Trusts* (1971) 47.

The phenomenal growth of industry and commerce in the 19th century was attended by the desire for a broader range of trustee investments. Since it had become the practice to regard government stocks as the only proper trustee investment, trustees thought it necessary to secure some kind of legislative sanction with respect to other kinds of investments. Legislative sanction, of course, afforded trustees some protection against charges of imprudent investment. Accordingly, in 1859, the British government authorized investment in the stock of the Banks of England and Ireland, and in East India stock.[4] Parliament was not yet prepared, however, to expand the scope of permissible trustee investments to include commercial and industrial stock in general. Although the government's conservatism on this point was ostensibly premised on concerns respecting the fluctuating and hazardous character of this kind of stock, their "prudence" assured them a virtual monopoly in the area of trustee investments.

In 1886, the *National Debt Reduction Act* reduced the interest on government Consols (Consolidated Annuities), the most popular trustee investment, from 3% to 2 1/2%. This development provoked new lobbying efforts on the part of trustees to expand the list of permissible trustee investments.[5] Their demands were eventually acceded to, at least in part, through the passage of a succession of legislation which permitted trustees to invest in the debentures and preferred shares of railway companies, public utilities stock, the issues of municipal corporations and county councils, and finally, any stocks of the Dominions and colonies guaranteed by the British government.[6] These investments together comprised the "legal list" of trustee investments which governed two situations: first, where a testator or settlor was silent as to which securities a trustee might select for purposes of investment, thereby impliedly adopting the list and, secondly, where a testator or settlor expressly stated that the trustee was to invest only in those investments authorized by law. Broadly speaking, however, until the *Trustee Investments Act* was enacted in 1961,[7] English trustee investment law continued to draw a distinction between securities issued and guaranteed by the government and certain public utility shares on the one hand, and commercial and industrial stocks on the other. That is, until 1961 no amount of pressure brought to bear upon the authorities could dispel the convention that commercial and industrial stocks were essentially speculative in nature and therefore unsuitable as trustee investments. The erosion of the purchasing power of currencies - the effect of inflation and high taxation - has since called into question the prudence of this kind of investment policy. In fact:

> Today because of inflation the distinction between investment and speculation cannot be stated with anywhere near the same clarity. All capital is now at risk, and the task of the trustee is to keep his portfolio reasonably balanced between investments so as to maintain and, if possible, expand the capital value of the trust funds.[8]

Manitoba's first trustee legislation was enacted in 1886[9] and its investment provisions essentially followed the conservative investment policy already established in England. That is, although subsequent revisions were characterized by a continual expansion of the list of permissible trustee investments, generally speaking, distinctions continued to be drawn between securities issued or guaranteed by various levels of government, mortgage bonds and public utility shares on the one hand, and commercial and industrial stock on the other. In 1965,

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[4] *Trustees' Relief Act, 1859* (U.K.), 22 & 23 Vict., c. 35, s. 32.

[5] Keeton, *supra* n. 3, at 48.

[6] See, *e.g.*, *Trust Investment Act, 1889* (U.K.), 52 & 53 Vict., c. 32; *Trustee Act, 1893* (U.K.), 56 & 57 Vict., c. 53, ss. 1-9; and *Colonial Stock Act, 1900* (U.K.), 63 & 64 Vict., c. 62.

[7] *Trustee Investments Act, 1961* (U.K.), 9 & 10 Eliz. 2, c. 62.

[8] Waters, *supra* n. 2, at 781.

[9] *An Act respecting Trustees and Executors and Administration of Estates*, S.M. 1886, c. 13.

however, Manitoba's trustee investment provisions were significantly liberalized to permit, among other things, investment in equity shares listed on approved Canadian stock exchanges.[10]

Between 1968 and 1983, a number of amendments were introduced to Manitoba's trustee investment provisions which merit brief comment insofar as they reflected a significant turn away from conventional investment practices. In 1968, for example, the list of permissible trustee investments was expanded to permit investment in securities issued or guaranteed by the International Bank for Reconstruction and Development (the World Bank) and approved mutual fund securities.[11] A subsequent series of amendments enacted in 1972 indicated that there was indeed a place for social and political considerations to enter into trustee investment practice. To begin with, the limitation on the number of trustees was removed.[12] Previously, other than for trusts for charitable, ecclesiastical or public purposes, the number of trustees permitted a trust was restricted to four. Significantly, the removal of this restriction was intended to permit trusts involving union or health and welfare funds to have larger boards of trustees representative of labour unions and employer associations.[13] Two further amendments authorized trustees to invest in securities issued by Manitoba Crown corporations and in hospital debentures where such debentures were payable out of funds assigned for that purpose by the hospital to the Manitoba Health Services Commission.[14]

In 1979, legislation was enacted permitting investment in units or shares of common trust funds set up by trust corporations.[15] The object of this amendment was to permit trust companies to pool moneys from various smaller estates for the purpose of facilitating investments. The benefit to the trust companies was a reduction in the paper work involved in keeping separate accounts of investments relative to individual estates. In return, individual estates enjoyed lower fees since the cost of investment counselling was spread among several accounts.[16] Nevertheless, this provision, along with the 1968 amendment permitting investment in mutual funds, transgressed the conventional wisdom which forbade commingling the funds of separate estates.

Finally, in 1983, pursuant to recommendations made by the Manitoba Law Reform Commission,[17] Manitoba repealed the legal list of trustee investments altogether and replaced it with the "prudent person" rule.[18] The rationale behind the introduction of the rule was simply to accord trustees greater flexibility in the face of a volatile stock market and a fluctuating economy.[19] Accordingly, we now turn to a consideration of the nature of this rule within the context of Manitoba's current *Trustee Act*.

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[10]Provided certain restrictions and conditions were complied with: *An Act to amend The Trustee Act*, S.M. 1965, c. 86. See also, *A Regulation under Subsection (9) of Section 63A of The Trustee Act*, Man. Reg. 99/68 and *A Regulation Respecting Approved Stock Exchanges made under Subsection (9) of Section 71 of The Trustee Act*, Man. R. Reg. T160-R1.

[11]*An Act to amend The Trustee Act*, S.M. 1968, c. 70, ss. 5-6.

[12]*An Act to amend The Trustee Act*, S.M. 1972, c. 60, s. 1.

[13]Manitoba, Legislative Assembly, *Debates and Proceedings*, vol. 19, no. 139, at 3591 (29 June 1972).

[14]*An Act to amend The Trustee Act*, S.M. 1972, c. 60, ss. 2-3. See also, Manitoba, Legislative Assembly, *Debates and Proceedings*, *supra* n. 13, at 3591 and *An Act to amend The Trustee Act*, S.M. 1979, c. 27, s. 2, which again expanded the legal list to permit investment in personal care homes.

[15]*An Act to amend The Trustee Act*, S.M. 1979, c. 27, ss. 1, 3 and 4. See also, *A Regulation under Section 77.1 of The Trustee Act Respecting Common Trust Funds*, Man. Reg. 220/79; *Common Trust Funds Regulation*, Man. Reg. 329/87R.

[16]Manitoba, Legislative Assembly, *Debates and Proceedings*, vol. 27, no. 54A, at 3692 (4 May 1979).

[17]Manitoba Law Reform Commission, *Investment Provisions under "The Trustee Act"* (Report #50, 1982).

[18]*An Act to amend The Trustee Act*, S.M. 1982-83-84, c. 38, s. 5.

[19]Manitoba, Legislative Assembly, *Debates and Proceedings*, vol. 31, no. 53A, at 2032 (25 April 1983).

B. *THE TRUSTEE ACT* AND THE PRUDENT PERSON RULE

In Manitoba, *The Trustee Act* generally applies to all trusts whenever created and to all trustees whenever appointed.[20] However, the powers, rights and immunities conferred by the Act remain subject to the instrument, if any, creating the trust and, unless otherwise stated in legislation, apply only if and so far as a contrary intention is not expressed in the trust deed.[21] Therefore, nothing in *The Trustee Act* authorizes trustees to do anything that they are in express terms forbidden to do, or to omit to do anything that they are in express terms directed to do, by the trust deed.[22] It is always open to the creators of trusts to insert a clause in the trust deed directing trustees to consider ethical criteria in making investment decisions.

Subject to any express provisions of the law or a trust deed providing otherwise, Manitoba's trustee investment legislation permits trustees to invest in any kind of property, real, personal or mixed.[23] The standard of care applicable to investment decisions is a form of the "prudent person" rule. Subsection 68(2) provides:

> Subject to any express provision of the will or other instrument creating the trust, 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.[24]

However, the investment powers conferred by the Act are in addition to the powers conferred by the instrument, if any, creating the trust.[25] It is therefore possible, in a trust deed, for settlors to prohibit investments which would otherwise be permissible under the prudent person rule.[26]

Whether it is correspondingly open for trust deeds to permit investments which might not be permissible under the prudent person rule is unclear. According to one argument, if settlors make it clear that it is their intention that their trustees shall invest in a particular manner, it is the duty of the trustees to carry out that instruction and they will not be liable for any loss that ensues as a result.[27] On the other hand, section 75 of *The Trustee Act* specifies:

> Nothing in this Act relieves a trustee of the duty
>
> (a) to take reasonable and proper care with respect to investments authorized under this Act or by the instrument creating the trust and with respect to any other transaction authorized under this Act; or
>
> (b) not to make any investment of trust money that, although an investment in which a trustee, exercising the judgment and care that a person of prudence, discretion and intelligence would exercise in administering the property of others, would make, is under any law in force in the province, an unlawful investment of trust money.[28]

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[20] *The Trustee Act*, C.C.S.M. c. T160, s. 2.

[21] *The Trustee Act*, C.C.S.M. c. T160, s. 3.

[22] *The Trustee Act*, C.C.S.M. c. T160, s. 4.

[23] *The Trustee Act*, C.C.S.M. c. T160, s. 68(1).

[24] *The Trustee Act*, C.C.S.M. c. T160, s. 68(2).

[25] *The Trustee Act*, C.C.S.M. c. T160, s. 72(1).

[26] *The Trustee Act*, C.C.S.M. c. T160, s. 72(2).

[27] Waters, *supra* n. 2, at 778.

[28] *The Trustee Act*, C.C.S.M. c. T160, s. 75.

Significantly, the amendment which introduced the prudent person rule also introduced an "investment policy defence" as an additional protection for trustees challenged with having made imprudent investments.[29] This defence provides:

> In an action against a trustee for failing to exercise, in respect of a particular investment, the judgment and care that a person of prudence, discretion and intelligence would exercise in administering the property of others, the trustee is not liable for loss arising from that particular investment if he satisfies the court
>
> (a) that the investment was made as the result of a general policy of investing the funds making up the trust property; and
>
> (b) that the general policy was not speculative and was a policy which a person of prudence, discretion and intelligence would follow if he were administering the property of others.[30]

Accordingly, it is a defence for trustees to show that, while a particular investment viewed in isolation may appear to have been speculative or imprudent, it formed but one constituent of a broad portfolio which overall reflected a prudent investment policy.

The incorporation of this kind of a "netting" principle into the law of trusts is important for two reasons. In the first place, it is at odds with the conventional view that, if trustees were permitted to offset the profits of some speculative investments against the losses of other speculative investments, they would be emboldened to recklessly pursue imprudent investments. As one court remarked,

> 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.[31]

Accordingly, American courts characteristically apply the prudent person standard to every single investment decision of a trustee rather than to the trust portfolio as a whole.[32] Admittedly, this particular policy is prompted by the concern to protect trust property against unnecessary risk. Nevertheless, as this Commission observed in 1982, the basic thrust of modern investment strategy, which is to diversify a portfolio in such a way as to put the total capital at minimal risk, may involve the inclusion of investments which, viewed in isolation, might appear to be imprudent.[33] This strategy is reflected in the rise of index or market funds which have abandoned the traditional attempt to "beat the market" by sorting through potential investments with a view to buying stocks believed to be undervalued, and selling stocks believed to be overvalued. Instead, these funds create and continue to hold a portfolio of securities which is designed to approximate some index of market performance.

Interestingly, the objections that have been raised in relation to ethical investment similarly attended the advent of market funds. Indeed, at one time it was suggested that investment in

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[29] *An Act to amend The Trustee Act*, S.M. 1982-83-84, c. 38, s. 6.

[30] *The Trustee Act*, C.C.S.M. c. T160, s. 79.

[31] *Cuyler's Estate* (1924), 5 Pa. D. & C. 317, cited in Manitoba Law Reform Commission, *supra* n. 17, at 25.

[32] See, *e.g.*, J.H. Langbein and R.A. Posner, "Market Funds and Trust-Investment Law", [1976] A.B.F. Res. J. 1 at 24 ff., where the authors argue that the individual investment standard or the "anti-netting" principle is inapposite *vis-à-vis* index or market funds.

[33] Manitoba Law Reform Commission, *supra* n. 17, at 27.

market funds was imprudent and therefore constituted a breach of trust.[34] Now, however, there is some consensus that market funds not only may yield higher net return to an investor, but they also maximize diversification while at the same time minimizing administrative expenses. This development not only illustrates the malleable nature of prudent investment, but it also indicates that there may be circumstances in which trustees may be unable to "play it safe" by ignoring new investment possibilities and continuing uncritically to adhere to traditional investment conventions.

The second reason why Manitoba's "investment policy defence" is significant in relation to the question of ethical investment is simply this: a "whole portfolio" approach makes it easier to defend the prudence of investments wherein non-financial as well as financial considerations have come into play.

> For example, even though an investment in a pool of local mortgages may yield a lower rate of return than a projected return on corporate equities, the mortgage investment may be designed to help stabilize performance and provide diversification within a portfolio already holding large concentrations of equity securities. Similarly, investment in a new local business as part of an effort to revitalize a downtown area may not be imprudent given the size of the plan's portfolio, the riskiness of the other investments, the liquidity and income needs of the plan, and a determination that the local investment will play an appropriate part in meeting the plan's investment objectives.[35]

Manitoba's trustee legislation does not provide a list of criteria that may be consulted - whether by trustees themselves or by a court - in order to determine whether a particular investment or an investment policy is prudent or not.[36] Manitoba's decision to omit such a list was consistent with the Commission's earlier recommendation that the goal of providing direction and guidance, particularly to lay trustees, would be better served by the publication of a *Trustee's Handbook and Guide* than by the imposition of statutory criteria.[37] Statutory guidelines for investment run the risk of becoming mandatory criteria, the effect of which would be to undermine the very flexibility the prudent person rule was intended to engender. As the Commission noted at the time:

> The courts have steadfastly refused to define "prudence". It is perhaps just as well, as a legal definition of prudence may prove as hard to capture as the precise value of pi. The above simile is appropriate in another respect; while the precise value of pi cannot be determined, it remains nonetheless a valuable tool for mathematicians. Similarly, the lack of a precise definition of "prudence" does not destroy its value as a legal tool.[38]

Moreover, the imposition of criteria in relation to individual investments seems inconsistent with the "portfolio" approach to investment permitted under Manitoba law.

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[34]Langbein and Posner, *supra* n. 32.

[35]J.D. Hutchinson and C.G. Cole, "Legal Standards Governing Investment of Pension Assets for Social and Political Goals" (1980), 128 U. Pa. L. Rev. 1340 at 1357.

[36]An example of such a list appears in the American *Restatement (Second) of Trusts*, §227, comment o (1959), which directs that the following criteria be considered by trustees in determining the prudence of an investment option:

> (1) the marketability of the particular investment; (2) the length of the term of the investment, for example, the maturity date, if any, the callability or redeemability, if any; (3) the probable duration of the trust; (4) the probable condition of the market with respect to the value of the particular investment at the termination of the trust especially if, at the termination of the trust, the investment must be converted into money for the purpose of distribution; (5) the probable condition of the market with respect to reinvestment at the time when the particular investment matures; (6) the aggregate value of the trust estate and the nature of the other investments; (7) the requirements of the beneficiary or beneficiaries, particularly with respect to the amount of the income; (8) the other assets of the beneficiary or beneficiaries including earning capacity; (9) the effect of the investment in increasing or diminishing liability for taxes; (10) the likelihood of inflation.

[37]Manitoba Law Reform Commission, *supra* n. 17, at 18. Unfortunately, no such handbook was ever published.

[38]Manitoba Law Reform Commission, *supra* n. 17, at 17.

In measuring the prudence of trustee investments, the courts have always taken the view that, if an honest and reasonable person could have come to the decision which a trustee made, that trustee will not be held liable for loss.[39] In addition, if it appears that a breach of trust has been committed at the instigation, or request, or with the consent in writing of a beneficiary, the court may indemnify the trustees or persons claiming through them.[40] Finally, trustees may always plead section 81 of *The Trustee Act* which provides:

> Where, in any proceeding affecting a trustee or trust property, it appears to the court that a trustee (or that any person who may be held to be fiduciarily responsible as a trustee) is or may be personally liable for any breach of trust (whenever the transaction alleged or found to be a breach of trust occurred) but has acted honestly and reasonably, and ought fairly to be excused for the breach of trust, and for omitting to obtain the directions of the court in the matter in which he committed the breach, the court may relieve the trustee either wholly or partly from personal liability for it.[41]

As this overview of its relevant provisions discloses, there is nothing in Manitoba's *Trustee Act* which either expressly permits or prohibits ethical investment *per se*. Rather, any exercise of investment discretion with reference to ethical criteria would fall to be judged under the relevant "prudent person" principles. Neither is there anything in the legislation which addresses the unique characteristics of certain institutional funds which take the juridical form of the trust. Since the issue of ethical investment often arises within the context of pension funds, we turn now to consider the relevant provisions of legislation governing the investment of these assets.

C. OTHER FEDERAL AND MANITOBA LEGISLATION

Regulation of pension fund investment is split among the federal and provincial jurisdictions. Generally speaking, the *Pension Benefits Standards Act, 1985*[42] of Canada applies to private pension plans established by businesses and undertakings subject to federal regulation.[43] The plans of businesses that fall under provincial jurisdiction are potentially subject to provincial regulation. While not all of the provinces have chosen to legislate in this area, pension schemes have been regulated in Manitoba since 1976.[44]

1. *Income Tax Act* (Canada)

The federal *Income Tax Act* provides that the income of a trust established solely for the administration of a registered pension plan will be exempt from taxation under Part I of the Act.[45] Hence, in Canada, the majority of pension schemes are trusteed plans. In order to acquire and maintain tax-assisted status, pension plans must be registered with Revenue Canada Taxation under the *Income Tax Act*, and must comply with the requirements set out in Information Circular 72-13R8.[46] Plans may be instituted by employers, groups of employers,

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[39] Waters, *supra* n. 2, at 784.

[40] *The Trustee Act*, C.C.S.M. c. T160, s. 80.

[41] *The Trustee Act*, C.C.S.M. c. T160, s. 81.

[42] *Pension Benefits Standards Act, 1985*, S.C. 1986, c. 40.

[43] Federal public service pension plans are generally regulated under the *Public Service Superannuation Act*, R.S.C. 1985, c. P-36, although certain segments of the service may be governed by pension legislation specific to that particular group.

[44] *The Pension Benefits Act*, S.M. 1975, c. 38.

[45] *Income Tax Act*, S.C. 1970-71-72, c. 63, s. 149(1)(o).

[46] Revenue Canada Information Circular No. 72-13R8 (1988).

trade unions and trade associations. However, in every case the employer must always be a contributor.[47] In addition, the Circular directs that the primary purpose of a pension plan arrangement must be to provide pensions to retired employees in the form of life annuities. That is, it cannot be a scheme for diversion of profits, or an employees' savings fund permitting rights of withdrawal during coverage.[48]

The Circular also stipulates that, unless a trusteed plan is registered under the pension benefits legislation of one of the provinces or under the federal *Pension Benefits Standards Act, 1985*, the plan must contain a requirement that all investments will conform to the investment rules established in the federal Act and its *Pension Benefits Standards Regulations, 1985*.[49] Failure to comply with these investment requirements will result in the denial or termination of registration.[50]

2. *The Pension Benefits Act* (Manitoba)

According to Manitoba's *Pension Benefits Regulation*, the trust is merely one of several vehicles that may be employed in the establishment of pension funds.[51] Nonetheless, pension plans are generally created as express trusts by plan sponsors in order to access the tax assistance available to trusteed pension schemes under federal taxation legislation.

Regulations prescribing the classes, quality and quantity of investments in which pension assets may be invested are made by the provincial Cabinet.[52] Significantly, the regulatory provisions respecting the investment of pension funds apply notwithstanding the provisions of any pension plan or any instrument governing the plan.[53] Manitoba's *Pension Benefits Regulation* stipulates that pension assets may be invested and loaned "only in accordance with the requirements of section 6 and Schedule III of the Pension Benefits Standards Regulations, 1985 (Canada), as amended from time to time."[54]

Section 6 of the Canadian *Pension Benefits Standards Regulations, 1985* directs that every pension plan shall require that the moneys of a pension fund be:

> (a) invested in accordance with Schedule III; and
>
> (b) invested
>
> (i) in a name that clearly indicates that the investment is held in trust for the plan and, where it is capable of being registered, registered in that name, or

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[47] For example, a plan under which employees alone mutually agree to make provision of any kind for themselves or their beneficiaries will not be accepted for registration as an employees' pension plan. See Revenue Canada Information Circular No. 72-13R8 (1988) para. 7.

[48] Revenue Canada Information Circular No. 72-13R8 (1988) para. 6(b)(i).

[49] *Pension Benefits Standards Regulations, 1985*, SOR/87-19.

[50] Revenue Canada Information Circular No. 72-13R8 (1988) para. 13.

[51] Section 20 of the *Pension Benefits Regulation*, Man. Reg. 188/87R states:

> Where the funds of a pension plan are not administered by a government, they shall be administered under the Government Annuities Act (Canada) or by a life insurance company, a corporate trustee, individual trustees, or a society established under The Pension Fund Societies Act (Canada).

[52] *The Pension Benefits Act*, C.C.S.M. c. P32, s. 37(c).

[53] *Pension Benefits Regulation*, Man. Reg. 188/87R, s. 16(1).

[54] *Pension Benefits Regulation*, Man. Reg. 188/87R, s. 16(2).

> (ii) in the name of a bank, trust company or other financial institution in accordance with an agreement that clearly indicates that the investment is held in trust for the plan and, where it is capable of being registered, registered in that name.[55]

Generally speaking, Schedule III of the Regulation provides a list of permitted investments, restricts the percentage of common shares of a corporation that can be purchased by a pension fund and imposes equity eligibility rules.[56] There is nothing in the federal or provincial pension benefits legislation which either directly precludes or authorizes consideration of social and ethical criteria in the formulation of investment policy. Finally, since neither section 6 nor Schedule III of the Canadian *Pension Benefit Standards Regulation*, nor Manitoba's *Pension Benefits Act*, specifies the standard of care to be observed when investing pension assets,[57] presumably, the prudent person rule as set out in subsection 68(2) of Manitoba's *Trustee Act* continues to apply.[58]

3. *The Civil Service Superannuation Act* (Manitoba)

Investment of Manitoba public pension assets is generally governed by *The Civil Service Superannuation Act*.[59] The Civil Service Superannuation Board established under the Act consists of nine members, four of whom must be representatives of the employees.[60] Although the Board may appoint such professional advisors as it deems necessary for the administration of the *Act*,[61] it nonetheless retains the status of trustee of the Civil Service Superannuation Fund[62] and is required to invest the fund in accordance with the directions of an investment committee. The investment committee consists of the chair of the Board, the Deputy Minister of Finance (or his or her representative) and a member of the Board appointed by the Lieutenant Governor in Council to represent the employees.[63] The investment committee has the following duties:

> The investment committee shall regularly review the investments in which the fund is invested and, subject to subsection 9(2), shall give directions in writing, signed by the chairman, as to the

[55] *Pension Benefits Standards Regulations, 1985*, SOR/87-19, s. 6.

[56] Two suggested reasons for the existence of equity eligibility rules are to ensure that: (1) pension fund investments do not contribute to the manipulation of security prices and other such abuses; and (2) Canadian pension funds are forced to construct their equity portfolios predominantly from equities that meet some minimum level of quality. According to one source, however, there is in fact no solid reason, financial or otherwise, for retaining equity eligibility rules: L. Kryzanowski and V. Jog, "Equity Eligibility Rules and Private Pension Fund Investment: Some Canadian Evidence" (1986), 4 Can. J. Ins. L. 90-91.

[57] Whereas ss. 8(4)-(5) of the *Pension Benefits Standards Act, 1985*, S.C. 1986, c. 40, expressly set out a prudent person standard:

> (4) In the administration of the pension plan and pension fund, the administrator shall exercise the degree of care that a person of ordinary prudence would exercise in dealing with the property of another person.
>
> (5) Without limiting the generality of subsection (4), an administrator who in fact possesses, or by reason of profession or business ought to possess, a particular level of knowledge or skill relevant to the administration of a pension plan or pension fund shall employ that particular level of knowledge or skill in the administration of the pension plan or pension fund.

[58] According to section 3 of *The Pension Benefits Act*, that Act prevails over other Acts, including *The Trustee Act*, in the event of conflict between its provisions and the provisions of other legislation. Since *The Pension Benefits Act* does not stipulate the standard of care to be observed when investing pension assets, there seems to be no conflict involved in observance of the standard laid down in *The Trustee Act*, namely, the prudent person rule.

[59] *The Civil Service Superannuation Act*, C.C.S.M. c. C120.

[60] *The Civil Service Superannuation Act*, C.C.S.M. c. C120, s. 5(1).

[61] Subject to the approval of the Lieutenant Governor in Council: *The Civil Service Superannuation Act*, C.C.S.M. c. C120, s. 6(1).

[62] *The Civil Service Superannuation Act*, C.C.S.M. c. C120, s. 8(1).

[63] *The Civil Service Superannuation Act*, C.C.S.M. c. C120. ss. 10(2)-(3).

investments in which moneys in the fund and available from time to time for investment shall be invested.[64]

With respect to permissible investments, the Act directs that

> Moneys in the fund may be invested in any investments that are permissible under The Pension Benefits Act and the regulations made thereunder, but the moneys in the fund shall not be used to purchase common stocks at any time when 25% of the book value of the investments of the fund are common stocks.[65]

However, the Act also provides:

> Notwithstanding subsection (2), and notwithstanding The Pension Benefits Act and the regulations made thereunder, moneys in the fund may be invested or loaned in any investments or on any security in or on which a trustee is authorized under The Trustee Act to invest or loan trust moneys.[66]

Whether by design or inadvertence, this section appears to completely override the earlier section and its intended restrictions. Presumably then, the prudent person rule which governs investment under *The Trustee Act* and which permits investment in any kind of property, also operates with respect to the investment of public pension assets. This suggests that public pension trustees are permitted a wider scope of investment than are private pension trustees.

D. ONTARIO LEGISLATION

It appears that only Ontario has sought to deal directly with the issue of "ethical investments". In 1988, it enacted the *South African Trust Investments Act*.[67] That Act provides that:

> Despite the *Trustee Act* or any other law, a trustee who acts in accordance with this Act and in a reasonably prudent manner does not commit a breach of statutory or other legal duty by,
>
> (a) disposing of a South African investment even if the value of the property for which the trustee is responsible decreases or fails to increase sufficiently as a result; or
>
> (b) refusing to acquire a South African investment.[68]

Unfortunately, although this Act settles the issue completely for those whose ethical considerations are limited to South African investments, it provides no answer at all to those who would wish to observe additional or other criteria. Furthermore, the fact that the Ontario Legislature considered it necessary to enact this legislation would seem to add further credence to the view that the question of whether ethical criteria may be observed when investing trust funds must be regarded as unsettled at best.

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[64] *The Civil Service Superannuation Act*, C.C.S.M. c. C120, s. 10(4).

[65] *The Civil Service Superannuation Act*, C.C.S.M. c. C120, s. 9(2). An exception applies to investments held by the fund as at January 1, 1977, which may be held for such period as the investment committee deems advisable whether or not they are permissible under *The Pension Benefits Act* and the regulations made thereunder: *The Civil Service Superannuation Act*, C.C.S.M. c. C120, s. 9(3).

[66] *The Civil Service Superannuation Act*, C.C.S.M. c. C120, s. 9(6).

[67] *South African Trust Investments Act*, R.S.O. 1990, c. S.16.

[68] *South African Trust Investments Act*, R.S.O. 1990, c. S.16, s. 3.

E. AMERICAN LEGISLATION

1. *Internal Revenue Code*

In the United States, the *Internal Revenue Code* provides that retirement plans must be maintained for the exclusive benefit of employees and their beneficiaries in order to qualify for tax-exempt status.[69] Nevertheless, in 1969 the United States Internal Revenue Service ruled that other parties may benefit from a fund's investment if the cost of the investment does not exceed fair market value, a fair return commensurate with prevailing rates is achieved, sufficient liquidity to operate the plan is not sacrificed and the safety and diversity required of a prudent person are present.[70] The government's allowance of collateral benefits to other parties has been upheld by American courts which have agreed that incidental benefit to a third party is not sufficient to justify disqualification of a plan.[71]

One year later, the Internal Revenue Service ruled that low-risk investments which produce income and also serve a social purpose will not be considered to be a diversion of the principal or income from trust purposes, even though these investments yield a rate of return lower than that available in the current market.[72]

2. *Employee Retirement Income Security Act*

In the United States, the investment activity of fiduciaries of employee benefit plans is regulated by the *Employee Retirement Income Security Act* (*E.R.I.S.A.*).[73] This statute established a coordinated federal regulatory framework for private sector employee benefit plans. As of January 1, 1975, *E.R.I.S.A.* pre-empted all state laws relating to private sector employee benefit plans.[74]

E.R.I.S.A. provides that

> . . . a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and --
>
> (A) for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries; and
> (ii) defraying reasonable expenses of administering the plan;
>
> (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
>
> (C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

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[69] 26 U.S.C. §401(a) (1988).

[70] Rev. Rul. 69-494, 1969-2 C.B. 88, cited in Hutchinson and Cole, *supra* n. 35, at 1348, n. 44.

[71] Hutchinson and Cole, *supra* n. 35, at 1348.

[72] Rev. Rul. 70-536, 1970-2 C.B. 120, cited in G.P. Cunningham, "The Employee Retirement Income Security Act of 1974 and Union Influence in Pension Fund Investment Decisions" (1984), 12 Fordham Urb. L.J. 151 at 165, n. 113.

[73] 29 U.S.C. §§1001 *et seq.* (1988).

[74] *E.R.I.S.A.* does not, however, apply to plans maintained by state or local governments (i.e., public plans).

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter. . . .[75]

There is no doubt that the legislation places primary emphasis on protecting the retirement benefits of participants. While this does not preclude ethical investment, it is permitted only to the extent that the other objective investment criteria are met. According to the United States Department of Labor:

> While fiduciary considerations such as investment performance may not properly be sacrificed in order to advance the social welfare of a group or region, an investment is not impermissible under ERISA solely because it has social utility. If the socially beneficial investment meets objective investment criteria which are appropriate to the goals of the portfolio, it may be considered in the same manner as other investments which meet these criteria. . . . If after evaluating other factors, two investments appear to be equally desirable, then social judgments are permissible in determining which to select.[76]

[75]29 U.S.C. §1104(a)(1) (1988).

[76]I. Lanoff, "On the Social Investment of Private Pension Plan Assets: May It Be Lawfully Done Under ERISA?" (1980) reported in 295 Pens. Rep. (BNA) 6.16.80, R.17-R.19 and cited in T.A. Troyer, W.B. Slocombe and R.A. Boisture, "Divestment of South Africa Investments: The Legal Implications for Foundations, Other Charitable Institutions, and Pension Funds" (1985), 74 Geo. L.J. 127 at 155.

CHAPTER 4

THE CASE LAW

It appears that no Canadian court has ever directly considered the issue of the propriety of ethical investment within the context of trust law.[1] Hence, the question of whether ethical criteria may be considered when investing trust funds is unsettled in Canadian law. Accordingly, we turn now to consider the relevance of cases arising in the United States and England which are frequently referred to in discussions touching on the subject of ethical investment.

A. UNITED STATES

1. *Blankenship* v. *Boyle*

In *Blankenship* v. *Boyle*,[2] an action was brought on behalf of coal miners with present or future rights to benefits from the United Mine Workers of America Welfare and Retirement Fund, alleging various breaches of trust on the part of the fund's trustees. The fund was created by the terms of the National Bituminous Coal Wage Agreement of 1950 and established as an irrevocable trust pursuant to provisions of the American *Labor Management Relations Act* of 1947.[3] The agreement required that each coal operator signatory pay a royalty into the fund based on the tonnage of coal mined. These royalties represented over 97% of the total receipts of the fund, the remainder being income from investments. The fund was administered by three trustees designated by the Union, the coal operators, and a neutral third party, respectively. The precise duties and obligations of the trustees were never specified in any of the plan documents and hence were suggested only by the designation of the fund as an "irrevocable trust". Nevertheless, the Court ruled that the common law fiduciary responsibilities of private trustees - in particular, the duty of undivided loyalty - applied with equal force to the pension fund trustees.[4]

Since 1950, the fund had conducted all of its banking business with the National Bank of Washington. Significantly, however, the Bank was at all times controlled by the Union. Several Union officials sat on its board of directors, and the Union itself, along with several of its locals, held substantial accounts with the Bank.[5] The major breach of trust alleged in the case was that the trustees had failed to invest available cash to generate income for the beneficiaries of the

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[1]Although one Canadian court has cited with approval portions of *Cowan* v. *Scargill*, [1985] Ch. 270 (discussed *infra*), the leading English case dealing with the observation of non-financial criteria in relation to trust investments, the point for which it was cited had nothing to do with ethical investment. The point at issue concerned a privative clause in a trusteed pension plan which purported to protect the exercise of a trustee's discretion from judicial review: *Boe* v. *Alexander* (1985), 21 E.T.R. 246 (B.C.S.C.), aff'd (1987), 28 E.T.R. 228 (B.C.C.A.), leave to appeal to S.C.C. denied, 28 E.T.R. 228n.

[2]*Blankenship* v. *Boyle*, 329 F. Supp. 1089 (D.D.C. 1971).

[3]*Labor Management Relations Act*, 29 U.S.C. §186(c) (1988).

[4]*Blankenship* v. *Boyle*, *supra* n. 2, at 1095.

[5]*Blankenship* v. *Boyle*, *supra* n. 2, at 1094.

fund, and had instead persistently permitted large sums of money to accumulate in interest-free chequing accounts held with the Bank.

By way of justification, the trustees claimed, among other things, that they were concerned about future developments in the coal industry which would necessitate ready access to large sums of money upon short notice. The Court simply dismissed this concern on the facts, noting that since 1960 both the profitability and the stability of the industry had steadily increased.[6]

The second major breach of trust related to the purchase of certain utility stocks. The trustees had authorized the purchase of large quantities of shares in certain electric utility companies in order to gain a position of influence and pressure the utilities into buying union-mined coal.[7] Although it is not clear from the reported decision whether this point was argued before the Court, it was understood that the fund stood to benefit if the utilities in question purchased additional union-mined coal since the agreement between the Union and the coal operators required royalties to be paid on every ton of coal mined. However, the evidence suggested that these investments were made primarily for the collateral purpose of benefiting the Union. Accordingly, the Court held that these activities presented a clear case of self-dealing and hence constituted a breach of trust.[8]

To summarize, the Court found that the trustees had: (1) failed to develop a coherent investment policy geared to either immediate or long-term goals; (2) collaborated with the Union contrary to their fiduciary duties; and (3) left excessive sums of money on deposit with the Union's Bank in order to assist the Union.[9] Although some commentators have referred to this case as authority for the proposition that trusteed pension funds may not be invested for "social purposes" (that is, presumably to assist the Union), in fact the Court's ruling turned on the finding of a blatant conflict of interest. Since allowing the fund monies to remain uninvested in non-interest bearing accounts in a union-controlled bank was obviously detrimental to the interests of the beneficiaries, while at the same time it clearly benefited both the Union and the Bank, there can be no doubt that a serious breach of the trustees' duty of loyalty occurred. However, ethical investments do not invariably invite conflicts of interest, particularly when they are undertaken at the behest of the beneficiaries of a trust, and care should be taken to distinguish between the two concepts. Although the ethical investment issue was relevant on the facts, the *Blankenship* case sheds little, if any, light on situations wherein neither harm to beneficiaries nor blatant conflicts of interest are involved.

In referring to the *Blankenship* case, Megarry V.-C. in the English case of *Cowan* v. *Scargill* concludes:

> The court re-affirmed the duty of undivided loyalty to the beneficiaries that a trustee owes, and did not accept that regard should also be paid to the union or its members who generated some of the income of the fund, or to the industry as a whole. That seems to me to be plainly right.[10]

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[6]*Blankenship* v. *Boyle*, *supra* n. 2, at 1097.

[7]*Blankenship* v. *Boyle*, *supra* n. 2, at 1105.

[8]*Blankenship* v. *Boyle*, *supra* n. 2, at 1106.

[9]*Blankenship* v. *Boyle*, *supra* n. 2, at 1112.

[10]*Cowan* v. *Scargill*, *supra* n. 1, at 291. The case is discussed *infra*.

2. *Withers* v. *Teachers' Retirement System of the City of New York*

Withers v. *Teachers' Retirement System of the City of New York*[11] is the second American authority frequently referred to in discussions concerning social investing, and it is sometimes represented as the antithesis of the *Blankenship* decision.

In November of 1975, the Teachers' Retirement System (the "T.R.S.") of the City of New York, along with four other municipal pension funds, agreed to purchase over $2.5 billion in New York City bonds as part of a plan to stave off the City's impending bankruptcy. The T.R.S., by authorization of its Board of Trustees, committed $860 million of its retirement fund assets to the purchase.

Cash contributions from the City constituted the major source of the retirement fund's income and substantially outweighed income from employee contributions and investments.[12] The evidence indicated that the trustees had gone to great lengths to ensure that there was no reasonable possibility of the City securing the necessary financing from other sources. In addition, they also insisted upon compliance with a number of conditions which, in their view, were necessary to secure the maximum protection for the beneficiaries of the T.R.S.[13] These included the passage of state legislation which contained provisions authorizing the City's pension funds to purchase City obligations without regard to the percentage of the assets of the fund invested therein and authorizing the trustees of the funds to consider, in addition to other appropriate factors recognized by law, the extent to which their investments in such obligations would

> (a) maintain the ability of the city of New York (1) to make future contributions to such systems and funds and (2) to satisfy its future obligations to pay pension and retirement benefits to members and beneficiaries of such systems and funds and (b) protect the sources of funds to provide retirement benefits for members and beneficiaries of such systems and funds.[14]

The plaintiffs contended, among other things, that the actions of the trustees constituted a breach of their fiduciary obligation to the retired beneficiaries of the fund because they: (1) purchased unmarketable and highly speculative City bonds; (2) made their investment decision with the objective of rescuing the City, rather than concentrating exclusively on enhancing the stability of the fund; (3) relied on uncertain reports respecting the City's imminent bankruptcy; and (4) acted under the compulsion of government officials rather than of their own free will.[15] With respect to the latter two claims, the Court simply found that the predominant and reasonable concern of the trustees was the effect that a bankrupt City would have on the solvency of the T.R.S. fund.[16]

As regards the first claim, although the trustees were empowered under New York law to invest in the City bonds, such statutory authorization did not relieve them of their duty to exercise prudence in relation to these investments. The Court observed:

> In the area of investment decisions, the obligation to exercise prudence is essentially an obligation to give primacy to the preservation of the trust estate and the procurement of a reasonable income

[11]*Withers* v. *Teachers' Retirement System of the City of New York*, 447 F. Supp. 1248 (S.D.N.Y. 1978), aff'd without opinion 595 F.2d 1210 (2nd Cir. 1979).

[12]*Id.*, at 1251.

[13]*Withers* v. *Teachers' Retirement System of the City of New York*, *supra* n. 11, at 1253.

[14]*Withers* v. *Teachers' Retirement System of the City of New York*, *supra* n. 11, at 1253.

[15]*Withers* v. *Teachers' Retirement System of the City of New York*, *supra* n. 11, at 1254.

[16]*Withers* v. *Teachers' Retirement System of the City of New York*, *supra* n. 11, at 1252.

while avoiding undue investment risks . . . and to make independent inquiry into the merits of particular investments rather than to rely wholly upon the advice of others.[17]

Interestingly, although the trustees' decision to invest so large a portion of the fund's assets in City bonds appeared to violate conventional notions of prudent investment, the Court ruled that under the circumstances their actions were prudent.

> . . . [S]ince the trustees had firm grounds for believing, after careful deliberation, that the alternative to purchasing the "highly speculative" City bonds would be the bankruptcy of their own retirement fund, their decision to accept the terms of the . . . Agreement, on behalf of the TRS, was a prudent one. Their investment context was distinguishable from the normal one in which "speculation" implies risking the corpus of the trust estate; in the case before them, purchasing "speculative" obligations was the *sine qua non* of preserving the corpus. Thus, under the unique circumstances presented -- in which the survival of "the fund as an entity" necessarily achieved prominence -- the trustees' investment decision was such as to fulfill their fiduciary obligations to the TRS.[18]

In regard to the second claim, the point at issue concerned the extent to which it was legitimate for the trustees to consider the plight of the City in making their investment decision.[19] On the authority of *Blankenship* v. *Boyle*, the plaintiffs submitted that, in considering the interests of an entity apart from the fund, the trustees had compromised their duty of undivided loyalty to its beneficiaries. The Court, however, distinguished the *Blankenship* case, stating:

> *Blankenship* was thus a case in which the trustees pursued policies which may incidentally have aided the beneficiaries of the fund but which were intended, primarily, to enhance the position of the Union and the welfare of its members, presumably, through the creation and/or preservation of jobs in the coal industry. The decision is inapplicable here. The trustees of the TRS gave consideration to the interests of the City of New York solely in its capacity as the major and indispensable contributor of monies to the pension system.[20]

Moreover, on the evidence, the Court concluded that neither the protection of the jobs of the City's teachers, nor the general public welfare, were factors which influenced the trustees. Rather, the extension of aid to the City was simply a means to the legitimate end of preventing the exhaustion of fund assets, and that this end was in the interest of all of the beneficiaries.[21]

Finally, it should be noted that the plaintiffs had also argued that the paramount obligation of the trustees was to the retirees rather than to the active members of the T.R.S., and that the purchase of the City bonds had diminished the value of the assets of the fund reserved for the exclusive benefit of the retirees.[22] The trustees, on the other hand, had unanimously taken the view that their fiduciary duty was to protect the interests of all the beneficiaries of the fund. This included both those who were still working and dependent on the long-term viability of the fund for their retirement incomes, as well as those who had already retired.[23] Significantly, the Court held that, as the law imposed an obligation on trustees to accord impartial treatment to

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[17] *Withers* v. *Teachers' Retirement System of the City of New York*, *supra* n. 11, at 1254. But *cf. Cowan* v. *Scargill*, *supra* n. 1, at 287, discussed *infra*, where Megarry V.-C. suggests that the investment duty of trustees is to obtain the "best return" for the beneficiaries judged in relation to the risks involved.

[18] *Withers* v. *Teachers' Retirement System of the City of New York*, *supra* n. 11, at 1259.

[19] *Withers* v. *Teachers' Retirement System of the City of New York*, *supra* n. 11, at 1255.

[20] *Withers* v. *Teachers' Retirement System of the City of New York*, *supra* n. 11, at 1256.

[21] *Withers* v. *Teachers' Retirement System of the City of New York*, *supra* n. 11, at 1256.

[22] *Withers* v. *Teachers' Retirement System of the City of New York*, *supra* n. 11, at 1254. More precisely, the plaintiffs contended that, to help finance the purchase of the City bonds, the trustees liquidated a portion of the fixed funds of the T.R.S. which were reserved exclusively for the benefit of retirees and therefore unavailable for investments that might in any way jeopardize their lifetime retirement expectancies (at 1257).

[23] *Withers* v. *Teachers' Retirement System of the City of New York*, *supra* n. 11, at 1252.

beneficiaries, the trustees of the T.R.S. would have violated their fiduciary obligation had they exhausted the assets of the pension system on a single class of beneficiaries (retirees).[24]

> Their obligation, plainly, was to manage the fund so as to enable it to meet its obligations not only to current retirees, but also to those scheduled to retire in the future, whose pension and annuity rights would have been similarly earned over their years of active service and to whom the fund therefore had a legal responsibility.[25]

Insofar as the Court specifically found that the trustees were not motivated by any considerations other than maintaining the solvency of the T.R.S. fund, *Withers* provides little guidance concerning the extent to which it is legitimate for trustees to factor ethical concerns into their investment decisions. While the case arguably takes a broad view of both prudent investment and just what constitutes the "interests" or "benefits" which trustees are obliged to promote on behalf of their beneficiaries, it was still ultimately decided on traditional principles which give predominance to the financial benefit of an even-handedness among beneficiaries.

3. *Donovan* v. *Walton*

In *Donovan* v. *Walton*,[26] the Secretary of Labor filed an action under the *Employee Retirement Income Security Act* (*E.R.I.S.A.*)[27] alleging that the trustees of a pension fund had breached both the "prudence" and "exclusive benefit" requirements set out in the legislation.[28]

Among other things, the trustees had financed the construction of an Administration Building on property owned by the fund and leased space therein to the Union, and had also sponsored a home mortgage loan program with fund money. Although the Union derived various benefits from these arrangements, the District Court held that these benefits were parallel to and inseparable from the benefits derived by the fund and its participants.[29] More importantly, however, the Court also ruled that *E.R.I.S.A.*

> . . . simply does not prohibit a party other than a plan's participants and beneficiaries from benefiting in some measure from a prudent transaction with the plan. Furthermore, by adopting the "exclusive purpose" standard, Congress did not intend to make illegal the fact of life that most often a transaction benefits both parties involved.
>
> The case law supports this view. What courts frequently find objectionable is an imprudent plan transaction in which the trustee has a personal stake.[30]

Subsequently, the Secretary of Labor brought an appeal for the purpose of obtaining a decision respecting whether the further requirement of *E.R.I.S.A.* that trustees charge a "reasonable rate of interest" on loans to pension plan participants meant that they had to charge the prevailing or market rate of interest.[31] The rules of the mortgage program provided that loans

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[24] *Withers* v. *Teachers' Retirement System of the City of New York*, *supra* n. 11, at 1257.

[25] *Withers* v. *Teachers' Retirement System of the City of New York*, *supra* n. 11, at 1257-1258. But *cf. Cowan* v. *Scargill*, *supra* n. 1, discussed *infra*.

[26] *Donovan* v. *Walton*, 609 F. Supp. 1221 (S.D. Fla. 1985), aff'd (*sub nom. Brock* v. *Walton*) 794 F.2d 586 (11th Cir. 1986), rehearing *en banc* denied without opinion, 802 F.2d 1399 (11th Cir. 1986).

[27] 29 U.S.C. §§1001 *et seq.* (1988).

[28] The relevant portion of *E.R.I.S.A.* is set out in the earlier discussion of the Act in Chapter 3.

[29] *Donovan* v. *Walton*, *supra* n. 26, at 1245.

[30] *Donovan* v. *Walton*, *supra* n. 26, at 1245.

[31] §§1106(a)(1)(B) and 1108(b)(1) of *E.R.I.S.A.* prohibit mortgage loans to employees of contributing employers, unless, among other things, they bear a reasonable rate of interest.

were to carry interest at a rate 2 1/8 percentage points below the prevailing rates in the community. The Court of Appeals held that the terms "reasonable rate" and "prevailing or market rate" were not synonymous, and that a reasonable rate of interest could be below the prevailing market rate. Consequently, the fact that the trustees permitted loans to carry interest at a rate 2 1/8 points below the prevailing rate in the community did not, in and of itself, demonstrate that they had breached their fiduciary duties under *E.R.I.S.A.*[32]

B. ENGLAND

1. *Evans* v. *London Co-operative Society Ltd.*

In *Evans* v. *London Co-operative Society Ltd.*,[33] an English court had occasion, apparently for the first time, to address the question of whether a trusteed pension fund could be used for purposes other than to provide direct benefits to its members. In 1927, the London Co-operative Society Ltd. established a superannuation scheme for the benefit of its employees and declared itself to be the trustee of the scheme. Rule 7 of the superannuation scheme provided:

> The monies from time to time in the hands of the Trustees upon the Trust hereof, and not presently required for making any payment pursuant hereto, shall, if and so far as the . . . Society shall be willing to accept the same, be advanced to the . . . Society by way of loan repayable on demand, and carrying interest at such rate as may be agreed upon by the . . . Society and the Pension Committee providing that it be not less than 3 3/4 per cent per annum with half-yearly rests, and the . . . Society may at any time pay off any monies so advanced, and any monies in the hands of the Trustees upon the Trust hereof, which the . . . Society shall at any time be unwilling to accept on loan may be invested in any investments by law permitted to Trustees, and the investments hereof may at any time be varied as may seem expedient to the Pension Committee, or may be placed on deposit with any bank or banks as the Pension Committee may think expedient.[34]

Since 1931, the Society had routinely borrowed at less than current rates of interest all of the money in the pension fund that was not required for the payment of pension benefits. This capital was apparently utilized to create employment opportunities for members of the fund, as well as to provide better shops and facilities for employees. In 1964, it was decided that the portion of the fund on loan to the Society ought to be secured. Accordingly, the Society executed an equitable mortgage in favour of the fund and retired from the trusteeship since it could not properly occupy the dual role of mortgagor and mortgagee. However, for practical purposes, nothing really changed and the Society did not shed its fiduciary relationship *vis-à-vis* the fund.[35]

Evans's claim that the Society was not at liberty to agree to a rate of interest lower than prevailing commercial rates was based on the "inflexible rule of a Court of Equity that a person in a fiduciary position . . . is not, unless otherwise expressly provided, entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict."[36] Brightman J. found, however, that since Rule 7 permitted the Society to borrow money from the pension fund in the first place, it could not reasonably be suggested that the Society was disentitled from profiting by its use of money so borrowed. Hence the money was lawfully lent to the Society

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[32] *Brock* v. *Walton*, 794 F.2d 586 at 587 (11th Cir. 1986).

[33] *Evans* v. *London Co-operative Society Ltd.*, [1976] C.L.Y. 2059 (Ch.D.). The full text of the case is not officially reported but does appear in R. Ellison, *Private Occupational Pension Schemes*, vol. 1 (1979) App. III. All subsequent references to the *Evans* decision are cited to Ellison.

[34] *Id.*, at 358-359.

[35] *Evans* v. *London Co-operative Society Ltd.*, *supra* n. 33 at 359-360.

[36] *Bray* v. *Ford*, [1896] A.C. 44 at 51. See *Evans* v. *London Co-operative Society Ltd.*, *supra* n. 33, at 364.

and the rate of interest lawfully agreed.[37] The Court then concluded that the failure of Evans's argument on this first point undermined his contention that it was not open to the Society to borrow, or for the Pension Committee to lend, at rates lower than the market rates of interest charged by outside lenders. Brightman J. observed that such a limitation had not, in fact, been written into Rule 7 and to imply such a limitation would be to import an "unnecessary and undesirable rigidity into the Rule."[38] However, it was held that, while the employer had power to borrow, and the trustees power to lend, at rates of interest lower than market rates, this required a formal consent by the trustees which had not been obtained. Since the trustees mistakenly believed that the Society was entitled as of right to borrow all the money it wanted at preferential rates of interest, the exercise of their discretion was fettered insofar as they failed to appreciate that the loan agreements with the Society could be negotiated on other terms. This failure constituted a breach of trust on the part of the trustees of the fund, and one in which the Society was a full participant since it knew precisely what was happening.[39]

Importantly, however, the Court did not limit its findings in the case to a construction of Rule 7. Brightman J. also stated:

> Self-investment of a pension fund may be undesirable in ordinary commercial undertakings but it is to my mind consistent with the aims and principles of a co-operative undertaking. . . . I also bear in mind that the members of the Pension Fund are all employees of the Society and therefore dependent for their employment on the financial health of the Society. No doubt that is always so in the case of the pension fund of a trading concern. If under the rules of a superannuation scheme the trustees of a pension fund have express power to lend money to the parent concern it would, in my view, be wrong to suppose that the trustees are forbidden to give the parent concern financial accommodation on preferential terms if the trustees consider that the security of the employment of their members may otherwise be imperilled . . . .
>
> . . . Their beneficiaries are the employees contributing to the Fund and the pensioners who have claims upon the Fund. The Society is not a beneficiary for this purpose. The Pension Committee may come to the view that in all the circumstances it is for the advantage of their beneficiaries as a whole that the Society should be permitted to have the loan of pension money at a rate lower than the Society would have to pay to an outside lender. On the other hand I think that only in the most exceptional circumstances would the Pension Committee be justified in lending pension money to the Society indefinitely in return for a rate of interest significantly lower than that obtainable on a bank deposit or on deposit with a first-class local authority.[40]

These comments are significant for two reasons. First, the Court recommends that a "long-term" view be taken of a beneficiary's "best interests", which suggests that the goal of securing immediate, maximum monetary returns on an investment may not comprise the whole of a trustee's fiduciary obligation in relation to making investment decisions. Equally important is the suggestion that, in making investment decisions, trustees may consider the interests of the members of a trusteed pension scheme as employees and not simply as prospective pensioners.

2. *Cowan* v. *Scargill*: The Mineworkers Case

The case of *Cowan* v. *Scargill*[41] stands as the leading authority on the question of ethical investment of trust funds. It is somewhat unique in that it involved a dispute among trustees of a pension fund over investment policy. Under a mineworkers' pension scheme set up by the

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[37] *Evans* v. *London Co-operative Society Ltd.*, *supra* n. 33, at 364.

[38] *Evans* v. *London Co-operative Society Ltd.*, *supra* n. 33, at 364.

[39] *Evans* v. *London Co-operative Society Ltd.*, *supra* n. 33, at 366.

[40] *Evans* v. *London Co-operative Society Ltd.*, *supra* n. 33, at 364-365.

[41] *Cowan* v. *Scargill*, *supra* n. 1.

National Coal Board, a Committee of Management was formed which was composed of ten trustees. Five of the trustees were appointed by the Board and five were elected by the National Union of Mineworkers. Together, the trustees were to administer funds provided by approximately equal contributions from both the Board and plan members. The Board also contributed additional amounts to allow for inflation. In the result, about two-thirds of the fund came from Board contributions, while the remaining one-third came from the members. The pension fund totalled about £3,000 million and, of that sum, approximately £200 million was made available for investment each year. The Committee of Management enjoyed wide powers of investment which they exercised with the assistance of an advisory panel of experts.

In 1980, a formal plan was established for the investment of the funds in marketable securities, land and industrial finance. The first two classes encompassed investments in oil and gas, and all three categories included overseas investments. In 1982, a revised policy was submitted by a subcommittee for approval by the Committee of Management. At this time, the five Union-appointed trustees raised objections to the revised plan and refused to concur in its adoption unless it was amended so as to: (1) prevent any increase in overseas investment; (2) provide for divestment of existing overseas investments at the most opportune time; and (3) prohibit investment in energies which were in direct competition with coal. While acknowledging that these objections involved matters of principle and reflected, at least in part, Union policy, the Union trustees also insisted that the best interests of the plan beneficiaries remained their sole consideration. The protracted negotiations which followed failed to achieve any consensus respecting the 1982 plan, and the Board trustees eventually commenced legal proceedings against the Union trustees, contending they were in breach of their fiduciary duties in holding up the adoption of the plan.

Mr. Scargill (a co-defendant who represented both himself and the other Union trustees) essentially argued that pension fund trustees were entitled to take account of their members' interests as employees, in addition to their interests as pensioners. This proposition, of course, had earlier found judicial support in the *Evans* case. Secondly, Mr. Scargill pointed out that the ability of the fund to pay existing and future pensions depended upon the continued profitability of the coal industry. Therefore, it was open to trustees to pursue investment policies which enhanced or at least protected the industry's profitability.

Megarry V.-C. determined that the legal starting point was the duty of trustees to exercise their powers in the best interests of the present and future beneficiaries of the trust, holding the scales impartially between different classes of beneficiaries.[42] In considering what investments to make, trustees were required to put aside their own personal interests and views, and might even be obliged to act dishonourably if the interests of their beneficiaries so demand.[43] This conclusion appears to have been based on the authority of *Buttle* v. *Saunders*,[44] a case which merits some comment.

In *Buttle* v. *Saunders*, when negotiations for the sale of property held by trustees were in an advanced stage, the trustees received a higher offer from one of the beneficiaries. However, they considered themselves bound by commercial morality to complete with the original purchaser and consequently refused the higher offer. The Court, in holding that it was the duty of the trustees to at least have probed the better offer, observed:

> It is true that persons who are not in the position of trustees are entitled, if they so desire, to accept a lesser price than that which they might obtain on the sale of property, and not infrequently a vendor, who has gone some lengths in negotiating with a prospective purchaser, decides to close the deal

[42] *Cowan* v. *Scargill*, *supra* n. 1, at 286-287.

[43] *Cowan* v. *Scargill*, *supra* n. 1, at 287-288.

[44] *Buttle* v. *Saunders*, [1950] 2 All E.R. 193 (Ch. D.).

> with that purchaser, notwithstanding that he is presented with a higher offer. It redounds to the credit of a man who acts like that in such circumstances. Trustees, however, are not vested with such complete freedom. They have an overriding duty to obtain the best price which they can for their beneficiaries.[45]

In *Cowan* v. *Scargill*, Megarry V.-C. ruled that, under a trust for the provision of financial benefits, the best interests of the beneficiaries are normally their best financial interests. Accordingly, the paramount duty of the trustees was to provide the greatest financial benefits for present and future beneficiaries.

> This duty of the trustees towards their beneficiaries is paramount. They must, of course, obey the law; but subject to that, they must put the interests of their beneficiaries first. When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests. In the case of a power of investment, as in the present case, the power must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question; and the prospects of the yield of income and capital appreciation both have to be considered in judging the return from the investment. . . .
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> . . . The assertion that trustees could not be criticised for failing to make a particular investment for social or political reasons is one that I would not accept in its full width. If the investment in fact made is equally beneficial to the beneficiaries, then criticism would be difficult to sustain in practice, whatever the position in theory. But if the investment in fact made is less beneficial, then both in theory and in practice the trustees would normally be open to criticism.
>
> This leads me to the second point, which is a corollary of the first. In considering what investments to make trustees must put on one side their own personal interests and views. Trustees may have strongly held social or political views. They may be firmly opposed to any investment in South Africa or other countries, or they may object to any form of investment in companies concerned with alcohol, tobacco, armaments or many other things. In the conduct of their own affairs, of course, they are free to abstain from making any such investments. Yet under a trust, if investments of this type would be more beneficial to the beneficiaries than other investments, the trustees must not refrain from making the investments by reason of the views that they hold.[46]

It has been argued that the decision in *Cowan* v. *Scargill* fails to recognize that the investment policy and conduct of trustees may, in fact, adversely impact on the beneficiaries of a trust in ways which would be clearly detrimental to their best interests. For example:

> The trustees, within the law, make unscrupulous bargains, act dishonourably, gazump at every opportunity, squeeze every penny they can from others for the benefit of the fund. They invest in a way that the public and the beneficiaries find very distasteful. Widows of methodist ministers, members of a college, retired coal miners, and many such ordinary, decent and respectable people, might feel a sense of affront and even outrage at their trustees acting in such a manner. Such beneficiaries may find themselves embarrassed or damaged in reputation or business or other activities.[47]

However, Megarry V.-C. did recognize that there may be limited circumstances in which the receipt of smaller financial returns may be for the benefit of a beneficiary.

> . . . [B]y way of caveat I should say that I am not asserting that the benefit of the beneficiaries which a trustee must make his paramount concern inevitably and solely means their financial benefit, even if the only object of the trust is to provide financial benefits. Thus if the only actual or potential beneficiaries of a trust are all adults with very strict views on moral and social matters, condemning all forms of alcohol, tobacco and popular entertainment, as well as armaments, I can well understand that it might not be for the "benefit" of such beneficiaries to know that they are obtaining rather larger financial returns under the trust by reason of investments in those activities than they

[45] *Id.*, at 195.

[46] *Cowan* v. *Scargill*, *supra* n. 1, at 287-288.

[47] P. Pearce and A. Samuels, "Trustees and Beneficiaries and Investment Policies" (1985) 49 Conv. (N.S.) 52 at 55.

would have received if the trustees had invested the trust funds in other investments. The beneficiaries might well consider that it was far better to receive less than to receive more money from what they consider to be evil and tainted sources. "Benefit" is a word with a very wide meaning, and there are circumstances in which arrangements which work to the financial disadvantage of a beneficiary may yet be for his benefit. . . . But I would emphasise that such cases are likely to be very rare, and in any case I think that under a trust for the provision of financial benefits the burden would rest, and rest heavy, on him who asserts that it is for the benefit of the beneficiaries as a whole to receive less by reason of the exclusion of some of the possibly more profitable forms of investment. Plainly the present case is not one of this rare type of cases. Subject to such matters, under a trust for the provision of financial benefits, the paramount duty of the trustees is to provide the greatest financial benefits for the present and future beneficiaries.[48]

This statement appears to acknowledge that the notion of "benefit" may, in some cases, mean much more than strictly financial benefit, but it is clear that, under a trust to provide financial benefits, financial criteria will clearly be paramount.

Megarry V.-C. also provides some guidance as to the extent to which the views of the trustees themselves may be relevant in the exercise of investment discretion. He clearly held that the trustees must not allow their own ethical objectives to influence the proper exercise of their investment discretion as trustees under the trust.

Although there was some evidence which indicated that the defendants were concerned to give effect to social views in formulating their investment policy,[49] the Court specifically found that they were "mainly, if not solely, actuated by a desire to pursue union policy"[50] and not at all concerned about the best interests of the beneficiaries under the trust. Megarry V.-C. stated:

I can see no escape from the conclusion that the N.U.M. trustees were attempting to impose the prohibitions in order to carry out union policy; and mere assertions that their sole consideration was the benefit of the beneficiaries do not alter that conclusion. If the N.U.M. trustees were thinking only of the benefit of the beneficiaries, why all the references to union policy instead of proper explanations of how and why the prohibitions would bring benefits to the beneficiaries? No doubt some trustees with strong feelings find it irksome to be forced to submerge those feelings and genuinely put the interests of the beneficiaries first. Indeed, there are some who are temperamentally unsuited to being trustees, and are more fitted for campaigning for changes in the law. This, of course, they are free to do; but if they choose to become trustees they must accept it that the rules of equity will bind them in all that they do as trustees.[51]

Although *Cowan* v. *Scargill* has subsequently been taken as authority for the proposition that ethical investment is not permissible within the context of trust law, it is not at all clear that this is the case. The Court's declaration that the Union trustees breached their fiduciary duties by refusing to concur in the adoption of the revised investment plan largely rested on its finding that they were not at all concerned about the interests of the beneficiaries under the trust. Indeed, Megarry V.-C. expressly found that the Union trustees "were adamant in their determination to impose the restrictions, whether or not they harmed their beneficiaries."[52]

Subsequently, at a Symposium on Trusts, Equity and Fiduciary Relationships held in Canada in 1988, Megarry V.-C. remarked that the Mineworkers case probably would have attracted little attention if the territory that it covered had been occupied by a reasonable body of

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[48]*Cowan* v. *Scargill*, *supra* n. 1, at 288-289.

[49]The union had earlier sought legal advice and one of the questions posed to the solicitor concerned how far pension fund trustees could give effect to social views in making investments: *Cowan* v. *Scargill*, *supra* n. 1, at 294.

[50]*Cowan* v. *Scargill*, *supra* n. 1, at 294.

[51]*Cowan* v. *Scargill*, *supra* n. 1, at 293.

[52]*Cowan* v. *Scargill*, *supra* n. 1, at 294.

authority. However, as he put it, ". . . in England the cupboard was bare."[53] He noted first that the defendants in the case had not had the benefit of professional legal representation, and suggested that one could not say what would have emerged had their case been presented by a Chancery silk.[54] More significantly, however, Megarry V.-C. also stated that a further important factor to be borne in mind was the narrow compass of the issue that actually lay for decision. He wrote:

> What was in issue was a matter not of preferences or policies but of exclusion. The wide powers of investment of the trustees were to be subjected, by fiat of the trustees, to a total prohibition on certain types of investment, come what may. The defendants' requirement was absolute. The scheme included a power of amendment by agreement between the Board and the Union, with a provision for resolving matters in default of agreement; but there was no suggestion that this power should be used so as to alter the investment clause. Nor was there any suggestion for softening the prohibition on investment in oil or overseas, as by excluding them if alternatives were available that were of equal merit.[55]

Megarry V.-C. then indicated that, although a policy of preference - as distinct from an absolute prohibition - on the part of the Union trustees would not have been free from difficulty, it may well have engendered a different result.

Megarry V.-C. concluded his presentation by offering up one final possibility, namely that, when investing ethically, trustees might simply refrain from broadcasting their intentions by laying down formal policies.

> Suppose that the trustees of a pension fund make no formal decision on the point, and lay down no formal policy. Suppose that they know that any investment in B Ltd. is likely to be obnoxious to a large section of their beneficiaries, though not to all. If, then, as a matter of practice they refrain from making any investment in B Ltd., unless they consider that such an investment has some advantage over others, it is difficult to see how they could be validly criticised. Furthermore, many of the investments to which some have social, political or other non-financial objections are open to valid objections purely on investment grounds, such as fears for the political stability of the country concerned. In short, much, though by no means all, may be achieved by trustees exercising their discretion on perfectly proper grounds without subjecting themselves to any absolute prohibitions or, indeed, any policy of preference.[56]

In short, Megarry V.-C. seemed to suggest that trustees could use ethical criteria if they were careful to maintain the appearance of not doing so.

3. *Harries* v. *Church Commissioners for England*

The most recent reiteration of the paramountcy of the financial return theory may be found in the October 25, 1991 Chancery Division case of *Harries* v. *Church Commissioners for England*.[57] In that case, the Church Commissioners administered large estates and funds for the Church of England comprising more than £2.4 billion and were responsible for paying more than 5,500 clergy salaries and 10,000 pensions.[58] The Commissioners had an ethical investment

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[53]Rt. Hon. Sir R. Megarry, "Investing Pension Funds: The Mineworkers Case" in T.G. Youdan, ed., *Equity, Fiduciaries and Trusts* (1989) 149.

[54]*Id.*, at 152. Indeed, according to some commentators, the lack of balanced legal argument led Megarry V.-C. to formulate incomplete and unduly narrow principles which undermines the authority of the decision: see, *e.g.*, J.H. Farrar and J.K. Maxton, "Social Investment and Pension Scheme Trusts" (1986), 102 L.Q.R. 32.

[55]Megarry, *supra* n. 53, at 152-153.

[56]Megarry, *supra* n. 53, at 158.

[57]*Harries* v. *Church Commissioners for England*, [1991] T.L.R. 478 (Ch. D.).

[58]R. Gledhill, "Bishop challenges ethical base of church investment", *The Times* (London), October 5, 1991.

policy which provided as follows: "We do not invest in companies whose main business is armaments, gambling, alcohol, tobacco and newspapers."[59] This policy excluded approximately 13% of listed U.K. companies.[60]

The Bishop of Oxford sought certain declarations in respect of the investment policy. He contended that the Commissioners committed a breach of their legal obligations by attaching overriding importance to financial considerations in the development and implementation of their investment policy and that they ought properly to have in mind that the underlying purpose for which they held their assets was the promotion of the Christian faith through the Church of England. He argued that the Commissioners should not exercise the investment function in a manner which would be incompatible with such purposes, even if it involved a risk of incurring significant financial detriment. In his view, more stringent ethical criteria - under which a total of 37% of listed U.K. companies would be excluded - should be employed by the Church Commissioners.[61] The Commissioners argued that they already had a sufficient policy and that their financial duties to their dependants were paramount.

Nicholls V.-C. agreed that the Commissioners already had an ethical investment policy and could see nothing in it inconsistent with the promotion of the Christian faith. He noted that the Commissioners had felt able to exclude the items specified in their existing policy from the scope of their investments (despite conflicting views as to the morality of holding such investments) because there remained open an adequate width of alternative investments and stated that the "approach of the commissioners was not legally incorrect."[62] On the other hand, the approach which the Bishop of Oxford wished the Commissioners to adopt (that investment decisions which entailed taking into account non-financial considerations should be made notwithstanding that it might put investment profits in jeopardy) would involve a departure by the Commissioners from their legal obligations to seek to obtain from trust property the maximum return:

> Where trustees held property as an investment to generate money, *prima facie* the purposes of the trust would be best served by the trustees seeking to obtain therefrom the maximum return, whether by way of income or capital growth, which was consistent with commercial prudence.[63]

The decision in *Harries* is consistent with the judgment in *Cowan* v. *Scargill* inasmuch as it reconfirms the principle that, in the case of a trust to provide financial benefits, a power of investment must be exercised primarily with reference to financial considerations. Indeed, the *Harries* case arguably goes beyond *Cowan* by suggesting that, in cases in which taking non-financial considerations into account might put investment profits in jeopardy, that would constitute a breach of the fiduciary's legal obligations. Nonetheless, it is significant that the Court expressed no difficulties with the Church's existing ethical investment policy; the key issue appeared to be the scope of that policy, that is, the extent to which that policy impeded the ability of the trustees to pursue their overriding legal obligation to seek to maximize the prudent financial return on the trust property.

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[59] *Harries* v. *Church Commissioners for England*, *supra* n. 57.

[60] R. Gledhill, "Defeated bishop takes shares fight to synod", *The Times* (London), October 26, 1991.

[61] *Id.*

[62] *Harries* v. *Church Commissioners for England*, *supra* n. 57.

[63] *Harries* v. *Church Commissioners for England*, *supra* n. 57.

CHAPTER 5

THE DUTIES OF PRUDENCE AND LOYALTY

An examination of the relevant legislation governing trustee investments in Manitoba discloses that there is nothing in these provisions which either expressly prohibits or endorses ethical or social investment of trust funds, provided that the investments otherwise satisfy the objective criteria of prudent investment. The weight of case authority is arguably consistent with the legislation, inasmuch as it may be said to conclude that trustees are permitted to consider non-financial criteria provided that they otherwise comply with their obligation to invest prudently including, other than in very exceptional cases, the satisfaction primarily of financial criteria.

Even so, a perusal of legal commentary reveals a divergence of opinion concerning the propriety of ethical investment of trust funds. While some sources contend that the principles of trust law preclude the practice of ethical investment, others maintain that these same principles not only permit, but at times oblige, trustees to give due regard to ethical considerations in making investment decisions; the following summarizes the rationale for the latter view:

> Trustees in deciding whether to invest in, or to retain, the securities of a corporation may properly consider the social performance of the corporation. They may decline to invest in, or to retain, the securities of corporations whose activities or some of them are contrary to fundamental and generally accepted ethical principles. They may consider such matters as pollution, race discrimination, fair employment, and consumer responsibility.
>
> To an increasing extent institutional fiduciaries, whether charitable, such as foundations, or educational and other charitable institutions, or noncharitable, such as trust companies and insurance companies, have become aware of this problem as to the choice of investments, and have come to realize that they have a concern in the social behavior of the corporations in whose securities they invest. Of course they may well believe that a corporation that has a proper sense of social obligation is more likely to be successful in the long run than those that are bent on obtaining the maximum amount of profits. But even if this were not so, the investor, though a trustee of funds for others, is entitled to consider the welfare of the community, and refrain from allowing the use of the funds in a manner detrimental to society.[1]

Two ideals have traditionally guided trustees in the performance of their investment duties: the duties of "prudence" and "loyalty". Any consideration of the role which ethical criteria might play in the exercise of investment discretion must necessarily be conducted in the context of these notions which are fundamental to trust law. The question of the propriety of ethical investment within the context of trust law must ultimately turn on the meaning or content to be extracted from these two duties. Accordingly, we now turn to a consideration of the nature of these concepts.

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[1] A.W. Scott and W.F. Fratcher, *The Law of Trusts*, vol. 3 (4th ed., 1987) 500-501.

A. THE DUTY OF PRUDENCE

The prerogative to invest trust property is an administrative power which must have as its object the production of income.[2] In England, the original or earliest investment duty of trustees was simply to act as prudent persons. However, the early advent of "legal lists" in that country tended to obscure, or impede the clear articulation of, the meaning of that duty. Hence, the prudent person rule of investment is said to have its origin in the American case of *Harvard College* v. *Amory*, where Putnam J. stated:

> All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.[3]

Generally speaking then, at a minimum, the duty of prudence requires trustees to invest the funds under their control so as to both attain an adequate or reasonable return and preserve the trust capital.

Subsequently, a number of American courts took the view that there was, or ought to be, a distinction between how ordinary business people invested their own money and how trustees ought to invest other people's money. This view was premised upon the assumption that ordinary prudent persons would take risks in investing their own money that prudent trustees ought not to take. In *Re Buhl's Estate*, for example, the Court stated:

> A trustee has not unlimited authority to invest as an ordinarily prudent man would invest his own; he must take such risks only as an ordinarily prudent man would take who is a trustee of the money of others.[4]

This distinction eventually gave rise to a variation of the prudent person rule, generally known as the "prudent trustee" rule. Today, most of the jurisdictions in the United States have incorporated one variation or another of the prudence requirement into their respective laws governing investments by fiduciaries. As discussed earlier, Manitoba adopted a modified version of the "prudent trustee" rule in 1983.

Although courts have steadfastly refused to define prudence, the American jurisprudence suggests that:

> So far as one can generalize, a trustee investing as a prudent man would avoid unproductive property, real estate outside the jurisdiction, unsecured loans, and investment in unincorporated businesses, as well as in temporary, high-risk, and wasting assets. Although the security may be sound, second mortgages would commonly be avoided, because the trustee loses control of the investment: the first mortgagee may foreclose, and the trustee may not have the funds to redeem. Moreover, under the prudent man rule, loss of control, improper delegation, commingling of funds, and questionable marketability account for the avoidance of shared investments by trustees. The same objections can be made with respect to investments in mutual funds, common trust funds, life insurance annuities left with insurance companies, and similar commingled investments. However, recent legislation, by permitting investment in mutual funds and common trust funds, has overridden these objections with respect to some modern securities. Diversification of investment is a factor that the prudent man would always consider, and most often judge to be wise, but the prudent man rule itself does not make diversification mandatory. Finally, if there are successive beneficiaries,

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[2]*E.g.*, *Re Power*, [1947] Ch. 572; *Re Barwick* (1884), 5 O.R. 710 (Ch. D.); *Re Henderson's Trusts* (1876), 23 Gr. 45.

[3]*Harvard College* v. *Amory*, 26 Mass. (9 Pick.) 446 (1830), cited in B.R. Campbell and W. Josephson, "Public Pension Trustees' Pursuit of Social Goals" (1983), 24 Wash. U.J. Urb. & Contemp. L. 43 at 48-49.

[4]*Re Buhl's Estate*, 178 N.W. 651 at 654 (Mich. Sup. Ct. 1920).

the prudent man rule requires that the trustee maintain an even hand between the interests of income beneficiaries and those of capital beneficiaries.[5]

The same considerations generally apply in Canada. Waters, for instance, writes:

> In selecting an investment, whether or not he is tied to a legal list, the trustee must consider a range of matters concerning the market conditions, the quality and probable duration of the proposed investment, the duration of the trust and the beneficial interests involved, the financial situation of income beneficiaries, and the impact of taxation and inflation. He must also consider in the planning of his portfolio of trust investments, whether and, if so, to what extent and in what manner, he ought to diversify. . . . Of course, the settlor or testator may give instructions to the trustee in the trust instrument on this subject, as on any other, and in those circumstances the trustee is perfectly entitled *vis-à-vis* the beneficiaries in following those instructions. However, wherever there is scope for the discretion which equitable principles fundamentally associate with the office of trustee, here prudence must come into play. Yet the courts have always taken the view that, if an honest and reasonable man could have come to the decision which the trustee made, the trustee will not be held liable for loss.[6]

Hence the measure of prudence is not result-oriented; that is, the presence or absence of prudence is not determined by how an investment portfolio performs. Rather, the "duty of prudence" is simply a legal abstraction which first requires trustees to conduct themselves reasonably in making investment decisions and then provides a tool for measuring the reasonableness of those decisions, not from the vantage point of hindsight, but as at the time they were made. This, in turn, can only be judged in light of the complete factual backdrop against which trustees formulate their investment policies. This backdrop necessarily encompasses the needs and characteristics of both the trust fund and its beneficiaries, the nature of a proposed investment, the socio-economic climate then prevailing, and the current of professional opinion respecting the quality of new and evolving investment vehicles.

According to Waters:

> Prudence is prudence; it cannot in itself be more or less. Experience shows that prudence as an attribute is most vividly portrayed when a man of business is planning the investment of his own moneys. Such prudence takes into account all the factors and circumstances before a decision is made. In the test as the House of Lords and the American model Act formulated it, the existence of a trust is one of the circumstances the prudent man takes into account. The nature of the beneficiaries' legitimate expectations from his investment policy is another circumstance which he takes into account.[7]

Might a business person, in planning the investment of his or her own moneys, take into account ethical as well as financial factors and circumstances before a decision is made? Is ethical use of money among the legitimate expectations beneficiaries may have in relation to a trustee's investment policy? If the duty of prudence simply introduces "reasonableness" as the standard of care to be observed by trustees in making investment decisions, and there is nothing self-evidently "unreasonable" about acknowledging ethical concerns in making those decisions, how is it that some have regarded the practice of ethical investment as imprudent *per se*?

The most common argument is that ethical investment increases administrative costs, reduces diversification to a detrimental degree and necessarily involves financial sacrifice. However, some sources suggest that no great expense would be involved in the construction of a portfolio which had relatively mechanical or easy-to-apply criteria for identifying undesirable investments. In addition, there currently exist a number of mutual funds which have already

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[5]Ontario Law Reform Commission, *The Law of Trusts*, vol. 1 (Report, 1984) 210. See also the criteria suggested by the American *Restatement (Second) of Trusts* set out in Chapter 3, n. 36.

[6]D.W.M. Waters, *Law of Trusts in Canada* (2d ed., 1984) 783-784.

[7]*Id.*, at 783.

developed and applied various ethical screens. Regarding diversification, this can, in many cases, be an issue of degree, as was illustrated in the *Harries* v. *Church Commissioners* case, where investment restrictions already existed, but those advocated by the plaintiff would have simply narrowed the field to an excessive extent. In terms of investment performance, ironically, some ethical investment funds or indices suggest that ethical investments have, in some cases, outperformed traditional investments. For purposes of illustration, we consider the following contradictory assertions which typify the nature of the debate on this point:

> We conclude that the usual forms of social investing involve a combination of reduced diversification and higher administrative costs not offset by net consumption gains to the investment beneficiaries. Social investing may therefore be economically unsound even though there is no reason to expect a portfolio constructed in accordance with the usual principles of social investment to yield a below-average rate of return -- provided that administrative costs are ignored.[8]

> In an analysis of twelve ethical funds by Lipper Analytical Services Ltd. for the first six months of 1988, it was found that eight performed better than the U.S. equity funds average and the Standard and Poor's 500. Two of the funds, Ariel Growth and Parnassus, were among the top five funds in the U.S.[9]

> Investing in one of these [ethical mutual] funds may mean sacrificing some return, if past performance is any indicator. None of the six we list finished higher than the third Ratings group. *Dreyfus Third Century*, the most highly rated based on risk and return, grew at a respectable 15.02 percent average annual rate for the past five years, although many funds in the Ratings grew at better than a 20 percent annual rate.[10]

> While long-term comparisons are impossible because of the recent advent of these funds in Canada, the performance of Ethical Growth Fund indicates that ethical funds have the potential to perform every bit as well as conventional investment funds. For the year ending June 30, 1988, the rate of return for Ethical Growth (with dividends and capital gains reinvested into the fund units) was 10.9 per cent. In a review of mutual fund performance published by the *Financial Post*, Ethical Growth was rated as the third-highest performing Canadian equity fund out of 120 funds followed by the *Post* for that period. Indeed, all four of the ethical funds or ethical fund groups available to individuals in Canada outperformed the average of Canadian equity funds for the year ending June 30, 1988.[11]

> "Ethical investing" sounds like a trade-off. Your money is deployed toward nice rather than noxious ends, but you reduce economics to a subset of ethics.
>
> Yet the conflict is perhaps illusory. Two indexes devised in the U.S. indicate that ethical investing is no less lucrative than an amoral approach.
>
> • The Domini Social Index, launched on May 1, 1990, bundles 400 stocks in companies that pass muster with the research house of Kinder, Lydenberg, Domini & Co. Inc. of Cambridge, Mass. By the end of this February the index had risen 34.2% versus 24.8% for the Standard & Poor's 500-stock index. That's in price only; with dividends reinvested, the DSI rose 40.8% while the S&P rose 32.8%.
>
> • Created by a sociologist, the Good Money Industrial Average and the Good Money Utilities Average have paralleled Dow Jones indexes since the start of 1977. By the end of 1991, the 30-stock industry average had more than tripled its Dow counterpart (688.9% versus 215.4%) and the 15-stock utility average had more than doubled its rival (244.6% versus 108.7%).

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[8] J.H. Langbein and R.A. Posner, "Social Investing and the Law of Trusts" (1980), 79 Mich. L. Rev. 72 at 76.

[9] E. Ellmen, *The 1989 Canadian Guide to Profitable Ethical Investing* (1989) 59.

[10] "Mutual Funds 1990, Part 1" *Consumer Reports* (May 1990) 330 at 333.

[11] Ellmen, *supra* n. 9, at 58.

. . . .

> The Domini index excludes companies that operate in South Africa or that derive more than 4% of their revenue from military contracts, tobacco, alcohol, gaming or nuclear power. It seeks companies with quality products, good customer and employee relations, good environmental performance and a sense of citizenship.[12]

In brief, even assuming for the sake of argument that trade-offs might be involved in this area, they are virtually impossible to "cost-benefit."

The same observations, by and large, apply with respect to the matter of reduced diversification. In Canada, it is not clear whether trustees have a duty to diversify. Professor Waters suggests that there is an attitude of restraint in the trustee's favour which is particularly evident in relation to matters of diversification.[13] While it is generally true that it is prudent to diversify, the scope of potential investments is always limited by selection criteria and ethical considerations merely inject another possible selection criterion into the decision-making process. A policy of diversification might just as easily encourage investment of a percentage of assets in socially or ethically desirable investments whose characteristics differ from the other securities in a portfolio. Hence, if prudence may, in some circumstances, dictate diversification, there is nothing about the requirement of diversification which intrinsically precludes trustees from considering ethical criteria in selecting investments, provided that the scope is not so narrowed as to make it difficult or impossible for the trustees to fulfil the other constituent elements of their duty to act prudently.

B. THE DUTY OF LOYALTY

1. The Fiduciary Principle

Over and above the responsibilities dictated by *The Trustee Act* and the terms of the instrument, if any, creating the trust, a number of fundamental duties inhere in the office of trustee itself. The most important of these is the fiduciary duty.

> The hallmark of a trust is the fiduciary relationship which it creates between the trustee and the beneficiary. The whole purpose of a trustee's existence is to administer property on behalf of another, to hold it exclusively for the other's enjoyment. The express trustee is expected to put the interests of the trust and the beneficiaries first in his thinking whenever he is exercising the powers or performing the duties of his office. His duty is one of selfless service. . . .
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> . . . .
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> The fiduciary's obligations have been defined in a number of ways by the courts and commentators, but essentially it means the duty to account to another, the person with the right of enjoyment over the property in question, for all that one does with the property and in the office of trustee. Nothing may be done which is not directed solely towards the best interests of the trust beneficiary or beneficiaries.[14]

Particularly in the United States, this fiduciary obligation has come to be known as "the duty of loyalty."

Critics of ethical investment contend that this fiduciary principle, or "the duty of loyalty," precludes trustees from observing ethical criteria in the determination of investment policy.

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[12] R. McKenzie, "Ethical investing can be profitable too", *The Financial Post*, March 23, 1992, 14.

[13] Waters, *supra* n. 6, at 784.

[14] Waters, *supra* n. 6, at 31-32.

They argue that ethical criteria are oriented towards non-financial ends and that observation of anything other than financial objects involves activity that is not directed solely towards the best interests of trust beneficiaries.

Proponents of ethical investment argue that there is no conclusive evidence which demonstrates that observation of ethical criteria impairs investment returns. The question of whether the practice of ethical investment is intrinsically at odds with a trustee's duty of loyalty to the beneficiaries of a trust must turn on an analysis of two things, namely: (1) the chief object or purpose of the fiduciary principle or the duty of loyalty; and (2) the nature and scope of the interests which trustees are duty-bound to protect and promote.

2. The Object of the Duty of Loyalty

Three basic duties are said to derive from the fiduciary principle. First, trustees must carry out their tasks honestly and with due care and attention. Second, trustees must not delegate to others the responsibilities reposed in them. Third, trustees must not permit their own interests to conflict in any way with their duty to their beneficiaries.[15] The first of these duties, though arising out of equitable principles, has also been the subject of legislation in a number of jurisdictions, including Manitoba.[16] In respect of this duty, "[p]rudence is the essential quality expected of trustees; prudence in the selection of good investments, and prudence in ensuring that those investments are also suitable, given the particular trust terms and the interests of each of the trust beneficiaries."[17] Hence any issues regarding ethical investment which might arise in relation to this duty of care have already been dealt with above under the prudence rubric. The duty of non-delegation poses no unique difficulties in relation to ethical investment.[18] The chief implication then of the duty of loyalty is that trustees must not permit their own interests to conflict in any way with their duty to their beneficiaries.[19]

In Canada, the objects of the rule against conflicts of interest and duty include deterring trustees from allowing themselves to be placed in situations where their judgment, as trustees of a trust, is vulnerable to their own interests, and preventing them from profiting by virtue of their office.[20]

Given that the obviation of conflicts of interest and duty is fundamental to the duty of loyalty, the question arises: does the practice of ethical investment necessarily entail such conflicts? Certainly, it is possible to imagine situations wherein social investing might appear to involve conflicts of interest. This was clearly the major concern of Megarry V.-C. in the Mineworkers case where it was found that certain of the trustees had subverted their legal duty to the beneficiaries to the policy objectives of the organization which appointed them to their fiduciary positions. It is important to appreciate, however, that in many cases the conflicts that might arise are inherent in the nature of the trust itself. That is, some institutional trusts are characterized by a multiplicity of interests and thus difficult questions arise regarding how the duty of loyalty of the trustee may be discharged.

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[15] Waters, *supra* n. 6, at 696 *et seq*.

[16] *The Trustee Act*, C.C.S.M. c. T160, s. 75(a).

[17] Waters, *supra* n. 6, at 765.

[18] In any event, this duty has been significantly relaxed by the passage of legislation permitting the employment of agents "to transact any business or do any act required to be transacted or done in the execution of the trust": *The Trustee Act*, C.C.S.M. c. T160, s. 35(1).

[19] Waters, *supra* n. 6, at 32.

[20] See, *e.g.*, the discussion in Waters, *supra* n. 6, at 710-749.

Consider, for example, an investment decision which requires that a choice be made between "playing it safe" with the assets of an employee benefit fund or investing the fund so as to protect employment security. While young employees may support the use of plan assets to enhance job security by either bailing out failing employers or creating new job opportunities, older workers and retirees may prefer that plan assets be used in some other manner. In this case, the conflict of interests does not necessarily arise as between trustees and beneficiaries, but as between different subclasses of beneficiaries. Yet the duty of loyalty is essentially oriented towards preventing trustees from becoming involved in situations where their own interests conflict or threaten to conflict with their duty to the beneficiaries of a trust. In this context then, what does it mean to assert that it is the duty of trustees to act solely in the interests of the beneficiaries of the trust? Trustees, of course, also have a duty to act impartially or to "hold an even hand" as between different classes of beneficiaries.[21] This principle applies not only to their handling of original assets, but also in relation to the exercise of their powers of investment.[22] As Megarry V.-C. stated in *Cowan* v. *Scargill*:

> The starting point is the duty of trustees to exercise their powers in the best interests of the present and future beneficiaries of the trust, holding the scales impartially between different classes of beneficiaries.[23]

Considering again the case of modern pension trusts, these schemes are established for the mutual advantage of employer and employee, and not for the exclusive benefit of one or the other. Their respective interests will at times conflict with each other. For this reason, and notwithstanding the rule against conflicts of interest, it is common practice to appoint "representative" trustees who are apt to be keenly aware of the unique interests of the constituency they represent. Yet "representative" trustees invite at least the appearance of a conflict of interest and at worst the potential for actual conflict. The present law of trusts in Manitoba does not recognize "representative" trustees as distinct from any other trustees. Trustees are trustees for all their beneficiaries and their fiduciary duties and obligations to keep an even hand among beneficiaries disregard the origin of their appointment. As such, as in *Cowan* v. *Scargill*, the observation of ethical criteria based on the ethical objectives of some person or entity (in that case, the Union) other than the beneficiaries, or on the ethical objectives of one group of beneficiaries to the exclusion of the others in formulating investment policies, may constitute a breach of the duty of loyalty to all the beneficiaries.

3. The Best Interests of Trust Beneficiaries

We turn now to consider whether the definition that is given to "beneficiaries' interests" ultimately determines the extent to which it is legitimate for trustees to observe ethical criteria in making investment decisions. As we have seen, questions concerning the nature and scope of "the best interests of trust beneficiaries" arise in connection with both the duty of prudence and the duty of loyalty. Are these interests strictly financial in nature, or might they encompass non-pecuniary expectations as well? Are they short-term or long-term interests? Must they be satisfied directly, or can they be met indirectly? The problem of determining what is in the best interests of trust beneficiaries or, indeed, if relevant, what they might have wanted, is a difficult one.

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[21] Waters, *supra* n. 6, at 787 ff.

[22] Waters, *supra* n. 6, at 819. As Waters points out, "[p]rudence in investment, and the holding of an even hand between beneficiaries, are distinct duties, but they are interwoven in practice" (at 766).

[23] *Cowan* v. *Scargill*, [1985] Ch. 270 at 286-287.

(a) Strictly financial?

In *Cowan* v. *Scargill*, Megarry V.-C. held that, when the purpose of a trust is to provide financial benefits for the beneficiaries, "the best interests of the beneficiaries are normally their best financial interests."[24] However, as noted earlier, the Court implicitly acknowledged that, in some limited cases, the interest of beneficiaries in the investment decisions of their trustees may not merely be financial. A similar acknowledgement seems to have been made in *Harries* v. *Church Commissioners for England*.[25]

There are, in Manitoba, legislative provisions which give extended meaning to the term "benefit" where used in relation to trust beneficiaries. Manitoba's *Trustee Act*, for example, permits the court to approve variations of trusts if it is satisfied (a) that the variation appears to be for the benefit of each person on whose behalf the court may consent; and (b) that in all the circumstances the variation appears otherwise to be of a justifiable character.[26] Significantly, subsection 59(8) of the *Act* stipulates:

> . . . without limiting the generality of the word "benefit", an arrangement in respect of a trust is for the benefit of a person
>
> (a) if it would enhance the financial, social, moral or family wellbeing of that person; or
>
> (b) where the person on whose behalf the court is being asked to consent to the arrangement, is a corporation or association, if it would advance or further the purposes of the corporation or association; or
>
> (c) where the persons on whose behalf the court is being asked to consent to the arrangement are persons who might derive some benefit from benefits used for a specified purpose, if it would advance or further that purpose.[27]

Obviously, a great deal must depend on the express terms of the instrument creating the trust and on the true purpose of the trust. Where it is clear from such instrument that the object of the trust is to provide financial benefits to the beneficiaries, the American and English authorities suggest that financial criteria must be paramount in the exercise by trustees of their investment discretion. However, as the *Harries* case demonstrates, this does not mean that financial criteria need be the *only* factors considered by the trustees. Clearly, in such instances where the application of ethical criteria does not diminish the financial return to the beneficiaries, there is no apparent reason why the trustees should be liable for considering ethical criteria in making their investment selections, provided they otherwise keep an even hand among beneficiaries. The issue seems less clear, however, where the application of such ethical or non-financial criteria would produce a lower financial return to the beneficiaries. The law seems to point in contradictory directions. On the one hand, it seems clear that, subject to express terms to the contrary, the maximization of financial returns must be the trustee's paramount objective. At the same time, the *Harries* case seems to recognize that ethical criteria, at least to some unstated extent, may be considered. It would seem that these two positions can be bridged only by the proviso that the consideration of ethical criteria may not result in a lowered financial return. Yet such a proviso is surely incompatible with the basic principle of trust law that the prudence of a trustee's actions is to be determined as of the time they were taken, and not with the benefit of hindsight.

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[24] *Id.*, at 287.

[25] *Harries* v. *Church Commissioners for England*, [1991] T.L.R. 478 (Ch. D.).

[26] *The Trustee Act*, C.C.S.M. c. T160, s. 59(7).

[27] *The Trustee Act*, C.C.S.M. c. T160, s. 59(8).

(b) Short-term or long-term interests?

In *Blankenship* v. *Boyle*, although the Court found that the trustees in question had breached their fiduciary duties in both failing to invest certain monies that were available to generate income for the trust beneficiaries and investing other monies for the collateral purpose of benefiting the Union, in awarding relief, Gesell J. found:

> . . . that while the beneficiaries have suffered as a result of the Fund's loss of investment income, they have benefited to some extent from the Union's activities over the past twenty years. In the longer view of matters, the Union's strength protects the interests of the beneficiaries, past and prospective; . . . .[28]

Similarly, in *Withers* v. *Teachers' Retirement System of the City of New York*, the Court clearly rejected the contention of the plaintiffs that the trustees' paramount obligation was to safeguard the immediate or short-term interests of retirees, noting that such a course of action would have violated their fiduciary obligation to "hold an even hand" as between different classes of beneficiaries.

> Their obligation, plainly, was to manage the fund so as to enable it to meet its obligations not only to current retirees, but also to those scheduled to retire in the future, whose pension and annuity rights would have been similarly earned over their years of active service and to whom the fund therefore had a legal responsibility.[29]

Although neither of these cases involved questions of ethical investment *per se*, they provide some suggestion to the effect that "benefit" may be given a broad meaning which can be measured over a long term.[30]

On the other hand, in *Cowan* v. *Scargill*, the concerns expressed regarding the long-term prosperity of the mining industry were disregarded by Megarry V.-C. because he viewed the pension trust in question as having been fully funded. He wrote:

> . . . it must be remembered that very many of the beneficiaries will not in any way be directly affected by the prosperity of the mining industry or the union. Miners who have retired, and the widows and children of deceased miners, will continue to receive their benefits from the fund even if the mining industry shrinks: for the scheme is fully funded, and the fund does not depend on further contributions to it being made. If the board fell on hard times, it might be unable to continue its voluntary payments to meet cost-of-living increases . . . . The impact of that remote possibility falls far short of the imminent disaster facing the City of New York and T.R.S. in the *Withers* case . . . and I cannot regard any policy designed to ensure the general prosperity of coal mining as being a policy which is directed to obtaining the best possible results for the beneficiaries, most of whom are no longer engaged in the industry, and some of whom never were. The connection is far too remote and insubstantial.[31]

(c) Direct or indirect benefits?

Assuming that the purpose of a trust is to provide financial or material benefits, must these benefits always be realized directly or is it possible to convey something of equivalent value to the beneficiaries of a trust indirectly? For example, can a pension trust be used not only to

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[28]*Blankenship* v. *Boyle*, 329 F. Supp. 1089 at 1112 (D.D.C. 1971).

[29]*Withers* v. *Teachers' Retirement System of the City of New York*, 447 F. Supp. 1248 at 1257-1258 (S.D.N.Y. 1978).

[30]That this is particularly the case in relation to co-operative undertakings, which more readily present occasions to engage in forms of social investing, was acknowledged by Brightman J. in *Evans* v. *London Co-operative Society Ltd.*, reproduced in R. Ellison, *Private Occupational Pension Schemes*, vol. 1 (1979) App. III, 364-365.

[31]*Cowan* v. *Scargill*, *supra* n. 23, at 292.

secure pension benefits for retired workers in the form of direct periodic payments, but also to reduce their expenses during their retirement years? For instance:

> . . . an employee pension fund could supply capital to build low-cost housing for the elderly in a community where its beneficiaries reside. Investment in housing to be used in substantial part by the plan participants and their beneficiaries would appear to satisfy the "solely in the interest" standard and would be permissible if it met the prudence test.[32]

The Court in *Blankenship* v. *Boyle* saw fit to mitigate the relief it awarded upon finding several breaches of fiduciary duty because it acknowledged that the trust beneficiaries had indirectly benefited from the Union's activity over the years.[33] Similarly, in *Withers* v. *Teachers' Retirement System of the City of New York*, the Court recognized that, by investing trust assets in the bonds of an entity that was threatened by bankruptcy, the trustees were indirectly benefiting both the trust and its beneficiaries insofar as the entity in question was the major and indispensable contributor of monies to the trust.[34] However, in these cases the recognition of indirect benefits was more implicit than explicit. In *Donovan* v. *Walton*, however, the Court expressly asserted that indirect benefits may be parallel to and inseparable from the more direct benefits derived from a trust.[35] Although the issue of indirect benefits was not specifically addressed in *Cowan* v. *Scargill*, the Court stated that "'benefit' is a word with a very wide meaning, and there are circumstances in which arrangements which work to the financial disadvantage of a beneficiary may yet be for his benefit . . . ."[36]

Thus, while there are some circumstances in which the law recognizes that the interests of beneficiaries may be non-financial as well as financial, long-term as well as short term, and indirect as well as direct, there is no legal basis for concluding that trustees may, absent express authority in the instrument creating the trust, give predominance to ethical, philanthropic, social, political or other non-financial considerations at the financial expense of the beneficiaries. Hence under the "best interests" rubric of the fiduciary principle, while there may be no intrinsic incompatibility between a trustee's duty of loyalty to his or her beneficiaries and the observation of ethical criteria in formulating investment policies, any conflict in fact between these must be measured in the context of the terms, nature and objects of the trust.

C. CONCLUSIONS AND RECOMMENDATION

As we have indicated in the preceding Chapters, the recent proliferation of large multi-beneficiary pooled pension and other common trust funds and of ethical investment funds has intensified the debate over the proper role of non-financial criteria in the exercise by trustees of their investment discretion. No problem arises where the trust document expressly permits - or prohibits - the use of such criteria. There is no legal impediment to a settlor, testator or person establishing a mutual, pooled, pension or other trust fund expressly stipulating the scope within which trustees may properly consider non-financial or ethical criteria in the development of their investment policy and exercise of their investment discretion. Indeed, this is precisely what has occurred in recent years in the establishment of ethical investment funds; there are numerous trusts in existence which circumscribe the investment powers of trustees with reference to other than strictly financial criteria.

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[32] J.D. Hutchinson and C.G. Cole, "Legal Standards Governing Investment of Pension Assets for Social and Political Goals" (1980), 128 U. Pa. L. Rev. 1340 at 1368.

[33] *Blankenship* v. *Boyle*, *supra* n. 28, at 1112.

[34] *Withers* v. *Teachers' Retirement System of the City of New York*, *supra* n. 29, at 1256.

[35] *Donovan* v. *Walton*, 609 F. Supp. 1221 at 1245 (S.D. Fla. 1985).

[36] *Cowan* v. *Scargill*, *supra* n. 23, at 288.

However, the problem is acute where the trust document is silent and the trustee or some of the beneficiaries wish to use such criteria. In such a situation, it is essentially unclear whether a trustee commits a breach of trust by taking into consideration, either to a major or a minor extent, ethical or other non-financial criteria in formulating investment policy. The jurisprudence in other jurisdictions in which the issue has arisen demonstrates that the matter involves complex questions relating to the nature, objects and express terms of the trust, the "benefit" of the beneficiaries, the relationship between financial and non-financial criteria and many others. The American and English authorities represent a broad diversity of fact situations and it is very difficult to synthesize in one or two legal propositions the combined effect of the cases. At best, it can be said that the various cases all seem to represent an attempt by the courts to balance the need to protect the financial interests of beneficiaries with the realization that, in appropriate circumstances, those interests are not all-encompassing. Thus, *Cowan* v. *Scargill* confirms the predominance of financial criteria in trusts established for the provision of financial benefits and appears to be essentially unsympathetic to the use of ethical criteria; at the same time though, it recognizes that, even in a trust for the financial benefit of beneficiaries, "'[b]enefit' is a word with a very wide meaning, and there are circumstances in which arrangements which work to the financial disadvantage of a beneficiary may yet be for his benefit. . . ."[37] *Harries* v. *Church Commissioners for England*[38] asserts that, in the absence of express words to the contrary, any trust which seeks to earn income is one for the provision of financial benefits, but also accepts that other, non-financial objectives may be relevant to the trust. The American cases which recognize a role for the consideration by trustees of non-financial criteria also accept the proposition that financial criteria must predominate. However, the balance which these cases seek to achieve is not often articulated clearly (or at all), so that they provide little guidance beyond their specific facts. Furthermore, the fact remains that no Canadian court has as yet had occasion to consider the matter. Neither *The Trustee Act* nor the general law of trusts prevailing in Manitoba addresses this issue directly. Accordingly, the question of whether ethical criteria may be observed when investing trust funds - let alone the extent to which they may be observed - must be regarded as being unsettled in Canadian law.

Unfortunately, the avenues available under Manitoba trust law for clarifying this issue are unsatisfactory. Applying for the opinion, advice or direction of the Court of Queen's Bench pursuant to section 84 of *The Trustee Act*[39] is a possible avenue of recourse. This option, however, would invite significant costs and delay. Moreover, since it can only be undertaken in relation to individual trusts and specific investment decisions, neither the general ambiguity in the law nor the questions of policy involved in the practice of ethical investment would necessarily be resolved.

These observations apply with equal force to a further possibility examined by the Commission, namely, that of applying for a variation of trust pursuant to section 59 of *The Trustee Act*.[40] We note also that, in many instances, it would be virtually impossible to satisfy the requirement of identifying, locating and securing the consent in writing of all persons who are beneficially interested under a trust before presenting a proposed variation to the court for approval.[41]

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[37]*Cowan* v. *Scargill*, *supra* n. 23, at 288.

[38]*Harries* v. *Church Commissioners for England*, *supra* n. 25.

[39]*The Trustee Act*, C.C.S.M. c. T160, s. 84.

[40]*The Trustee Act*, C.C.S.M. c. T160, s. 59.

[41]*The Trustee Act*, C.C.S.M. c. T160, s. 59(6), stipulates: "Before a proposed arrangement is approved by the court, it must have the consent in writing of all persons who are beneficially interested under the trust and who are capable of consenting thereto."

In our view, the uncertainty which attends the issue of ethical investment is undesirable from a policy point of view and should be addressed. This is especially so having regard to the very significant sums of money currently invested in trusteed funds, the legitimate concerns of trustees and beneficiaries respecting the use of these funds and the obvious desire of many people in society to apply ethical standards to investment decisions, as evidenced by the proliferation of ethical investment funds in Canada. Trustees are entitled to a measure of certainty in the law which governs - and potentially penalizes - their conduct and should not have to rely on the subterfuge suggested by Megarry V.-C.[42]

We acknowledge that, in trust instruments for the provision of financial benefits to beneficiaries, absent any express direction from the person creating the trust as to the non-financial criteria to which the trustees may properly have regard in exercising investment discretion, the securing of a reasonable financial return is and should remain the predominant consideration. The security and preservation of the trust capital and the procurement of a reasonable financial return are in the very nature of a trust to provide financial benefits; in order to continue to provide for the financial well-being of the beneficiaries without eroding the trust capital, the trust must necessarily earn a reasonable return. It is consistent with the presumed intent of the settlor or testator to attribute a position of pre-eminence to the objective of securing a reasonable financial return. After all, a settlor or testator having a different intent is free to express it in the trust document and would surely do so.

However, we also recognize that there may be circumstances where it would be appropriate to include ethical or other non-financial considerations as additional (but subordinate) factors. For example, some trusts may reasonably be said to encompass objectives which go beyond the predominant goal of securing a reasonable financial return. This explains the Court's acceptance of limited ethical investment guidelines in *Harries* v. *Church Commissioners for England*; the ethical criteria served one of the objectives of the trust (the promotion of the Christian faith) without materially detracting from the trust's primary objective (the maximization of financial return).[43] An investment policy which respected the reasonable and firmly held moral precepts of a trust's beneficiaries may well be justified, so long as such a policy would not imprudently imperil the financial returns to the trust; this was clearly contemplated by Megarry V.-C. in *Cowan* v. *Scargill* when he spoke of adults with strict views on such matters as "alcohol, tobacco and popular entertainment".[44] It may even be appropriate to have regard to criteria relating to widely-held societal values in fields such as human rights and clean environment; a trustee who chooses not to invest the trust's assets in enterprises notorious for dangerous products or discriminatory hiring practices should surely not be held guilty for a breach of trust for such a policy if he or she has nonetheless ensured a sufficiently wide range of alternative investments to produce a reasonable financial return.

We do not suggest that a trustee should ever be permitted to invest based solely on his or her personal views of what is "ethical" or as to what other non-financial criteria should be taken into account. The trustee must always try to be guided by what would be objectively considered to be appropriate non-financial criteria. Nor do we suggest that a trustee should have unlimited discretion to consider non-financial criteria; such criteria must remain subordinate to the primary objective of the trust, a reasonable financial return. However, in our view, a trustee of a trust for financial benefits who keeps paramount the need to provide a safe and reasonable return on investments, but who honestly and reasonably considers non-financial criteria in the formulation

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[42]Rt. Hon. Sir R. Megarry, "Investing Pension Funds: The Mineworkers Case" in T.G. Youdan, ed., *Equity, Fiduciaries and Trusts* (1989) 149 at 158, discussed *supra* Ch. 4 at 29.

[43]See also *Donovan* v. *Walton* in which investments which benefited the union pension fund as a whole, and in the long term, also benefited the union itself and its members: *Donovan* v. *Walton*, 609 F. Supp. 1221 (S.D. Fla. 1985), aff'd (*sub nom. Brock* v. *Walton*) 794 F.2d 586 (11th Cir. 1986), rehearing *en banc* denied without opinion, 802 F.2d 1399 (11th Cir. 1986).

[44]*Cowan* v. *Scargill*, *supra* n. 23 at 288.

of investment policy should not be penalized for doing so. It would not be just to assign blameworthiness to a trustee who, while acting prudently and promoting the paramountcy of financial return, reasonably and in good faith seeks to benefit additional objectives of the trust, seeks to respect the moral precepts of the beneficiaries or is guided by widely held societal values. In all cases, it is a question of prudence. The law should make it clear that the consideration of non-financial criteria is not imprudent or improper *per se*, so long as it does not displace the primary obligation of maximizing the financial benefit to the trust. In our view, *The Trustee Act* should be amended to dispel the suggestion that the use of non-financial criteria in investment policy is necessarily proscribed. The balance to be achieved should be the creation of a defined scope for the proper consideration of non-financial criteria, on the one hand, with the fundamental need to protect the financial integrity of a trust for financial benefits, on the other hand.

RECOMMENDATION

The following section should be added to The Trustee Act immediately after section 79:

> ***Non-financial criteria***
> ***79.1 Subject to any express provision in the instrument creating the trust, a trustee who uses any non-financial criterion to formulate an investment policy or to make an investment decision does not thereby commit a breach of trust if, in relation to that investment policy or investment decision, the trustee also exercises the judgment and care that a person of prudence, discretion and intelligence would exercise in administering the property of others.***

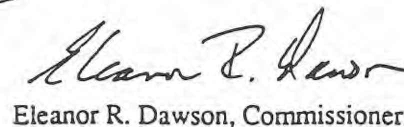
In our view, this is a moderate legislative amendment which should alleviate the uncertainty which presently prevails while leaving place for further reform as the law in this field continues to develop.

This is a Report pursuant to section 15 of *The Law Reform Commission Act*, C.C.S.M. c. L95, signed this 25th day of January 1993.

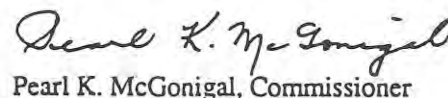
Clifford H.C. Edwards, President

John C. Irvine, Commissioner

Gerald O. Jewers, Commissioner



Eleanor R. Dawson, Commissioner



Pearl K. McGonigal, Commissioner

REPORT ON ETHICAL INVESTMENTS

EXECUTIVE SUMMARY

EXECUTIVE SUMMARY

The Manitoba Law Reform Commission's Report on *Ethical Investments* proposes that, in the absence of direction from the trust instrument, a trustee should be allowed to consider non-financial criteria when formulating investment policy or when making an investment decision, provided that the trustee always meets the usual standard of prudence that is expected of trustees.

BACKGROUND

It has become increasingly common in recent years for some investors to consider non-financial or "ethical" criteria while making their investment decisions. Such criteria are often of a social, religious, environmental, political or other philosophical nature. These investors may not want their money to be used to advance purposes with which they disagree philosophically or, alternatively, they may see investment as a tool to implement a specific purpose which they wish to promote. In either case, they may even accept a lesser financial return on their investment for the opportunity of putting their principles into action.

"Ethical investment" can pose problems in a trust situation. For example, where a trustee administers a large multi-beneficiary trust (such as a pension plan), there is unlikely ever to be unanimity among the beneficiaries concerning the type of "ethical" criteria the trustee should use while investing. Also, where beneficiaries are indifferent to the use of non-financial criteria, should there be any scope for a trustee's personal convictions to guide investment policy?

THE CURRENT LAW

The legal standard of prudence that a trustee must maintain while investing has historically been judged by the law of trusts using only financial criteria such as profitability, degree of capital appreciation, security of the investment, and minimization of tax consequences.

Neither the general law of trusts prevailing in Manitoba nor our *Trustee Act* clarifies the extent, if any, to which non-financial criteria may be used by a trustee where the trust instrument is silent on this issue. No Canadian court has ever directly considered this issue, which therefore must be considered as being unsettled in our law. (Of course, if a trust instrument explicitly authorizes the use of non-financial criteria, its terms will govern.)

It is clear from case law in other jurisdictions, however, that this issue involves complex questions relating to the nature, objects and express terms of the individual trust, the nature of the concept of "benefit", the relationship between financial and non-financial criteria, and so on. It is also clear from foreign case law that, even where a court recognizes a role for "ethical" criteria, financial criteria nevertheless remain predominant.

RATIONALE FOR REFORM

The Manitoba Law Reform Commission believes that continued uncertainty in this area is undesirable because of the increasingly significant sums of money invested in trusteed funds and the equally increasing and legitimate concerns of both trustees and beneficiaries concerning the investment use of these funds. The proliferation of ethical investment funds in Canada highlights the growing general concern with issues of this nature.

RECOMMENDATION

The Manitoba Law Reform Commission recommends a legislative amendment to *The Trustee Act* that will balance recognition of the use of non-financial criteria with restraints to prevent unreasonable financial detriment. Where a trust instrument is silent concerning the use of non-financial criteria, its trustee should not be under a legal disability to consider non-financial criteria, provided that the predominant goal remains the securing of a reasonable financial return. A trustee who uses non-financial criteria should continue to be obliged to meet the usual standard of prudence.

This moderate approach is designed to remove the present uncertainty while preserving the primary obligation to maximize financial benefit to the trust.