

The Prudent Trustee

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Abstract: Comprehensive legal and financial advice must now be combined as a result of the sweeping changes to the investment provisions in the Trustee Act of Ontario. The Act creates a new standard of care which must be adhered to by trustees, board members of charitable organizations and individuals acting under authorization of an enduring Power of Attorney for property. Failure to act in accordance with the new provisions could result in personal liability for those individuals.

It should be noted that the provisions of the Substitute Decisions Act, which govern Powers of Attorney in Ontario, state that the rules and guidance set out in the Trustee Act do not apply to those individuals who hold Powers of Attorney. However, the standard of review and the expectations of the court relating to investments tend to follow the statutory provisions of the Trustee Act. Therefore, the guidance given in the Trustee Act to trustees should be carefully reviewed and followed if one is an attorney for property.

Old Rules

The Trustee Act, prior to 1999, allowed a trustee to invest only in an authorized list of investments unless provisions in the trust document indicated otherwise. This “legal list” came into effect in 1868 and permitted trustees to invest in guaranteed investment certificates, government bonds, first mortgages and blue chip securities.

The objective was to preserve capital and earn a modest return; in essence, do what a “prudent man” of the time would do.

In the event that one of the trust’s investments suffered a loss, regardless of gains in the other investments within the trust’s portfolio, the trustee could be held liable for that loss. This was known as the “anti-netting”

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rule, that is, the court could not consider the performance of the other assets in the portfolio when determining the liability for a breach of trust. The courts did have the option to rule in limited circumstances that if the trustee had acted in good faith and in an honest manner, they could be freed from liability arising from that loss.

A New Standard

Ontario, following the trend in the United States, the United Kingdom and other jurisdictions, has made dramatic changes to the Act resulting in a new standard of care that trustees must be alerted to. In 1999, the “legal list” approach was abolished. There are no longer any prohibited investments. Investments must now be selected based on their contribution to the overall portfolio rather than their individual risk attributes. Portfolio design must shift from the elimination of individual investment risk to a balance in the risk/return relationship as it relates to all of the beneficiaries’ varying objectives. As a result, the standard of care required of trustees has also become more rigorous.

Under these new rules, the courts are not prevented from relieving a trustee of liability for a breach of trust. Notwithstanding, legal commentary suggests that the trustee could still be liable not only for the loss incurred by the trust, but also for the missed gains had the trust been invested in a “prudent” manner.

Prudent Investor Rule

The “legal list” approach was replaced by the “Prudent Investor Rule” which states that

... a trustee must exercise the care, skill, diligence and judgment that a prudent investor would exercise in making investments.

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

The Trustee Act now goes to great lengths to stress the need to be prudent. The Act describes how prudence must be used when:

- Selecting investment options;
- Investing trust property;

- Relying on advice;
- Selecting an agent;
- Delegating investment functions to an agent; and
- Monitoring the agent

In the United States, the courts have historically examined the conduct of the trustee when considering whether or not they acted prudently. The conduct was compared to the standard expected of a prudent person managing his or her own affairs. The investments were not to be speculative in nature and the trustee needed to consider the probable income as well as safety of capital.

The courts will likely continue to look at the prudent investor rule from the standpoint of the general standard of care expected. The courts have considered such guidelines to include the duty to conform to fiduciary standards and the general requirements of care, skill and caution. In order to meet these criteria, trust investments should reflect modern financial practices and trustees should act in a loyal, impartial and prudent manner.

Effectively, the legal domain of trust management has now been pushed into the realm of modern investment practice. In his address to The Canadian Association of Financial Planners (May 2002), Phil Renaud LL.B., a specialist in Estates and Trusts, indicated “the prudent investor rule is the legal application of modern portfolio theory.”

Modern Portfolio Theory

MPT is a Nobel Prize winning area ... which describes how adding risky assets can actually lower the overall risk of the entire portfolio...

Groundbreaking advancements in investment theory occurred in the latter half of the 20th century and have evolved into what is known as Modern Portfolio Theory (MPT). Originated by Harry Markowitz in the 1950s and furthered by William Sharpe in the 1960s, MPT is a Nobel Prize winning area of investment thought which describes how adding risky assets can actually lower the overall risk level of the entire portfolio at the same time as

increasing the return potential. This was not widely put into practice until the 1970s when the power of computers made the multitudes of calculations that are required in MPT possible.

The key to MPT rests in the direction of the movements of the various assets within a portfolio. Diversification among assets that move in perfect tandem with each other does not achieve any risk reduction. It is when an asset is added that is negatively correlated to the movement of other assets in the portfolio that risk reduction is realized. Options for diversification are many and include Canadian, US and global equities, domestic and foreign bonds as well as active versus passive management. Diversification among management styles can also reduce overall portfolio volatility. For example, a “value” oriented manager will often have contrasting results with a “growth” oriented manager. Therefore, hiring one investment manager may not be as “prudent” as taking a multi-manager approach. Many large trusts hire only one manager and this may pose a potential liability issue down the road.

The trustee must do the best they can to:

- achieve the highest level of return for a given level of risk;
- effectively diversify the portfolio to lower risk without lowering return;
- increase the expected level of return by increasing market risk when appropriate;
- limit costs

The question of risk tolerance will depend largely upon the distribution needs of the trust and the circumstances of the beneficiaries. The following is a list of some of the considerations by which trustees’ conduct will be evaluated as prudent or imprudent:

- What was the intention created by the trust?
- Who are the beneficiaries and what are their personal circumstances?
- Are there any potentially unknown beneficiaries?
- Are there conflicting interests between the various classes of beneficiaries?
- Are there regular distribution requirements of the trust?

- Is there a need for any unique, one-time distributions to be made?
- Does the trust instrument allow for encroachment on capital?
- Does the trust document contain any directives or restrictions with respect to investments?

Mandatory Investment Criteria

The Trustee Act has provided specific guidelines which trustees need to consider (in addition to any other relevant criteria) before making investment decisions. These items are:

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1. General economic conditions
2. Effect of inflation or deflation
3. Tax consequences
4. Role of each course of action or investment within the overall portfolio
5. Expected total return from income and capital gain
6. Liquidity needs, regularity of income and preservation or appreciation of capital
7. An asset's special relationship to the trust or one or more of the beneficiaries

The simple days of trust fund management have suddenly become much more complex.

Even Handed Rule

Under common law the “even handed rule” requires a trustee to take into consideration the needs of any of the trusts’ beneficiaries when establishing the investment plan for the trust without giving undue benefit to any one beneficiary or class of beneficiaries. As in criteria #6 above, the trust must consider the need for liquidity, amount and frequency of income and the need for preservation and/or appreciation of capital. Each beneficiary has the right to have their specific interests served and it is up to the trustee to ensure that any conflicting interests are equally balanced. This is not a new rule however the way in which these conflicting interests are balanced will now have a much greater impact on the formation of the portfolio.

Governance Process

The management of trust assets has entered a new era of governance. It amounts to three guiding principles: know what is right; do what is right, and document everything. In order to achieve these three aims we recommend a process, though particular to each trust, which boils down to eight primary steps:

1. Choose a highly qualified financial advisor
2. Articulate the objectives of all potential beneficiaries
3. Address the mandatory criteria
4. Develop a written investment plan
5. Select only qualified investment managers
6. Regularly monitor investment managers
7. Periodically review the written plan and modify as necessary
8. Document all actions and deliberations along the way

Though this seems like a daunting task, the legislation allows and the courts most likely expect that the trustee seek professional advice and rely upon that advice if that is what a “Prudent Investor” would do under comparable circumstances. However, the ultimate responsibility remains with the trustee. Such investments as mutual funds, pooled funds and segregated funds (offered by insurance companies) are now permitted investments as long as those investments are chosen by the trustee and not by an agent acting on behalf of the trustee. This is where it can get tricky; one level of delegation of investment decisions is permitted provided it would be prudent to do so, but sub-delegation is not. For example, if the trust account is being managed on a discretionary basis by an investment manager that manager could not select a mutual fund as an investment because they would in effect be sub-delegating that portion of the trust.

This does not prevent a trustee from acting on professional advice. The trustee could seek the advice of a financial planner on how best to invest the trust portfolio and then act on those recommendations.

The trustee needs to have a carefully conceived and well-documented strategy...

The trustee also needs to have a carefully conceived and well-documented strategy for investment of trust assets. The trust's investment plan should detail how and to what degree the previously mentioned mandatory criteria have been considered in formulating the plan document. If there is no properly formulated plan and the investments do not perform in an acceptable manner the trustee is open to potential action from the beneficiaries of the trust.

Having a detailed, appropriate investment plan is not the end of the process. Trustees need to review the investment performance on a regular basis and take action when circumstances justify a change in either the investment selections or the investment manager. The plan itself needs to be reviewed at regular intervals to ensure that it still meets the objectives of the trust and its beneficiaries.

The new amendments expressly permit trustee investment in mutual funds, pooled funds and common trust funds where the co-trustee was a trust company. Furthermore, it did resolve the uncertainty in the law as to the authority of the trustee to delegate investment management decisions more generally.

The Ontario Trustee Act does contain a general provision authorizing delegation of investment decision-making by trustees. A trustee may, according to Section 27.1(1), authorize an agent to exercise any of the trustee's functions relating to investment of trust property to the same extent that a prudent investor would. However, there needs to be great care taken in respect to the steps involved in delegating that authority. If the required steps set out in the Trustee Act are followed, delegation to discretionary investment managers would be permitted.

It is a mandatory requirement to have a written agreement between the trustee and the discretionary manager.

Most large trusts currently delegate investment selection to discretionary managers because that is often the prudent thing

to do. If one does use the assistance of a discretionary investment manager then it is mandatory for the trustees to have a written plan or strategy. It is also a mandatory requirement to have a written agreement between the trustee and the discretionary manager.

Trustee Liability

In the event that a beneficiary brings action against a trustee, the courts will likely seek to establish whether or not the trustee acted as a “prudent investor” would have acted under similar circumstances. Without a well-documented plan, the courts will only have the trust’s performance to look to when arriving at their decision. The trustee must be able to defend their investment decisions by having a detailed investment plan which meticulously outlines the process that was used to determine the investments selected. A trustee is not liable for a loss to the trust if it can be shown that “...the conduct of the trustee that led to the loss conformed to a plan or strategy for the investment of trust property, comprising reasonable assessments of risk and return that a prudent investor could adopt under comparable circumstances.”

To put it into dollar terms, the following example shows how a trustee could be faced with a substantial liability:

Suppose Mr. Jones passes away and leaves his estate in trust for Mrs. Jones and directs that she has a lifetime income interest in the estate. They have no children, and upon Mrs. Jones’ death the estate will pass to nieces and nephews. At the time of Mr. Jones’ death in 1983 the estate is worth \$500,000. Mrs. Jones being younger and in good health lived for an additional 19 years and passed away in 2002. Over this time period the trust has been fully invested in GICs as the high interest producing assets of the early 1980s were allowed to continue to roll over at lower and lower interest rates.

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Upon the death of Mrs. Jones, the estate is still worth \$500,000. The nieces and nephews are bringing action

against the trustee because the value of the estate has been eroded by inflation over those 19 years.

If the prudent investor rule had been in place for this entire time period, it is conceivable that a judge could determine that the trustee is liable for a breach of trust in this case and find for the beneficiaries. When deciding on compensation, the judge could consider what the value of the estate would be if it had been invested by prudent trustees. It could be argued that the trustees had a duty to invest 40% of the portfolio (\$200,000) in blue chip common shares to provide growth for the eventual capital beneficiaries which would have earned 14.8%¹ invested in the S&P 500. To account for commission and conservatism, this return is discounted by 20% leaving a net annual potential compound return of 11.84%. Had the trust been invested prudently, the value would have grown to \$1.98 million. This could leave the trustee potentially liable for \$1.48 million.

When a board of trustees involves several members, each member shares in the potential liability. Each member must keep up to speed on the investments of the charity's funds as it is not an effective defense to say, "I didn't know what was going on." It is also advisable that if a member opposes a particular investment decision that his or her opposition be clearly stated in the minutes of the board meeting. As well, absence from meetings does not exclude a board member from liability for decisions made in their absence.

Lawyers' Liability

Lawyers have a fiduciary responsibility to properly review and advise the executor or trustee about the duties and obligations that are imposed on those administering and investing trust assets. If they fail to keep their clients fully up to speed, lawyers may be held liable for that omission.

¹Jeremy Siegel, Stocks for the Long Run, 3rd Edition, (2002), p. 343.

Many lawyers act as executors or trustees and therefore, they may be held to a much higher standard of care with regard to their conduct when administering and investing trust funds. Courts will expect the legal community to be better informed on this topic than the average layperson.

Not only do trustees have a duty to invest properly, but they must also act in a timely manner. The lawyer could face a liability problem if they do not administer the trust assets within a reasonable period of time. When it is appropriate for the trust to sell shares of a security, the trustee must ensure that the sale takes place within a suitable period of time. Delay in the sale will provide no upside benefit to the trustee but could give rise to large problems if the beneficiaries were able to successfully argue that the sale should have taken place at an earlier point.

Drafting Out of the New Requirements

In section 27(9) of the Trustee Act it states that the trustee is not required to “act in a manner that is inconsistent with the terms of the trust.” Therefore the testator, when establishing the trust, has the option of removing the requirement that the trustee consider some or all of the mandatory criteria prior to making investment decisions. It would be wise to exercise caution when doing so. These criteria have been included in the Act to assist trustees in making investment decisions. These are items which a prudent investor would most definitely consider when making investment decisions. It is likely that the court would expect a trustee to take these items into account when formulating the investment plan. You can draft out of the legislation, but you cannot draft out of the common law. Fiduciaries have a duty to invest responsibly and prudently. Should the testator remove those mandatory criteria from required consideration, it may be harmful in the long run for both the trustee and the beneficiaries.

Conclusion

The changes to the legislation are relatively new so it will take a number of years for the courts to rule on specific cases. Those rulings will help further define the new standard of governance for trust assets. What is very clear now is that trustees will be expected to manage trust property according to a more stringent duty of care. To be successful, a

trust should have a prudent trustee to provide leadership, expert financial guidance to aid in addressing beneficiary needs and portfolio design, as well as a chartered accountant for tax and reporting requirements and sound legal advice to ensure the process and documentation meet the new standards.

Disclaimer

This paper is opinion only and does not constitute legal advice. The contents are intended for general information purposes only and under no circumstances can be relied upon for legal decision making. Readers are advised to consult with qualified financial and legal counsel concerning the specifics of their particular situation.

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