LAW REFORM COMMISSION

COMMISSION DE RÉFORME DU DROIT

REPORT

ON

INVESTMENT PROVISIONS UNDER "*THE TRUSTEE ACT*"

February 12, 1982

Report #50

MG-3750

The Manitoba Law Reform Commission was established by "*The Law Reform Commission Act*" in 1970 and began functioning in 1971.

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CHANGE COMPELS US TO THINK AGAIN ABOUT OUR RULES.

Lord Denning M.R.

Schorsch Meier Gmbh v. Hennin,
[1975] 1 All E.R., 152 at 155

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I. HISTORICAL INTRODUCTION

The purpose of this Report is to examine whether or not section 70 subsection (2) of *"The Trustee Act"* is in need of reform. The Commission has undertaken this project pursuant to clause 6(1)(b) of its governing legislation on reference from a Commissioner and a private individual. Subsection 70(2) of *"The Trustee Act"* deals with the investment powers of the trustee, but it is very important to stress that the provisions of section 70 subsection (2) only become effective if they do not conflict with the trust-creating document.[1] It is also very important to stress that it is possible, and very easy, for the settlor to give more liberal powers to the trustee or to direct that the trustee's powers be more restrictive. Thus section 70 subsection (2) applies to those trusts where the settlor, by choice or omission, has not fully stated those investment powers that he wishes the trustee to possess. Section 70 subsection (2) also applies to those trusts which arise through operation of law, as well the investment provisions are referred to by reference 23 times in the Statutes of Manitoba. The Commission feels that these provisions are outside its terms of reference and makes no recommendations with respect to them. For convenience they are set out in Appendix A.

The Commission has heard representations that one of the most important questions to be dealt with when constructing a trust is that of the trustee's investment powers. The Commission does not recommend, nor does it wish any part of this Report to be interpreted as recommending, that any of the powers presently possessed by the settlor in structuring investment powers for the trustee be curtailed. Where the settlor makes a decision and states it clearly in the trust-creating document, those wishes ought to be observed as they are at present. This Report deals with the situation where those wishes are not apparent.

The present approach of section 70 subsection (2) of *"The Trustee Act"* is to prescribe an enumerated list of permitted investments. This is sometimes called the legal list approach. To understand the *raison d'être* of the legal list approach a brief historical digression is required.[2] The following historical background, of necessity, begins in England, as does much of our law, and then moves to Canada. In the 17th century there were no statutory limitations on the investment powers of trustees and few judicial ones. Much of the subject matter of trusts was land. With the beginnings of colonization and interests in previously unknown parts of the world commerce began to grow. With the growth of commerce it became more and more common for the corpus of the trust to be money and not land. By the mid-18th century commerce was booming and there was an air of optimism with respect to investments. The mid-18th century saw the "Burst of the South Sea Bubble". Briefly the South Sea Company, like the East India Company and the Hudson's Bay Company was founded to explore areas of the new world. Many people invested large sums of both private and trust funds in the venture. Unfortunately the South Sea Company was not to have the success of either the East India Company or the Hudson's Bay Company. Without warning the company went bankrupt. The effect of this bankruptcy was similar to that of the fall of Wall Street in 1929.

It must be borne in mind that 200 years ago the sale of stocks and debentures was not subject to the degree of legislative control as is seen in the various Securities Acts of the second half of the 20th century. The whole concept of trusts had been created by the Court of Chancery and as a result of this unprecedented disaster the Court of

Chancery was quick to react. Judicial thinking moved to the position that stocks are essentially speculative and that a trustee ought not to speculate with trust funds. It was also at about this time that government stocks, ie. loans to the government secured by government revenues, were created. England was already showing the signs of the coming empire and government stock was an attractive non-speculative investment. The Court of Chancery was quick to invest funds under its control in government stocks and to direct other trustees to do the same. It must be remembered that during this period of time inflation was an almost unheard of phenomenon. Pound sterling was the epitome of stability. Dr. D.W.M. Waters has described 3% consols of this time as being more fundamental to English society than the *Book of Genesis*. 3% consols did indeed accomplish all of the requirements of a trust investment; this was a stable investment, it yielded an adequate income for the life tenant and it preserved the corpus for the remainderman.

1859 saw the first trust investment legislation.[3] The Act prescribed a list of permitted investments which became known as the legal list. The actual items in the list were to change over the decades as the list was gradually expanded but the basic concept remained the same, the investments were either backed by the British government or were in a company that had become as much an institution as the government itself. In the mid-19th century Canada had neither the commerce nor the capital that was present in England. Most Canadian trustees invested in 3% first mortgages. Shortly after the legislation in England, Canadian jurisdictions enacted legislation of their own.[4] The Canadian legislation was largely a reflection of the Imperial Statute, and for the next several decades Canadian legislation followed the legal list that the Imperial Parliament prescribed from time to time. Although the lists changed, the changes were

not to alter the character or the concept of the legal list. The legal list was still safe, reliable and was thought to protect both the income and the capital from risk.

If the concept of the legal list remained unchanged the real world did not. In the space of 40 years the world saw a world war, a stock market crash, a great depression, another world war and unprecedented inflation. The post-war era bore almost no resemblance to the Victorian era but the legal list remained largely the same. Even conservative lawyers began to sense the "winds of change". In 1951 the Uniformity Commissioners took up the question. Six years of study and discussion resulted in the model list of 1957. This list allowed preferred stocks but no common stocks. In the early sixties many provinces enacted new lists which included both common and preferred stocks.

In the mid-sixties the Uniformity Commissioners took up the question again. After several years of study and debate, the Uniform Law Conference of Canada concluded that a piecemeal revision of the legal list was not the answer and that what was required was a new approach. In 1970, the Uniform Law Conference of Canada recommended the "prudent man rule". The theory behind the rule is that a trustee may make those investments that he wishes so long as he exercises discretion and prudence. To date this approach has been followed by three Canadian jurisdictions: New Brunswick, the Northwest Territories and the Yukon Territory.[5]

The American experience has been somewhat different. Most jurisdictions at one time had a legal list which was prescribed either by legislation or by the courts but the State of Massachusetts has never had a legal list. The

Massachusetts courts pioneered the prudent man rule in 1830. In the 1940s and the early 1950s a great debate was flourishing in the United States among law reformers with respect to the relative merits of the two different approaches. By the mid-1950s approximately half of the American jurisdictions had gone to the prudent man rule and by 1981 the figure had grown to approximately 80%. At the present the debate in the United States has progressed even further. There is no one in the legal or professional literature who is advocating the return of the legal list concept, but many scholars and practitioners are advocating an even more flexible approach than is possible under the prudent man rule.

II. THE PRUDENT MAN

There are two basic ways for a legislature to approach the question of restrictions on trustee investments. One approach is to provide a list and the other approach is not to provide a list but a general criterion. A list, be it a wide list or a narrow list, is static in its conception. It requires legislative amendment to be changed. Often the legislature has more pressing problems to deal with. This delay can cause hardship. The Commission heard from representatives of the insurance industry whose investments are governed by federal legislation which provides a list.[6] It was stated that waiting for amendments to the list can be very frustrating. A provision for a mandatory decennial revision as is provided in the *Bank Act* goes a long way to alleviate the problem but it does not eliminate the concept.[7] Moreover there is a strong argument that even decennial revision can be inadequate in view of how quickly the market place can change. For example, less than ten years ago no one realistically considered the possibility of an oil and gasoline crisis, or of double digit inflation, or of interest rates of 20%.

Proponents of the legal list approach say that the legal list is there for a purpose; it is there to prevent the trustee from risking the capital. The capital ought not to be at hazard; it ought to be preserved. This is a universal cry and one which is correct; however it is not complete. Most trusts have two objectives and preserving the capital is only one of them; the second objective is to generate an income. These two objectives are more often than not in conflict and it is the duty of the trustee to strike a balance between the two of them.

Does the legal list accomplish this two-fold purpose? In 1870 England, which had seen no inflation for three centuries and where a 3% return on capital provided a generous living allowance, the legal list was a perfect tool for the trustee to use. Alas, today the world is far more complicated. Investors who wish to strike a fair balance between preservation *of capital and suitable income must be flexible, sophisticated* and aggressive. The Commission heard representations from charities, whose incomes are derived from trust investments, to the effect that the legal list is nothing more than a millstone about their necks. The charities have stated that because of the restrictions in the legal list they are prevented from achieving a realistic investment portfolio and as such the income is very much less than it could be. These are people who would like to be able to hire professional investment counsellors and to pursue a realistic investment policy. Not only does the legal list not assist or guide them, it is a positive hindrance.

The Commission also heard representations from professional trustees. They informed the Commission that they preferred the flexibility of the prudent man rule and that whenever they were consulted before the creation of a trust, they would suggest that the investment powers be the prudent man rule and not the legal list. When questioned as to why they preferred this position, they indicated that because all trusts are different, each must be approached individually and the extra flexibility of the prudent man rule allowed the trustees better to achieve the objectives of the trust.

It must also be remembered that the market place is dynamic. This being the case, trust management is an active enterprise. As the market changes, the trustee ought

to be able to change the investment strategy of the trust and to do this requires flexibility.

As well the concept that bonds represent stability whereas the stock market represents speculation is no longer the case. While this might have been the case in the 17th century or even the first half of the 20th century, the sophisticated securities legislation that is present in virtually all common law jurisdictions ensures a more stable market. Moreover, bonds have performed very poorly in the last decade, showing great fluctuations.[8]

The clear message that the Commission received from the professional trustees was that the best and safest way both to preserve the capital and generate an income is to have a good mix of bonds and stocks. What constitutes a good mix changes from time to time to reflect the change in the market. Being tied to a legal list is only a hindrance; it does not necessarily add to income or protect capital nor does it provide useful guidance to the trustee.

The Commission also noted that support for the legal list position seemed to be founded to a large extent on two misconceptions. The first misconception is that if a trustee follows the legal list he will be immune from being sued. The second misconception is that if there is a prudent man rule, every time the trustee makes a bad investment, he will have to make good the loss. Neither proposition can be supported in law. At this point the law will be canvassed in some detail to support the above statement.

Dealing first with the question of immunity. Section 70(2) of "*The Trustee Act*" commences by saying

". . . if the investment is in all other respects reasonable and proper. . . ". These words are a clear indication that the Legislature never intended to provide immunity to the trustee who merely followed the legal list; the trustee must still exercise reasonable care. Most academics agree with this position and as well there is case law to support it. The classic case on point is that of *In Re Whiteley*. This case received extensive treatment in both the Court of Appeal, reported at (1886) 33 Ch. D., 347, and the House of Lords, reported (1887), 12 App. Cas., 727. There are many valuable principles in both judgments but perhaps the most succinct statement of the law, and one which we could find no evidence of ever being overruled, was stated by Lord Justice Lopes in the Court of Appeal:

> The duty of a trustee in investing the money of his *cestuis que trust* may be thus defined. He must choose those investments only which are within the terms of his trust. In the selection of investments within the terms of his trust he must use the care and caution which an ordinary man of business, regardful of the pecuniary interests of the future of those having claims upon him would exercise in the management of his own property.

It is very clear from the above statement that merely staying within the prescribed list of investments, be it a legal list or a list in the trust-creating document, will not in and of itself be a defence to a suit brought by the beneficiaries.

Further examples of the above proposition can be found in two modern Canadian cases:

> *Re Meakes*, [1968] 2 O.R., 637 (York County Surrogate Court)
>
> This was a trust created by a will. The trustee was empowered to invest in such securities as were authorized by the *Canadian and British Insurance Companies Act*. The trustee invested

in a first mortgage which was an authorized investment. The court held that even though the investment was authorized, it was not appropriate bearing in mind the needs of the beneficiaries. The trustee was ordered to reimburse the money invested in the mortgage.

Fales, et al. v. Canada Permanent Trust Company, [1976] 6 W.W.R., 10 (S.C.C.)

This trust was created by a will. The bulk of the estate consisted of shares in B Company for which there was a very limited market. The trustees were given the power to deal with the shares as if the testator were still living. The trustees sold the shares to I Company in return for cash, promissory notes and shares in I Company. The shares in I Company were speculative but there was a ready market for them on the stock exchange. A few years later I Company went bankrupt and the trust still owned these shares. The court held that the purchase of I Company shares was proper even thought it was speculative as there was no other way to dispose of B Company shares but that once this was done the I Company shares for which there was a market ought to have been sold and the trustee was responsible, and therefore liable for not doing so.

Those with a contrary view will reply that the legal list is still safer because there is less chance of the trustee making a mistake. This is not necessarily so. An incompetent trustee is an incompetent trustee and remains so regardless of what legislation prevails in his jurisdiction. The original purpose of the legal list was to protect the beneficiaries of the trust, not the incompetent trustee.

What then of the second argument that if a prudent man rule is used a trustee will be sued for every bad investment. This misconception arises from a misunderstanding of the prudent man rule. The prudent man rule is not a rule of result, it is a rule of conduct. The trustee is not expected to be

omniscient but is expected to make his decisions in a sound business-like manner. Below are six examples, all of which are good law in Manitoba, which indicate that a trustee is not expected to be omniscient and can make an honest mistake:

Smith v. Smith (1876), 23 Gr. 114 (Ont. C.A.)

In this case the trustees were given broad discretion to invest the money as they saw fit for the best advantage of the grandchildren of the settlor. The trust arose from a will. The corpus of the estate was both lands and monies. Among other things the trustees invested in 40 acres of land on which they constructed a house for the settlor's grandchildren and their parents to live in. The trustees also invested in several acres of land adjacent to a piece of land that was owned by the trust. Over the course of time there were great economic setbacks and the value of the land was greatly deflated. One of the beneficiaries brought suit against the trustees. The Court of Appeal held that the buying of the land to build the house wherein the beneficiaries of the trust could live, bearing in mind also that their parents were in impecunious circumstances, was a valid and prudent investment. The court further held that the buying of the land adjacent to the land already owned was bought to preserve water rights to the land that was already owned and as such was also a prudent investment. That there was a great period of deflation which no one could foresee at the time of the purchases was not to make the trustees liable for the losses as they had exercised their discretion as sound men of business.

In Re Johnson (1886), W.N. 71 (C.A.)

This trust arose from a will and the testatrix left among other things 200 L5 shares on which 10s. had been paid in a certain company. The testatrix also gave the trustees very broad powers of investment. The trustees held on to the shares and eventually as the calls were made paid the full value for the shares from other monies in the trust. After a period of time the company began to perform poorly and eventually went bankrupt. The bankruptcy

resulted in a loss to the estate of L600. One of the beneficiaries brought suit against the trustee. The Court of Appeal unanimously held that what happened was ". . . a reasonable exercise of discretion on the part of the executor, who appeared to have retained the shares not as a matter of speculation, but because he thought that in a few years' time, when the daughters of the testatrix on attaining their majority would be entitled to have the shares handed over to them, the price would rise. The Court ought not, therefore, to hold this executor liable for the loss when he had apparently exercised his discretion in the matter for the best, though in the result what he had done had turned out unfortunately for the estate.".

In Re Smith, [1896] 1 Ch., 71

In this trust, arising from a will, the settlor gave his trustees discretion to invest in such stocks as they should think fit. Two trustees managed the estate. Both trustees decided to invest L3,000 in a certain company. One trustee had taken a kickback of L300 to make this investment, the other trustee was motivated to make the investment on an honest assessment of the company's performance. The company went bankrupt. The beneficiaries brought suit against the trustees. It was held by Lord Justice Kekewich that the suit ought only to succeed as against the trustee who took the kickback. The other trustee made an honest business investment and the fact that it was not successful ought not to be held against him. His Lordship went on to say that merely because the investment was a floating security it did not make the investment imprudent. Indeed ". . . it is familiar to us all that there is a class of men, who are prudent but not very cautious, who do invest money in such debentures and regard them as good security.".

In Re Chapman, [1886] 2 Ch. 763 (C.A.)

Under the terms of a will the trustees were authorized to invest money in first mortgages. Accordingly the trustees invested in long term first mortgages in the County of Norfolk. Over the succeeding years there was an unprecedented depreciation in land values in the Norfolk area.

The result was that many of the mortgages were foreclosed and there was a great loss to the estate. The beneficiaries sued the trustees. First mortgages had always been regarded as a very safe investment and this case was a major precedent. Indeed one of the law Lords stated that this case was one of the most important that had been before the court for years. The Court of Appeal held that the trustees were not liable for the loss because the great depression in land values could not be foreseen. Lord Justice Lindley stated "there is no rule of law which compels the court to hold that an honest trustee is liable to make good loss sustained by retaining an unauthorized security in a falling market, if he did so honestly and prudently, in the belief that it was the best course to take in the interest of all parties. Trustees acting honestly, with ordinary prudence and within the limits of their trusts, are not liable for mere errors of judgment." Lord Justice Lopes stated "it is very easy to be wise after the event; but in order to exercise a fair judgment with regard to the conduct of trustees at a particular time, we must place ourselves in the position they occupied at that time, and determine for ourselves what, having regard to the opinion prevalent at that time, would have been considered the prudent course for them to have adopted."

Re Banghan, [1933] O.W.N. 785 (Ont. C.A.)

In this case the trustee was authorized to invest in first mortgages which he did very heavily. Owing to the great depression the price of real estate fell drastically and the trust lost a large sum of money. The beneficiary sued the trustee, Mr. Fry. The Court of Appeal unanimously held that the trustee was not liable stating: "the fact that these mortgages have been foreclosed shows that Fry may have made a mistake. But the appellants must do more than this, they must show a lack of prudence. All considered, it cannot be said that they have done so. The evidence is that the collapse of real property values in the Border Cities was such as no man could reasonably have foreseen."

Ch'ng Joo Puan Neoh et al v. Khoo Tek Keong, [1934] 3 W.W.R. 737, (P.C.)

By will the trustee was given very wide powers of investment. The trustee invested a portion of the estate in personal loans bearing interest and being secured by the deposit of jewellery with the trustee. The estate lost money. The beneficiary sued. Their Lordships held that the suit could not succeed stating "they were loans made upon security of property and carrying interest; they were accordingly 'investments' within the meaning of Clause 11 of the will."

It is respectfully submitted that the above cases, spanning some 60 years and three jurisdictions, speak for themselves. It is clear from the above cases that the courts consider the prudent man rule as a rule of conduct and not a rule of result and that the courts do not consider a trustee to be a guarantor. The courts are concerned with the *bona fides* of the trustee and whether or not he is making his decision on sound business principles.

The Commission therefore recommends that section 70 subsection (2) of *"The Trustee Act"* be repealed and the prudent man rule be enacted in its place.

Having recommended a prudent man rule, the Commission feels obliged to be more specific. The prudent man rule has been articulated in many ways.[9] These different versions reflect distinctions on matters of substance. There is, of course, the model Act proposed by the Uniform Law Conference of Canada. As mentioned above this has been enacted by the Northwest Territories, New Brunswick and the Yukon Territory.

The Commission has a bias towards the draft proposed by the Uniform Law Conference of Canada, not only because it is a clear articulation of the rule but also because the

Commission feels strongly regarding the principle of uniformity among Canadian jurisdictions.

A caveat to be added is that the Commission finds the punctuation of the Northwest Territories legislation preferable to that of New Brunswick and the Yukon Territory. The New Brunswick and Yukon Territory legislation is open to the misleading interpretation that a trustee is only required to act in a prudent manner if there are no directions in the trust-creating document. This is, of course, not the case as a trustee must exercise prudence in all matters relating to the administration of the trust and not just in investments.

The Commission recommends one further improvement to the model Act and that is substituting the words "if he were administering" for "as a trustee of" in the last line of the model Act. This alteration eliminates the tautology of defining a trustee as a trustee.

The Commission therefore recommends that the prudent man rule as articulated in Appendix C be enacted.

III. CORPORATE AND LAY TRUSTEES

In recommending a prudent man rule, the Commission has been conscious of a serious dilemma. There are many types of trustees, ranging from the highly skilled professional invariably acting as trustee for a fee, to the small trustee usually a friend or relative of the settlor acting as trustee out of friendship or family loyalty. Between these two extremes are several other types of trustees with varied degrees of sophistication and expertise. Does the prudent man rule demand the same level of performance from all trustees? If it does, is it just that the rule demand the same level of performance from the trustee who is acting gratuitiously, usually a friend or relative, as from the professional corporate trustee acting for fees?

It was the concern of the Commission that a fair balance be struck between the two extremes, that the lay trustee not be held to the high standard expected of the professional trustee, but that at the same time the professional trustee not be allowed to vindicate himself because he met a standard which would be adequate for a lay trustee. It is clear to the Commission that basic fairness demands that in some way the above two types of trustees be treated differently.

The Americans have noted this problem and have wrestled with it for some time. Section 174 of the *Restatement Second, Trusts*, has recommended the addition of the following:

> The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has or procures his appointment as trustee by representing that he has greater skill than that of a man or ordinary prudence, he is under a duty to exercise such skill.

The advantages of such a clause are immediately obvious. The clause is flexible and open-ended. The test for the different standards becomes a question of fact for the trial judge and allows the trial judge to look at each trustee individually. The one major disadvantage of the above clause is that there seems to be an inherent anomaly in legislating different standards of prudence.

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 π.[10] The above simile is appropriate in another respect: while the precise value of π 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.

It has been suggested to the Commission that one method of both protecting the lay trustee and adding some certainty to the definition of prudence is to adopt a statutory list of criteria which would not be an exhaustive definition of prudence but would be indicative of the presence or absence of prudence. Here again American scholars have wrestled with this concept. An example of a list of criteria is provided by section 227 of the *Restatement, Second, Trusts* and states that a trustee would normally consider the following:

(1) the marketability of the particular investment;

(2) the length of time 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 re-investment at the time when the particular investment matured;

(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 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.

It is argued that the above list would serve to educate and instruct the lay trustee and would assist the court in deciding whether or not a trustee was imprudent. Dealing with the second argument first, it was demonstrated in Chapter II of this Report that the courts have been dealing with the question of prudence for over one hundred years, and it is submitted, quite adequately.

But what of giving direction and guidance to the lay trustee? This, of course, is a laudable goal and one which the Commission wholeheartedly supports; but the Commission does not feel that legislation is the place to achieve this goal. The Commission feels that this goal would be better achieved by the publication of an information handbook and guide. This publication would be available to the public and would not only be a guide to trustees but would provide them with notice as to what the duties of a trustee are. Accordingly, the Commission recommends the

preparation and publication of a Trustee's Handbook and Guide.

There is a way to deal with the dilemma of different standards for trustees which exists in the present *"Trustee Act"*. More specifically, section 81 of *"The Trustee Act"* reads as follows:

> 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.

This section is meant to be a curative measure to allow the court to relieve a trustee from liability for a technical breach if he has acted "honestly, reasonably, and ought fairly to be excused". It is the last phrase "ought fairly to be excused" which opens the door to judicial discretion, and judicial discretion has expanded the defence beyond that of its original intent. The following are representative examples of the use of that judicial discretion:

> *National Trustees Company of Australasia, Limited v. General Finance Company of Australasia, Limited,* [1905] A.C., 373 (P.C.)
>
> The facts of this case are somewhat complex, but basically the trustee company acting on the advice of well respected solicitors paid the money to the wrong party. The proper beneficiary sued and the trustee company claimed relief under section 3 of the *Victorian Trusts Act, 1901* which is the exact counterpart of section 81 of *"The Trustee Act"*. In dismissing the claim Sir Ford North stated:

"It is a very material circumstance that the appellants are a limited joint stock company, formed for the purpose of earning profits for their shareholders; part of their business is to act as trustees and executors; and they are paid for their services in so acting by a commission which the law of the Colony authorizes them to retain out of trust funds administered by them, in addition to their costs. . . . The position of a joint stock company which undertakes to perform for reward services it can only perform through its agents, and which has been misled by those agents to misapply a fund under the charge, is widely different from that of a private person acting as a gratuitous trustee. And without saying that the remedial provisions of the section should never be applied to a trustee in the position of the appellants, their Lordships think it is a circumstance to be taken into account, and they do not find here any fair excuse for the breach of trust, or any reason why the respondents, who have committed no fault, should lose their money to relieve the appellants, who have done wrong and have denied the respondents' title.".

Weir v. Jackson (1905), 7 O.W.R., 281 (C.A.)

In this case the defendant trustee took the advice of one M and purchased an investment from him. M of course had an interest in the advice he gave. The trust lost money. In allowing the defence under the remedial provisions of *"The Trustee Act"* Chief Justice Meredith stated: "The executor was a farmer having probably very little knowledge of that kind of business, and I do not think it would be reasonable to say that he should have been aware that it was an improper or an unwise thing for him to take the advice, as I have said he did, of a prominent businessman of high repute, simply because that man was the vendor of the stock."

Perdue v. Perdue (1928), 34 O.W.N. 173 (High Ct.)

"The defendant, being a farmer, without experience in investments, placed the amount in the hands of a solicitor, then of standing and reputation in the community, for investment upon mortgage. The defendant honestly believed it to be in the best

interests of his son and for the protection of the money to take this course. The solicitor proved to be unreliable and the sum was lost to the plaintiff." In accepting the statutory defence and dismissing the plaintiff's claim on the above facts, Mr. Justice Grant stated: "The defendant, having acted honestly and conscientiously, should be relieved, under section 34, from the consequences of his technical breach of trust."

Fales' Case (supra p.10)

In this case the testator's widow and the Canada Permanent Trust Company were co-trustees. The beneficiaries sued the company which joined the widow as a third party. The court held that the investments were imprudent. Both the widow and the corporate trustee claimed relief under the statutory defence. In not allowing the defence for the corporate trustee, and speaking for the unanimous court, Mr. Justice Dickson stated: "All of the circumstances would have to be considered, including whether the trustee was paid for its services . . . among other relevant considerations is whether the breach is merely technical in nature or a minor error of judgment; whether decline in value of securities was attributable to general economic conditions; whether the trustee is someone who accepted a single trust to oblige a friend or is a company organized for the purpose of administering estates and presumably chosen in the expectation that it will have specialized departments and experienced officials; above all, whether the conduct of the trustee was reasonable. The actions, or inaction, on the part of Canada Permanent which gave rise to the breach of trust in the present instance were not reasonable in my view. No case can possibly be made out for granting Canada Permanent relief . . .".

But in allowing the defence for the widow, Mr. Justice Dickson stated: "Her acts were not greatly less nor more than might be expected of one in her position. At the death of her husband, she was a housewife with four young children. She had been a school teacher and had taken a three months' night school course on 'How to invest your money'. . . . She made all decisions

> which she was asked to make within the limits of her experience and knowledge, I cannot find that at any time she failed to listen to reason or that she responded irrationally or obdurately. In short, it would seem to me that this is the very sort of case for which s. 98 of The Trustee Act was intended and that Mrs. Wohlleben ought fairly to be excused for her breach of trust."

The above cases illustrate not only the virtues of our judicial system, but the fact that the courts have, for a long time, been aware of this serious problem and have over the years dealt with it very well. The Commission is of the view that the lay trustee will be adequately protected by the twin shields of section 81 and judicial interpretation.

IV. IMPROVING THE PRUDENT MAN RULE

As mentioned in Chapter I, the Americans adopted the prudent man rule several years ago. This Chapter will briefly examine the American jurisprudence to determine whether or not there is anything that we may learn from their experience.

The prudent man rule was born in Massachusetts in the case of *Harvard College v. Amory*, (1830) 9 Pick. 446, when Mr. Justice Putnam 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 capital to be invested.

Through the succeeding years the Massachusetts courts provided a textbook example of the Common Law at its finest. The courts steadfastly stated general guiding principles but avoided specifics to allow the law to grow and be flexible. For example, on the issue of whether or not a second mortgage was a prudent investment, the court in the case of *Taft v. Smith*, (1866) 13 Allen 413, stated:

> We are aware that in several cases in other States it has been stated that a trustee must not invest in second mortgages. While we accept that as a principle generally to be applied, we cannot accept it as an absolute, iron-clad rule. After all, the true rule is whether under the circumstances

an investment in a second mortgage is inconsistent with sound discretion.

Some further examples are that the courts allowed the purchase of real estate but frowned on it being out of State (*Thyer v. Dewey*, (1904) 185 Mass. 68) as that also meant that it was out of the jurisdiction of the court and held it to be imprudent if it were bought for speculation (*Brigham v. Morgan*, (1904) 185 Mass. 27). The courts also gave trustees directions to diversify. It was held in *Warren v. Pazolt*, (1909) 203 Mass. 328, that it was imprudent to place too much of the trust's capital into one investment and similarly in both *Dickenson, Appellant*, (1809) 152 Mass. 184, and *Davis, Appellant*, (1903) 183 Mass. 499, it was held that too large a commitment in one corporation was imprudent.

However, the prudent man rule has not been without its critics, and the most popular criticism centers around the anti-netting principle which was articulated in the case of *Creed v. McAleer* (1951) 275 Mass. 362, as follows:

> A trustee must exercise reasonable skill and prudence and sound discretion in making or retaining each investment and is chargeable with any loss by failing to do so . . . . The gain in each investment belongs to the trust estate and in no way can a trustee reap a personal profit from it. . . . A trustee cannot offset a loss for which he is liable by a gain belonging not to him but to his cestui.

This same principle was used by the English Court of Chancery in *Re Barker* (1898) 77 L.T. Rep., 712, where Mr. Justice North refused to offset the profits of speculative investments which appreciated against the losses of speculative investments

which depreciated. In the case of *Cuyler's Estate* (1924), 5 Pa. D. and C. 317, the court stated the reason for the rule as follows:

> 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.

We see then, that the basis of this anti-netting principle is the age-old concern that the trust property be protected from unnecessary risk.

Let us now consider this principle in the context of the modern marketplace. Suppose the shares of W Ltd. are selling at $5.50. Suppose also that these shares have, over the past five years, never declared or paid a dividend and have greatly fluctuated in value. Suppose also that T, a trustee sells short (that is sells shares he does not own in the hope that the value will decrease and thus cause a profit) 100 shares of W Ltd. The above transaction has none of the characteristics of a prudent investment; it is pure speculation. If the trust lost money on the above transaction, T would certainly be personally liable for the monies lost.

Let us suppose further that W Ltd. last year had issued a $1,000 convertible debenture paying interest at

7 1/2% annually and convertible into common shares at the rate of 111 shares per debenture at the owner's option. Let us suppose further that this debenture is presently selling at $650. Let us suppose that T2, another trustee purchases this debenture on 50% margin (that is, only paying for half of it but being required to pay for the other half on demand from the vendor). Would this investment of T2 be prudent? The answer seems to be that it would not. Although the investment bears a high rate of interest, 23% ($75 per $325 invested), the value of the principal of the bond is tied to the value of the common stock and this has fluctuated greatly over the past five years. This would almost certainly be held to be a risky investment. And if the trust lost money, T2 would unquestionably be held liable for the loss.

Let us consider a third trustee, T3, who buys the convertible debenture on 50% margin, and simultaneously sells short 100 shares. If one looks at the two transactions together, are they imprudent? Do they put the capital at any unnecessary risk? It is true that the value of the shares in W Ltd fluctuate greatly. It is true that the capital value of the debenture issued by W Ltd fluctuates greatly. However, when one looks at the two transactions together, one notices that as the value of the shares in W Ltd. go up the capital value of the debenture in W Ltd. goes up and since T3 has sold shares short if he is called upon to produce those shares that he has sold short, he can convert the debenture to common shares and produce those shares with virtually no loss to the trust. Similarly if the value of the debenture drops substantially, then the value of the shares that T3 has sold short also drop substantially and T3 can purchase those shares at a much lower price than the $550 that he received for them when he sold short. In short,

the capital is virtually never at risk and a high rate of return is generated for the trust.

The above scenario involving T3 is an example of what stockbrokers call "convertible hedging" and is one of the simplest devices that investors use to be able to generate a substantial income but at the same time protect the capital. Furthermore, the above example is taken from a real life situation on August 14, 1972 Illustrated World Encyclopedia Inc., a company listed on the New York Stock Exchange, was selling both shares and convertible debentures as in the above example.[11]

There are other techniques which investment brokers use which are far more sophisticated, but the basic thrust of modern investment practice is to diversify the portfolio in such a way that the total capital is at very little risk. This very often involves, as demonstrated above, investments which if viewed in isolation would appear to be speculative.[12]

The Commission therefore recommends that an additional section should be enacted stating that if a trustee is sued for imprudence, it shall be a defence for that trustee to show that while a particular investment viewed in isolation may have been speculative or imprudent, the trustee nonetheless followed a prudent investment policy and that this total policy was not speculative and not imprudent. An example of such a clause is contained in Appendix D.

V. TRANSITIONAL PROVISIONS

The Commission feels that the amendments to the trustee investment powers should apply to all existing trusts where the investment powers are not stated in the trust instrument or where the trust instrument or legislation limit trustees' investment powers to those permitted under the present law.

The Commission is of the view that this is accomplished by the wording of the prudent man rule contained in Appendix C. However, we wish to make it abundantly clear that the proviso in that rule concerning contrary authorization or direction shall not preclude that section applying to the above-mentioned cases.

The Commission therefore recommends that the amendments apply to all existing trusts where the investment powers are not stated in the trust instrument or where the trust instrument or legislation limit trustees' investment powers to those permitted under the present law.

VI. SUMMARY OF RECOMMENDATIONS

1. That section 70 subsection (2) of *The Trustee Act*" be repealed and a prudent man rule be enacted in its place. (p. 14).

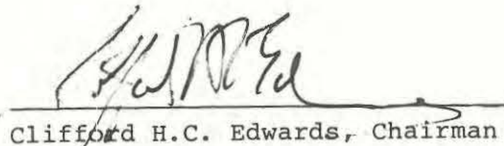
2. That the prudent man rule as articulated in Appendix C be enacted. (p.15)

3. That a Trustee's Handbook and Guide be prepared and made available to the general public to assist and instruct trustees. (P. 19)

4. That an additional section be enacted stating that if a trustee is sued for imprudence, it shall be a defence for that trustee to show that while a particular investment viewed in isolation may appear to be speculative or imprudent, the trustee nonetheless followed a prudent investment policy and that this total policy was not speculative and not imprudent. (p. 27)

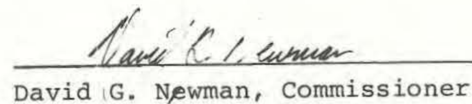
5. That the amendments apply to all existing trusts where the investment powers are not stated in the trust instrument or where the trust instrument or legislation limit trustees' investment powers to those permitted under the present law. (p.28

This is a Report pursuant to section 5(2) of "*The Law Reform Commission Act*", signed this 12th day of February, 1982.



Clifford H.C. Edwards, Chairman

Patricia G. Ritchie, Commissioner



David G. Newman, Commissioner

Knox B. Foster, Commissioner

Beverly Ann Scott, Commissioner

Victor Rosenman, Commissioner

D. Trevor Anderson, Commissioner

FOOTNOTES

1. *"The Trustee Act"*, C.C.S.M. T160, s. 74.

2. Much of the following historical material is drawn from a presentation to the Commission by Dr. D.W.M. Waters, Professor of Law, University of Victoria. The Commission wishes to express its gratitude for Dr. Waters' presentation and for his advice on this paper.

3. *Law of Property (Amendment) Act*, 1859, 22 & 23 Vict. c. 35.

4. For example, see *An Act to Confer Certain Powers on Trustees and Executors*, S.O. 1868-69 (32 Vict.), c. 37.

5. *Trustees Act*, R.S.N.B. 1973, T15, S. 2; *Trustee Ordinance*, R.O.N.T. 1974, T8, s. 3; *An Ordinance to Amend the Trustee Ordinance*, O.Y.T. 1980 (1st Sitting) c. 33, s. 1(1).

6. *Canadian and British Insurance Companies Act*, R.S.C. 1970, c. I-15.

7. R.S.C. 1970, c. B-4, s. 6.

8. See, for example, the *Globe and Mail Report on Business*, Monday, November 16, 1981, B37.

9. See Appendix B.

10. This is the circumference of a circle divided by its diameter, called a transcendental number as it is incapable of being accurately expressed.

11. The preceding example was taken from an article by Thomas D. Johnston "Prudence in Trust Investment" (1975) *Journal of Law Reform*, Spring, 491.

12. Mr. Johnston's article (*supra* note 12) contains many other examples of modern-day investment techniques.

APPENDIX A

PROVISIONS WHICH REFER TO SECTION 70 SUBSECTION (2) OF *"THE TRUSTEE ACT"*

Section 70 subsection 2 is referred to in 23 provisions of the Continuing Consolidation of the Statutes of Manitoba.* These provisions fall into six general groups. They may be classified as follows:

"The Architects Act", A130, s. 35

"The Chartered Accountants Act", C70, s. 2(5)

"The Land Surveyors Act", L60, s. 65(2)

"The Law Society Act", L100, s. 4(1)(B)

"The Optometry Act", O70, s. 16(2)

These provisions deal with the investment of monies controlled by a self-governing professional bodies.

"The Civil Service Superannuation Act", C120, s. 9(6)

"The Financial Administration Act", F55, s. 19(3)(A)

"The Planning Act", P80, s. 77(1)(B), s. 77.1(5)(B)

"The Teachers' Pensions Act", T20, s. 44(2.1)

"The Wheat Board Money Trust Act", W120, s. 3

"The Workers Compensation Act", W200, s. 78(7)

"The City of Winnipeg Act", S.M. 1971, c. 105, s.349(2), s. 637(5

These provisions deal with the investment of monies which are under the control of a government or quasi-government entity.

"The Child Welfare Act", C80, s. 4(13)

"The Corporations Act", C225, s. 335(1)

"The Surrogate Courts Act", C290, s.80

"The Mental Health Act", M110, s. 70(c)

These provisions deal with the investment of monies which are held in short term trusts.

"The Elderly and Infirm Persons' Housing Act", E20, s.12(2)

"The Museum of Man and Nature Act", M280, s. 8(2)

These provisions deal with the investment of monies under the control of non-profit organizations.

"The Cemeteries Act", C30, s. 31(1)

"The Prearranged Funeral Services Act", F200, s. 6(4)

These provisions deal with the investment of monies which have been paid for a prearranged funeral or for perpetual care of gravesites.

"The Credit Unions Act", C300, s. 150(1)(F)

This provision deals with the investment of monies maintained in a credit union stabilization fund.

*References to *"The Trustee Act"* are also contained in some of the private Acts which have not been listed as we are certain they would be well known to those affected by them.

APPENDIX B

EXAMPLES OF PRUDENT MAN LEGISLATION

1. Mr. Justice Putnam's articulation of the rule

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 capital to be invested.

2. The 1942 American Model Act

In acquiring, investing, reinvesting, exchanging, retaining, selling and managing property for the benefit of another, a fiduciary shall exercise the judgment and care under the circumstances then prevailing, which men of prudence, discretion and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable incomes as well as the probable safety of their capital. Within the limitations of the foregoing standard, a fiduciary is authorized to acquire and retain every kind of property, real, personal or mixed, and every kind of investment, specifically including, but not by way of limitation, bonds, debentures and other corporate obligations, and stocks, preferred or common, which men of prudence, discretion and intelligence acquire or retain for their own account.

3. The *Restatement, Second, Trusts*

The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man ofordinary prudence would exercise in dealing with his own property; and if the trustee has or procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill.

4. The New Brunswick and Yukon Territory legislation

Unless a trustee is otherwise authorized or directed by an express provision of the law or of the will or other instrument creating the trust or defining his powers and duties, he may invest trust money in any kind of property, real, personal or mixed, but in so doing, he shall exercise the judgment and care that a man of prudence, discretion and intelligence would exercise as a trustee of the property of others.

5. Northwest Territories legislation

Unless otherwise authorized or directed by an express provision of the law or of the will or other instrument creating the trust or defining the duties and power of the trustee,

(a) subject to paragraph (b), a trustee is authorized to invest in every kind of property, real, personal or mixed; and

(b) in investing money for the benefit of another person, a trustee shall exercise the judgment and care that a man of prudence, discretion and intelligence would exercise as a trustee of the property of others.

6. *Employee Retirement Income Security Act* of 1974 (ERISA)

. . . 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

(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.

7. The Utah Prudent Trustee standard

The trustee shall observe the standards in dealing with the trust assets that would be observed by a prudent man in dealing with the property of another.

APPENDIX C

PROPOSED PRUDENT MAN RULE

Unless otherwise authorized or directed by an express provision of the law or of the will or other instrument creating the trust or defining the duties and power of the trustee,

(a) subject to paragraph (b), a trustee is authorized to invest in every kind of property, real, personal or mixed; and

(b) in investing money for the benefit of another person, a trustee shall exercise the judgment and care that a man of prudence, discretion and intelligence would exercise if he were administering the property of others.

APPENDIX D

PROPOSED DEFENCE CLAUSE

In an action by the beneficiaries alleging that a particular investment was imprudent, it shall be a defence for the trustee to establish that the overall investment portfolio of the trust was prudent and that the particular investment in question was a reasonable part of the investment plan of the portfolio.