Contributions to one of our three special issues each year can be made of the contributions sought and any special requirements. All authors may like to submit a synopsis. The Commissioning Editor will be happy to discuss in advance the suitability of a proposed submission, and which section it would best suit, and authors may like to submit a synopsis.

Trends and developments
Contributions intended for this section should be "short and snappy" (ideally 300 to 500 words) summaries of the very latest legislative changes and developments. They should not contain footnotes or diagrams, and should only contain very brief references which solely cover the citation of cases, legislation, and literature, which should appear in brackets as part of the main text.

Articles
Contributions intended for this section should be 3,000 to 5,000 words and may contain footnotes, diagrams, tables, etc. All material should be capable of being printed in monochrome. Where charts or diagrams are produced from data held in spreadsheets, the original spreadsheet should also be submitted. Contributions should be accompanied by an Abstract, Key Points, and Pull-out Quotes. For details of these features, see below.

In depth
Contributions intended for this section should be 5,000 to 10,000 words. They should deal with one topic and discuss the matter in more depth than a normal article. Topics for this section should be agreed in advance with the freelance Commissioning Editor. It is envisaged that topics intended for this section will be of major significance in trust law. Contributions should be accompanied by an Abstract, Key Points, and Pull-out Quotes. For details of these features, see below.

Case notes
Contributions for this section of the journal should contain very clear and concise facts, judgement, and commentary on the implications of the case. Contributions should be in the range of 1,000 to 2,000 words. This section will primarily include recent judgments. Historical judgments of major significance or reviews of case law in a particular area should be dealt with in an Article or In Depth contribution. The case note should be given a title and also indicate, at the start, the case (with citation) being considered. Contributions should be accompanied by an Abstract and Pull-out Quotes. For details of these features, see below.

In focus
Contributions to this section of the journal follow a specific question and answer format and focus on one particular trust law jurisdiction per issue. Contributions to this section can only be made with the prior agreement of the Commissioning Editor.

Abstracts
These should be between 50 and 100 words and summarise the main content of the article or argument in the case note. They should set the scene and be informative enough to draw the reader in without giving away the conclusions drawn by the author.

Key points
These take the form of bullet points. They should catch the reader’s attention and “sell” the article to them as something they want to or need to read. They should be no more than 100 words in total.

Pull out quotes
For the 2009 edition, we intend to introduce “pull out” quotes which reproduce key quotes from the article in a larger font which draws the reader’s eye. Please use the highlight function in Word to indicate any phrases within your article (short sentences which make very salient and essential points) which you would like to be considered for this style of highlighting.

Special issues
Contributions to one of our three special issues each year can be made by contacting the Commissioning Editor (or for the Private Foundations special issue, Dr Johanna Niegel) who can provide details of the contributions sought and any special requirements. All
**Contents**

**Three months in prospect** ........... 519

**Editorial** .............................. 521

Lord Hoffmann

**In brief** ................................. 522

**Articles** ................................. 524

I am a trustee. I can’t make head or tail of

$$P_0 = S_0 N(d_1) - X e^{-rt} N(d_2)$$

where

$$d_1 = \frac{\ln \left( \frac{S_0}{X} \right) + \left( r + \frac{\sigma^2}{2} \right) t}{\sigma \sqrt{t}}$$

and

$$d_2 = d_1 - \sigma \sqrt{t}$$

Am I at risk? .............................. 524

Tony Molloy

The worried trustee ..................... 596

Nicholas Le Poidevin

Negligent investment: claims against trustees and agents ............................. 602

David Halpern

Investment—can private trustees learn anything from pension scheme trustees? . . 611

James Clifford

Crunch! When the worlds of trusts and insolvency collide ............................. 619

Will Richmond-Coggan

The importance for trustees to understand their tolerance to investment risk ........ 626

James Martineau

Taxing times for trustees ................ 633

Anita Gatehouse

**Trust Register** .......................... 640
Editorial

Lord Hoffmann*

On 31 July 1987, I made an order giving the trustees of the Wellcome charitable trust freedom to invest in equities and ventured the observation that, on past form, equities had been a safer form of investment than gilts: see Steel v Wellcome Custodian Trustees [1988] 1 WLR 167, 173. I do not know how quickly the Wellcome trustees made use of this new power. A little dilatoriness would have been in order, because on 19 October 1987 the equity market collapsed. The Dow Jones index fell 20 per cent in a single day—till recent events, the largest fall since 1929. It just goes to show. Perhaps that was the reason why it took another 13 years before Parliament, for much the same reasons as those that persuaded me in the Wellcome case, finally passed the Trustee Act 2000 to abolish the obsolete concept of an authorized investment and allow the conduct of trustees to be judged by reference to the portfolio as a whole.

The 1987 crash does not seem to have produced much litigation but that of 2008 is likely to be a different matter. I hope that judges will not show the magnificent hindsight of Staughton LJ, who, looking back at securities that had lost their value as a result of political changes during and after the Second World War, was able to say that they “sooner or later must have become of little value except as wall paper”: (Nesle v National Westminster Bank [1993] 1 WLR 160, 1275). But one question in particular which is bound to arise is the extent to which trustees, charged with a breach of their duty under section 1 of the 2000 Act to exercise “such care and skill as is reasonable in the circumstances”, to rely upon what is known in tort law as the Bolam principle, namely, that they were acting in accordance with a practice followed by a respectable body of expert opinion. Can they say that a large number of reputable investors also entrusted their clients’ funds to Mr Madoff? As Keynes said after the 1929 crash: “a sound banker, alas, is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional and orthodox way with his fellows, so that no-one can really blame him.” In the law of torts, especially medical negligence, there are limits to this doctrine. The views of the respectable body of opinion are subject to a rationality test that the investment with Mr Madoff might not pass. But following the herd is part of the expertise of investment: as Keynes also said, it is an exercise in forecasting what average opinion will forecast average opinion to be. The question therefore remains an open and, like others discussed in these essays, a highly topical one.

*Lord Hoffmann is a retired Law Lord who accepts appointments as an arbitrator and mediator. He was an advocate of the Supreme Court of South Africa 1958–60, called to English Bar by Gray’s Inn in 1964 and appointed Queen’s Counsel in 1977. He was appointed a judge of the High Court (Chancery Division) 1985–1992, elevated to the of the Court of Appeal 1992–1995 and appointed a Lord of Appeal in Ordinary 1995–2009. From 1980 to 1985 he was a (part-time) member of the Courts of Appeal of Jersey and Guernsey. Since 1998 he has been a non-permanent judge of the Court of Final Appeal of Hong Kong. In his career at the Bar he undertook a wide range of commercial and property disputes, including ICC and Swedish Chamber of Commerce arbitrations. His recent leading judgments on arbitration have included Fiona Trust v Privalov (2007), Premium Nafta Products Ltd v Fili Shipping Company Ltd [2007] UKHL 40 and West Tankers Inc v RAS Rimini Adriatica (2007).
Articles

I am a trustee. I can’t make head or tail of

\[ P_0 = S_0 N(d_1) - X e^{-rt} N(d_2) \]

where \( d_1 = \frac{\ln\left(\frac{S_0}{X}\right) + \left(r + \frac{\sigma^2}{2}\right) t}{\sigma \sqrt{t}} \) and \( d_2 = d_1 - \sigma \sqrt{t} \)

Am I at risk?\(^1\)

Tony Molloy QC*

Abstract

Co-editor Tony Molloy QC’s keynote address to this year’s Trusts and Estates Litigation Forum, at Terre Blanche, confronted the problems of financial investments so complex as to preclude any meaningful assessment of the risks associated with them; and of a financial system so lacking in transparency as to have been compounding investment risk under cover of its claims to have been dissipating it. To break open some of the potential consequential trustee investment litigation issues, he found it necessary to traverse finance, economics, sociology, politics and philosophy, as well as to reconsider the leading cases from a number of jurisdictions. As appears from this revised version of his paper, this led to Bernard Madov, lap dancers, centrefold models and the South Sea Bubble jostling with Lord Walker, St Thomas Aquinas, Lord Lindley, Sir Anthony Kenny, Lord Hoffmann (who, having reviewed it in writing his editorial, wrote that he had "very much enjoyed Molloy’s article"), Sister Catherine Crowley, Lord Jacobs, the Carmelite Nuns, Lord Nicholls, Pope John XXXIII, Lord Millett, Playboy, the Gospel According to Matthew, Norman Mailer, the Book of Isaiah, the Prime Ministers of Iceland and Australia, alcoholic Telomian Hounds and the personal habits of Mongolian Gerbils: to name but a few.

The word 'investment' has no very precise legal meaning, but its natural meaning, in a financial context, is the acquisition of an asset to be held as a source of income: see for instance Jenkins J in Re Power [1947] Ch 572, 575.


Part I: Before the meltdown

Scope

Professor Langbein’s famous paper on ‘The Uniform Prudent Investor Act and the Future

---

*Tony Molloy QC, Shortland Chambers, 70 Shortland Street, Auckland, New Zealand. Tel: +6493091769; E-mail: apmolloyc@shortlandchambers.co.nz

1. In the theorem set out in this title, \( P_0 \) is the option price; \( S_0 \) the current market price of the share; \( X \) the agreed future price at which the option could be exercised; \( t \) the time to maturity—i.e. the expiration date of the option; \( \sigma \) is the annualized volatility—i.e. the foreseeable potential variation in the price of the share between the date of payment of the option price and the expiration date of the option; \( r \) is the risk free rate of return in the economy; \( e \) the exponential; and \( \ln \) the natural logarithm. See ‘A world of algorithms, computer trading and black boxes,’ at p 350 below.

© The Author (2009). Published by Oxford University Press. All rights reserved.

doi:10.1093/tandt/ttp081
of Trust Investing articulated what he called the ‘fractionation’ of trusteeship:

Trusteeship entails three relatively distinct functions: investment, administration, and distribution. Investment includes not only the initial selection of securities or other assets, but also the tasks of monitoring the investments for continuing suitability, investing new funds, and voting the shares.

As the then Chancellor Kent Professor of Law at Yale University proceeded to note, each of these functions imposes its own special demands:

As financial assets have become the characteristic asset of the modern managerial trust, there is ever less reason for these three relatively disparate functions—investment, administration, and distribution—to remain consolidated in a single pair of hands. No deep connection exists between, for example, being good at working with beneficiaries on the distribution side, and being expert at investing trust funds or preparing fiduciary tax returns.

Neither administration nor distribution is going to get any easier for trustees in the present volatile market. But trustee risk in respect of those functions pales alongside investment-related risks incubating amid ‘financial assets’ that would make John Langbein’s hair curl if he had to review his article today. Apart from their obvious oxymoronic aspect, these ‘assets’ might well engage not so much the trust lawyer in him as the lawyer whose acclaimed scholarship includes books on the Adversary Criminal Trial, Torture and the Law of Proof, and Prosecuting Crime in the Renaissance.

‘Investment’ not authorized

Although Prof. Waters QC has shown clearly that it was not always so, trust investment powers these days are very wide. Nonetheless, a trustee who manages to dissipate the trust estate on an unauthorized investment commits a breach of trust.

It will avail nothing that, in investing without authority, the trustee acted in good faith. Thus, in Webb v Jonas, Kekewich, J. began his judgment in this way:

I cannot help regretting that I am obliged to decide this point, and still more so because I think it is my duty to decide it against the trustees. Personally, if I may say so, I am extremely unwilling to treat trustees otherwise than with the greatest leniency which the law permits when they have acted honestly; and I have not the slightest doubt that in this case they acted honestly, that is to say, with an anxious desire to do their best for their cestuis que trust, and to invest the money on what they believed to be a sufficient and prudent security. But I have not to consider in this case any question of prudence, exercise of discretion, or honesty in the usual and proper sense of the word. I have only to consider whether the trustees, as agents of their cestuis que trust, have fulfilled the terms of their authority or gone beyond their authority. I have already said, and I repeat, that it is no answer for an agent, who is blamed for having omitted to do that which he was told to do, or done something in excess of that which he was told to do, to say: ‘What I have done has been done in good faith, and is beneficial to my principal.’ The agent is bound to keep himself within the terms of his authority.

Because ‘the most important duty of the trustee is to obey the terms of the trust’, the trustee is not
permitted to debit the cost of that unauthorized investment to the account of the trust estate. 9 As will be suggested below, 10 his account will be falsified, and, in equity’s exclusive jurisdiction, 11 he will be subjected, if necessary, to an order for compensation by way of substitutive performance to restore to the trust estate the amount lost—calculated, with hindsight, as at the date of judgment against him.

**Investment within power but careless**

The existence of a power to invest in a particular asset will rule out substitutive compensatory relief. Nonetheless, as also will be suggested below, 12 while an unauthorized investment also is a breach of trust, the power authorising investments is an administrative power only. It is not part of the trusts on which the trust estate is held. 13

*Intra vires*, but improvident, investment accordingly is not a breach of fiduciary duty. The trustee’s accountability for it is on the basis of ‘wilful default’—for what she might have received given due diligence on her part. If an account is sought, equity will surcharge the trustee by reference to the loss caused by his want of care and skill. The remedy therefore falls, not within the exclusive jurisdiction of equity, but within its concurrent jurisdiction, 14 where, following the law, equity dispenses reparative compensatory relief in the form of damages, based on negligence 15 shown to have been an operative cause of the loss.

**Prudence**

At a recent seminar, 16 the Archbishop of Canterbury, Dr Rowan Williams:

Professor Orbach wasn’t so keen, suggesting that they ‘sounded a bit like Gordon Brown’. Dr Williams, while admitting they did sound a bit ‘Scots’, rallied to their defence. Prudence, he said, was ‘Good judgement’, temperance was ‘emotional intelligence’…understanding our desires and bringing them into self-critical awareness’, fortitude was ‘courage…without being deflected by circumstance’ and justice ‘was what it said on the can… it’s doing what is due to the individual, society and environment’. This, he said, ‘was not a bad definition of what a growing, learning humanity should look like’. …Dr Williams…said…that humanity had an ‘abiding dignity’ and that virtues rest on the

9. Hayton *et al.*, Underhill & Hayton: Law Relating to Trusts and Trustees (Butterworths, London, 2006) 17th edn 89.1(1), 89.3 say that his account must be falsified to delete the unauthorized payment.

10. Under ‘Consequences of unauthorized investment but for which the trust estate would not have suffered,’ at p. 564 below.


12. Under ‘Consequences of authorized, but negligent, investment,’ at p. 557 below.

13. See ‘Consequences of authorized, but negligent, investment,’ at p. 557 below.

14. Where, prior to the Judicature Act, equity gave the like remedy by following the common law, and so rested content for the cause to be tried in either court save only where ‘the court of equity was able to give a more perfect remedy or the nature of the case admitted of its being better tried by the procedure of a court of equity than by a court of law’: Browne, Ashburner’s Principles of Equity (2nd edn, Butterworths, London 1933; reprinted by Legal Books Pty Ltd, Sydney, 1983) 1933, 2nd edn, p. 4.


In Target Holdings Ltd v Redfem [1994] AC 421 (HL) the court endorsed Lord Cottenham’s views in Clough v Bond [(1838) 3 My & Cr 490 at 496–497] that if a trustee or personal representative invests funds in unauthorized securities or puts them within the control of persons who are not authorised to be entrusted with them and a loss be sustained, then such trustee or personal representative will be liable to make it good, however unexpected the result, however little likely to arise from the course adopted and however free such conduct may have been from any improper motive. On this basis if trustees delegated management of their investment portfolio to a discretionary manager where not authorised to do so, then the trustees would be automatically liable even if the loss in value of the portfolio was caused by an unforeseeable market crash. The beneficiaries could therefore derive a significant advantage from framing their claim as a substitutive performance claim rather than as a reparation claim, in a case where the trustee’s decision to delegate management of the trust portfolio is negligent as well as unauthorized. In such a case, their reparation claim for breach of the trustee’s equitable duty of care would be subject to principles relating to causation, foreseeability and remoteness that would not apply to their substitutive performance claim.

something that is greater than ourselves; they are 'transcendental'. We all start from self-love, as St Augustine said. But what changes is not self-love, it’s the self that we’re loving, and if the self that we love is expanding into relation, expanding into maturity, recognizing its dependence and its limits, then what is in the interest of that self, what shows love for that self, is actually the same as the interest of the human community and the other. That is the extraordinary work of human liberation, or, you might say, salvation.’

Of course, as Kekewich, J. held, in the passage already cited from his reasons in Webb v Jonas, all the prudence in the world will not save a trustee from the consequences of his having made an unauthorized investment. But where authorized investment is concerned, it is the cultivation, and exercise, of the virtue of prudence which is the key to avoiding trustee risk.

In the philosophy of St Thomas Aquinas, prudence is the virtue of ‘actions, choices, and means to ends. Prudence is knowledge put to use.’ It is ‘right reason about things to be done.’ On the one hand, it is the antithesis of impulsive or heat-of-the-moment decision making—‘non solum ex impetu aut passione’—something to bear in mind when considering later suggestions that much recent investment activity may have been testosterone-driven. And on the other hand, it is not to be confused with ‘over-cautious bean counting’.

Put another way, it is ‘the quality of an integrated personality,’ and is the virtue ‘most necessary for human life’, in the sense that it helps us to lead a good life and not merely become a good person. A distinction made his own by St Robert Megarry, who held that the requirement of prudence ‘is not discharged merely by showing that the trustee has acted in good faith and with sincerity. Honesty and sincerity are not the same as prudence and reasonableness’.

The American Law Institute Restatement of the Law Third: Trusts: Prudent Investor Rule §227 provides a convenient statement of the principles:

**General Standard of Prudent Investment**

The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.

(a) This standard requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.

(b) In making and implementing investment decisions, the trustee has a duty to diversify the

---

17. (1888) 39 Ch D 660.
21. See ‘A world full of algorithms, computer trading, and black boxes,’ p. 564 below.
22. In her interview with Chris Blackhurst, ‘The nun who knew first’, *The Tablet* 11 April 2009, 12, 13, Sister Catherine Crowley, whose prescient book *The Value of Money: Ethics and the World of Finance* (Continuum, London, 2006), is discussed under ‘Nun sense: Sister Catherine Crowley,’ p. 591 below, is reported as having said:

‘There’s been a lack of certain virtues, for example, justice, and a lack of understanding of certain virtues, for example, prudence... When Aristotle wanted to give an example of the prudent person, he chose a successful general, because prudence involves looking at all your options and working out what the most effective means are to achieving what one wants to achieve. So the good general will deploy troops in an effective way. It’s got nothing to do with over-cautious bean counting. That is not prudence. I think the way we have lost sight of what prudence originally meant means we can’t develop prudence very easily.’ She chuckles again. ‘Which is why it’s simple to use another term which is practical wisdom.’

investments of the trust unless, under the circumstances, it is prudent not to do so.

(c) In addition, the trustee must:
(1) conform to fundamental fiduciary duties of loyalty (§170) and impartiality (§183);
(2) act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents (§171); and
(3) incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship (§188).

(d) The trustee’s duties under this Section are subject to the rule of §228, dealing primarily with contrary investment provisions of a trust or statute.

The judgments in the classic case on prudent investment, *Re Whiteley, Whiteley v Learoyd,* retain high topicality in the current financial maelstrom. The terms of the relevant trusts expressly permitted investment in ‘real securities in England and Wales’. The trustees invested by taking title—as mortgagees—to the legal estate, subject to the right of the mortgagors to redeem. The mortgagors became insolvent, and failed to redeem. The trustees attempted to exercise their power of sale. They found that the property was unsaleable.

In the Court of Appeal, Cotton LJ discussed the matter on the footing that:

- The mortgage was technically within the investment power.
- It did not follow that the trustees were free from liability in respect of the loss revealed when the trustees tried to sell up.
- Trustees are not required to have special knowledge.

- They are, however, required to recognize where special knowledge is required.
- Where special knowledge is required, the trustees must seek it from appropriate experts.
- When they have obtained specialist advice—as they had done in that case, in the form of a report from a valuer—the trustees were not free to accept that advice, that the property is good security for a certain sum, *without first having subjected to critical analysis its reasons and its underlying assumptions.*
- The trustees had failed in that regard.

Lindley LJ famously restated the trustees’ obligation:

The principle applicable to cases of this description was stated by the late Master of the Rolls in *Speight v. Gaunt* to be that a trustee ought to conduct the business of the trust in the same manner that an ordinary prudent man of business would conduct his own, and that beyond that there is no liability or obligation on the trustee. I accept this principle; but in applying it care must be taken not to lose sight of the fact that the business of the trustee, and the business which the ordinary prudent man is supposed to be conducting for himself, is the business of investing money for the benefit of persons who are to enjoy it at some future time, and not for the sole benefit of the person entitled to the present income. *The duty of a trustee is not to take such care only as a prudent man would take if he had only himself to consider; the duty rather is to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide.* That is the kind of business the ordinary prudent man is supposed to be engaged in; and unless this is borne in

---

28. (1886) 33 Ch D 347 (CA); affd (1887) 12 App Cas 727 (HL).
31. 22 Ch D 739. When *Speight v Gaunt* came before the House of Lords, Lord Blackburn held that a trustee ‘sufficiently discharges his duty if he takes in managing trust affairs all those precautions which an ordinary prudent man of business would take in managing similar affairs of his own’: (1883) 9 App Cas 1, 19.
mind the standard of a trustee’s duty will be fixed too low . . .

Whilst on the one hand the Court ought not to encourage laxity and want of care, on the other hand the Court ought not to prevent people from becoming trustees by converting honest trustees into insurers of the moneys committed to their care. I have endeavoured to avoid both errors.

Of the passage I have italicized, Hoffmann, J. has held32 that:

This was an extremely flexible standard, capable of adaptation to current economic conditions and contemporary understanding of markets and investments. Modern trustees acting within their investment powers were entitled to be judged by the standards of current portfolio theory, which emphasises the risk level of the entire portfolio, rather than the risk attaching to each investment taken in isolation.33 But care must be taken not to endow the prudent trustee with prophetic vision or expect him to have ignored the received wisdom of his time. A trustee must have regard to the interests of those entitled in the future to capital, and such regard will require them to take into consideration the potential effects of inflation, but a rule that real capital values must be maintained would be unfair to both income beneficiaries and trustees.

In referring—in the above passage from his reasons for judgment in Re Whiteley, Whiteley v Learoyd34—to the investment having been intended for the benefit of the persons to take on the death of the life tenant, Lindley LJ. appears to have intended to do nothing more than emphasize the importance of the long-term safety of the capital. The same can be said of Cotton LJ,35 and, particularly of Lopes LJ,36 each of whom made similar remarks.37 There was a life tenant in the case. The asset in which the trustees had invested was a brickwork. The land on which it stood was being wasted in the production of the bricks—which, as Cotton LJ had observed in the Court of Appeal,38 was ‘constantly exhausting the security’. The rate of diminution may not have been so rapid as to have been a threat to the security of the interest of the life tenant, but Lindley LJ clearly was awake to the possibility of disadvantage to the remaindermen on the life tenant’s death.

On appeal, Lord Halsbury LC declared himself:39 unable to follow or adopt some observations of the Court of Appeal which seem to point to a different degree of care in regard to the conduct of the business of a trust according to whether there are persons to take in the future, or whether the trust fund is to be held for one beneficiary absolutely. The question must be the due care of the capital sum. Whether that capital sum is one in which there is a life estate only, or absolutely for the use of the beneficiary, seems to me to bear no relation to the question of

33. In Dominica Social Security Board v Nature Island Investment Company Limited & Anor (Dominica) [2008] UKPC 19 (2 April 2009), their Lordships (pp. 10–11) said that:
   It may well be that investing in a telecommunications and broadcasting business operating in Dominica is a relatively high-risk investment, and DSSB is in a position of stewardship for the people of Dominica. But the law recognises that when very large investment funds are available, the degree of risk acceptable to fiduciaries should to some extent be judged by reference to the entirety of the holdings in a diversified portfolio, rather than by reference to individual holdings (see Sir Robert Megarry V-C in British Museum Trustees v Attorney-General [1984] 1 WLR 418, 425 and the extracurial observations of Lord Nicholls of Birkenhead in (1995) 9 Tru Li 71, quoted in Lewin on Trusts, 18th ed (2008) p. 1285). Those are all matters which the DSSB, and in particular its Investment Committee, must be supposed to have taken into account in deciding on the joint venture with WRB; and they go to prudence, not to vire.

34. (1886) 33 Ch D 347, 355.
35. (1886) 33 Ch D 347, 350.
36. (1886) 33 Ch D 347, 358.
37. (1886) 33 Ch D 347, 350 (Cotton LJ), 358 (Lopes LJ).
38. (1886) 33 Ch D 347, 352.
39. Learoyd v Whiteley (1887) 12 App Cas 727, 732.
the due caution which a trustee is bound to exercise in respect of the investment of the trust fund.

The learned Lord Chancellor, like Lord Fitzgerald—who made similar remarks\textsuperscript{40}—may have failed to get properly to grips with the basis on which Lindley LJ had found that the trustees had failed to get properly to grips with their expert’s advice. Lindley LJ’s remarks are expressive of, and they are consistent with, ‘due care of the capital sum’ being the uppermost consideration.

There is nothing in the judgment of the third Law Lord, Lord Watson, to indicate that the judgments of the Court of Appeal had struck him in the way they seem to have struck Lord Halsbury LC and Lord Fitzgerald.

In any event, the House of Lords upheld the judgment of the Court of Appeal.

**Trustees’ responsibility for ‘right reason’**

Their Lordships did not expressly cite St Thomas’s view that prudence is ‘right reason about things to be done’.\textsuperscript{41} An important consideration against ascribing this omission to Protestant malice was that Lord Fitzgerald was sitting with the Lord Chancellor and Lord Watson on this appeal. As well as hinting at, at least, bedroom Catholicism, his Lordship’s thirteen children suggest that, when it came to recognizing a deficiency of prudence and due care in others, it took one to know one.

But if he did not cite the Angelic Doctor, Lord Halsbury LC was at least of like mind with him:\textsuperscript{42}

No one either at the Bar or in either of the Courts in which this matter has been litigated has doubted that the trustees intended to do what was right, and no imputation can certainly be made against them that they were actuated by any other motive than that of procuring the highest amount of interest that they could for their cestui que trust. But the goodness of their motives cannot justify the propriety of the investment.

\[ \ldots \] I do not think it is true to say that one is entitled to consider the special qualities or degree of intelligence of the particular trustee. Persons who accept that office must be supposed to accept it with the responsibility at all events for the possession of ordinary care and prudence.

In this, Lord Halsbury was of one mind, and also, with Bowen LJ who—a mere four years earlier—had held that the standard of ‘honesty’ is that of a sane and rational person:\textsuperscript{43}

Bona fides cannot be the sole test, otherwise you might have a lunatic conducting the affairs of the company, and paying away its money with both hands in a manner perfectly bona fide yet perfectly irrational.

Bowen LJ said this in the context of his famous dictum that the bona fides of the provision of gratuities to directors and staff of a company are to be considered in the light of the principle that there can be ‘no cakes and ale except such as are required for the benefit of the company’\textsuperscript{44}—an admonition seldom mentioned by directors who vote bonuses in the tens of millions to the chief executives to whom they owe their own appointments to the Board.

**Their duty not only to obtain competent and skilled advice, but to ‘test the soundness’ of that advice: a trustee must understand**

To bring the trustee to ‘right reason’ about the ‘things to be done’ in order to make such an investment as the ordinary prudent person would make for the benefit of other people for whom she felt morally bound

\[ \text{40. Learoyd v Whiteley (1887) 12 App Cas 727, 736.} \]
\[ \text{41. Summa Theologica I–II Q 57 a 4 c.} \]
\[ \text{42. Learoyd v Whiteley (1887) 12 App Cas 727,731.} \]
\[ \text{43. Hutton v West Cork Railway Co (1883) 23 Ch D 654, 672–673.} \]
\[ \text{44. Hutton v West Cork Railway Co (1883) 23 Ch D 654, 671.} \]
that a trustee is entitled to rely upon skilled persons in matters in which he cannot be expected to be experienced. He may perhaps rely upon a lawyer on some matters of law, and in this case I do not deny that he would be entitled to rely on a valuer upon a pure question of valuation. But unless one examines with reference to what question the skilled person gives advice it is possible to confuse the reliance which may be properly placed upon the skill of a skilled person with the judgment which the trustee himself is bound to form on the subject of the performance of his trust.

The valuers’ instructions appear to have been vague, and the issue they addressed—the value of the land, plant and business—was not the relevant issue of the value of the land alone. Lord Watson gave the tenor of their Lordships’ reasoning:

If they employ a person of competent skill to value a real security, they may, so long as they act in good faith, safely rely upon the correctness of his valuation. But the ordinary course of business does not justify the employment of a valuator for any other purpose than obtaining the data necessary in order to enable the trustees to judge of the sufficiency of the security offered. They are not in safety to rely upon his bare assurance that the security is sufficient, in the absence of detailed information which would enable them to form, and without forming, an opinion for themselves. At all events if they choose to place reliance upon his opinion without the means of testing its soundness they cannot, should the security prove defective, escape from personal liability, unless they prove that the security was such as would have been accepted by a trustee of ordinary prudence, fully informed of its character, and having in view the principles to which I have already adverted.

In Olsen v Hegarty, it was argued by the plaintiffs before the US District Court for New Jersey that:

The decision-making process that justified this makeup, according to the Plaintiff, was marked by uneducated assumptions, a lack of independent investigation, and a failure to obtain needed expertise as to the best way to meet the Plan’s goals. The Plaintiff argues that the overall investment strategy was the result of the majority of Trustees merely attending monthly meetings and rubber stamping the judgment of Defendants Hegarty and Campbell, along with Mr. Foley, thereby abdicating their duty to make informed and independently investigated investment decisions.

Rejecting the defendant trustees’ summary judgment application, the Court held that:

Whether the Defendants have violated their fiduciary duty of prudence cannot be decided solely based on a comparison of the Plan’s performance in light of the ideal return of a portfolio with a similar purpose over the same time period. It is not within the province of this Court to create an artificial standard of return, against which all portfolios are measured to determine whether a violation of fiduciary duty has occurred. Rather, this Court must examine and analyze the particular behavior and decision-making processes that account for these investments and determine whether these actions or omissions were so imprudent as to constitute a violation of [their duty], regardless of the outcome of the investment.

Even with the assistance of outside consultants making up for their lack of investment experience, the Trustees still were required to maintain an independent and critical eye toward the decisions that they approved. . . . The investment making process revealed in the record illustrates an approach wherein Defendants Hegarty and Campbell, along with
Mr. Foley, were in total control of the Fund’s investments, while the other Defendants passively looked on, moving only to blindly participate when their official approval was called for under the terms of the Trust.

At the very least, the Plaintiff here has raised a genuine issue of material fact as to whether the Trustees, for the most part not competent enough to rely on their own expertise, exercised this level of independent scrutiny when approving the Fund’s investments.

The passages I have italicized in the Learoyd v Whiteley48 and Olsen v Hegarty49 judgments under this heading of this article relate to matters likely to feature in any arguments about, say, investments in hedge funds, collateralized debt obligations and other such ‘securities’ of the current era.

I refer later 50 to the Emperor’s New Clothes, and to the questions the US Secretary of the Treasury and the Chairman of the Federal Reserve should have asked, but did not. Lord Jacobs is in the same boat: although, it seems, fortunately for him, not as a trustee. He is said to have blown £30 million of his £128 million fortune by placing it with Mr Madoff. According to the Sunday Times:51 Madoff’s ‘Ponzi’ fraud used cash from new investors to pay high returns to those who had already committed money, giving the illusion of genuine profits.

Jacobs said: ‘Ponzi schemes typically fold after two to three years but this went on for 20 years and it was paying out 10% a year and 21/2% a quarter.’

... 

Asked what he had done to look into Madoff before injecting funds, he said: ‘When people say you should have done due diligence, what could I have done? I knew several people that had been in the fund for more than 15 years’.

‘The only joke is my friends in England who are quite savvy said, “What return are you getting?” I said, “9%–11%”. They said they were in hedge funds that were producing 25%. I went for the lower return because I am risk-averse, which makes me out to be a total idiot.’

Trustees cannot be so reticent. They have to understand. They must seek advice.52 They must be prepared to ask, and they must ask, the hard questions. They cannot possibly invest ‘prudently’ otherwise. Trustees must be prepared and able to point to a diversified investment strategy; must be able to explain how it was developed for this Trust, and why they considered it to be prudent under the circumstances; and, where those circumstances have changed from time to time, how they adjusted the strategy to meet those new circumstances, or why they considered that no adjustments were necessary on the particular occasion.

‘Prudence is knowledge put to use’53—not ignorance, and impulse, run amok. Yet, as will appear, hedge funds that are not Ponzi schemes may turn out to be run by companies, the managers of which cannot begin to explain what they are doing—apart from making an unconscionable lot of money irrespective of the damage they may be in the course of inflicting on their clients and on the world economy.54 If, like Lord Jacobs, the trustees cannot understand, but—in desperation—are hell bent on investing ‘solum ex impetu aut passione’,55 they are going to be vulnerable to impressive ‘names’.

48. (1887) 12 App Cas 727, 731: cited in the text to footnotes 45 and 46 above.
50. See ‘The committee to save the world’ thinks ‘something’ is happening in the economy, to which ‘time-honoured rules of thumb might not apply, at p. 575 below.
52. In Cowan v Scargill [1985] Ch 270, 289, Sir Robert Megarry refers to the duty of trustees to ‘seek advice on matters which the trustee does not understand, such as the making [and reviewing] of investments.’ See also footnotes 46 and 318.
55. St Thomas Aquinas, Summa Theologica I-II Q 57 a 5 c.
The relevance of a ‘good name’

We have just been living in an era during which investment has been occurring in funds that are being invested on the strength of doubtful and opaque security, of ‘names’, of rating agencies, and of the ‘respectability of the parties’.

Unhappily, at times, medical students without bank accounts, and wine merchants with ‘very small’ businesses, can become trustees. They certainly did in Robinson v Harkin. The medical student left the investment decision entirely in the hands of the wine merchant. In his turn, the latter left it all up to a broker who was not a member of the Stock Exchange. The small-time wine merchant had selected him on the basis that the broker was ‘regarded as a good customer by a firm of wine merchants in a small way of business’. Judgment was given against both trustees for the mess that they made of the trust estate.

Lord Watson saw similar features in Learoyd v Whitely when it was before the Lords:

The course which was followed by the appellants in entering into the transaction of January 1878 is very compendiously stated by Mr Learoyd [one of the trustees: an accountant—see the eighth rule of thumb], in whose evidence, so far as it related to matters within his personal knowledge, Mr Carter [the other trustee: a schoolmaster] generally concurred. In his examination in chief Mr Learoyd was referred to a report by Messrs Uttley & Gray [the ‘valuators’], dated the 8th of October 1877, and interrogated:

‘(Q) Did you and Mr Carter on that report form an opinion that it was a proper security for the investment?

(A) We did after further inquiries.’

Being interrogated in cross-examination:

‘(Q) What other inquiries did you make about the brick properties?

(A) I instructed our solicitor to make inquiries respecting the respectability of the parties.’

It plainly appears from these answers that the appellants had no information regarding the subjects mortgaged except what was contained in the report of their valuators.

The ‘parties’ on whose ‘respectability’ the trustees staked the trust estate had been identified in the Court of Appeal as the proprietors of the ‘speculative and fluctuating brick-making business’: ‘a business largely dependent on the energy and solvency of those working in it… and which cannot be carried on without such an excavation and destruction of the soil as must eventually leave what remains nearly useless’. If they had been convicted fraudsters, or serial bankrupts, the check would have been useful, and might have put the trustees off. But to have plunged in just because the solicitors had not been able to impugn the proprietors’ ‘respectability’ in some such way was hardly prudent. Prof. J. K. Galbraith repeatedly advised the need for taking great care when dealing with big names. Thus:

The world of high finance can be understood only when it is recognized that the greatest admiration is accorded those who are paving the way for the greatest catastrophe.

And thus:

It must be recognized that from few matters has modern society more suffered than from the excesses

56. See ‘But I relied on a rating agency,’ p. 595 below.
57. [1897] 2 Ch 415, 416.
58. (1887) 12 App Cas 727, 735.
60. (1886) 33 Ch D 347, 359 per Lopes LJ; adopted as having stated the position accurately in (1887) 12 App Cas 727, 737 per Lord Fitzgerald.
and errors of what is now called the financial community, although it once had the more luminous sobriquet of high finance.

Lord Kylsant almost certainly would have passed a ‘respectability’ check by a provincial solicitor before he went to jail because the prospectus for which—as a director—he bore legal responsibility failed the test stated by the Court of Criminal Appeal in Rex v Kylsant.63

The falsehood in this case consisted in putting before intending investors, as material on which they could exercise their judgment as to the position of the company, figures which apparently disclosed the existing position but in fact hid it.

The prospectus Lord Kylsant had signed represented that the company had paid a dividend in every year since the end of World War I. It had, too. Hence, one might have thought that its business was prospering. But it failed to mention that, for the last seven years, the company had been making large trading losses. The dividends had been possible only because the company had made large profits in a brief artificial shipping ‘boom’ attributable to the ending of the war, and because it had been the beneficiary of a number of non-recurring items such as refunds by the Revenue authorities of wartime excess profits taxes.

Trustees accordingly need to wash investment proposals in ‘cynical acid’, 64 for, as Professor Galbraith has also noted: 65

Having money may mean, as often in the past and frequently in the present, that the person is foolishly indifferent to legal constraints and may, in modern times, be a potential resident of a minimum-security prison.

A risk which Lord Walker, also, has stressed: 66

A director who is also controlling shareholder of a company may need a lot of persuasion that he is not fully entitled to feather his own nest at the expense of ‘his’ company. Indeed he may find himself serving a custodial sentence before he begins to believe it.

Reconciling prudence and risk

An ordinary prudent person might well invest more expansively for herself than she would invest as trustee for the benefit of other people for whom she felt morally bound to provide. As Lord Watson explained, in Learoyd v Whiteley, the trustee is denied.67

the same discretion in investing the moneys of the trust as if he were a person sui juris dealing with his own estate. Business men of ordinary prudence may, and frequently do, select investments which are more or less of a speculative character; but it is the duty of a trustee to confine himself to the class of investments which are permitted by the trust, and likewise to avoid all investments of that class which are attended with hazard.

In Estate of Rodney B Janes,68 the Surrogate Judge held that the prudential obligation entailed that the trustee ‘does not have a license to speculate.’

None of this means that the trustee is forbidden all risk. He is not an insurer of the trust estate.69

63. [1932] 1 KB 442, 448.
67. (1887) 12 App Cas 727, 733.
69. Re Mulligan [1998] 1 NZLR 481, 501, ‘I accept that a trustee is neither a surety, nor an insurer of the fund for which he is responsible. Loss of trust money, or... diminution in the real value of a trust fund, does not of itself render a trustee liable. It must be shown that the loss of diminution arose from some failing on the part of the trustee, which can be properly characterized as a breach of trust.’ See also Re Whiteley, Whiteley v Learoyd, (1886) 33 Ch D 347, 357 per Lindley L:.

Whilst on the one hand the Court ought not to encourage laxity and want of care, on the other hand the Court ought not to prevent people from becoming trustees by converting honest trustees into insurers of the moneys committed to their care.
Life presents many dangers. Not the least of them is safety. As the faithless servant in Matthew’s *Parable of the Talents*70 discovered, totally risk-free investment is an oxymoron. Not even burying the trust estate affords protection against loss,71 and, as Geoffrey Shindler has put it:72

Keeping the money under the bed is not risk-free; you are subject both to inflation and burglars (though not necessarily in that order). Even if money at the bank ought probably to remove the burglar risk, it will not remove the inflation risk.

Indeed, at the beginning of his reasons for judgment in *Re Godfrey*, Bacon V-C held that:73

No doubt it is the duty of a trustee, in administering the trusts of a will, to deal with property intrusted into his care exactly as any prudent man would deal with his own property. But the words in which the rule is expressed must not be strained beyond their meaning. Prudent businessmen in their dealings incur risk. That may and must happen in almost all human affairs.

Reconciling Lord Watson’s depreciation of hazard with Bacon V-C’s recognition and acceptance of the inevitability of risk, Brightman J has held that ‘the distinction is between a prudent degree of risk on the one hand, and hazard on the other’.74

*Where the settlor wants all the trust eggs in one basket, the trustee had better watch the basket closely*

That reconciliation can be hardest where the terms of the trust fetter what otherwise might be trustee’s better judgment. The ‘prototypical trust asset’ of old was ancestral land.75 Today, it is more likely to be a family company. In either situation, sentiment

---

70. Mt 25: 14–30: ‘You wicked, lazy servant! So you knew that I harvest where I have not sown and gather where I have not scattered seed? Well then, you should have put my money on deposit with the bankers, so that when I returned I would have received it back with interest. Take the talent from him and give it to the one who has the ten talents. For everyone who has will be given more, and he will have an abundance. Whoever does not have, even what he has will be taken from him. And throw that worthless servant outside, into the darkness, where there will be weeping and gnashing of teeth.’


72. (1883) 23 Ch D 483, 493.

73. *Bartlett v Barclays Bank Trust Co Ltd (No 1) [1980] Ch 515, 531.*


is a fetter on the trustee—who is more on her mettle than ever.

In the family company context, Cross, J. held, in *Re Lucking’s Will Trust*,76 and, in *Bartlett v Barclays Trust Co (No 1)*,77 Brightman, J. repeated and elaborated, that a trustee of a controlling shareholding in a family company must keep a close eye on the company’s activities. The trustee must not rest content with receiving no more than the statutory accounts. Without having to go so far as to monitor the directors’ every move, the trustee nonetheless must not just turn a blind eye. Rather, he must secure the regular supply of all the information that an ordinary prudent investor would require, so as to enable him to act timeously for the protection of the trust estate. Their Lordships said that this could involve the trustee in, for example, all or some of:

- running the business himself,
- becoming a non-executive director,
- appointing a nominee to the board to report to him,
- overseeing the company’s affairs by studying the agenda and minutes of board meetings, the management accounts, and the quarterly or other periodical reports to the board.

The same principle applies whenever the share parcel included in the trust estate is big enough to empower the trustees to insist on such, or similar, rights in respect of the company’s business.78

If the information so secured begins to show that drastic action is called for, including even selling the underlying business or property, the trustee must continue as a prudent investor, and do what has to be done.

This is just what the trustee in *In the Matter of Repus Trust and Trustcorp Ltd*79 had set out to do in respect of a trust estate the sole asset of which was the illiquid 744 acre Barne Estate in Tipperary, Ireland, on which stood a period house and other buildings, all in a state of decay and disrepair. The estate had been in the family for more than three centuries. Confirming the trustee’s decision to sell up, against beneficiary opposition, the Bailiff, Sir Philip Bailhache, exercised the jurisdiction which Robert Walker, J. had confirmed in these terms in an unnamed, undated and unreported judgment in the Chancery Division:80

The second category is where the issue is whether the proposed course of action is a proper exercise of the trustees’ power where there is no real doubt as to the nature of the trustees’ powers and the trustees have decided how they want to exercise them but, because the decision is particularly momentous, the trustees wish to obtain the blessing of the court for the action on which they have resolved and which is within their powers. Obvious examples of that which are very familiar in the Chancery Division are a decision by the trustees to sell a family estate or to sell a controlling holding in a family company. In such circumstances there is no doubt at all as to the extent of the trustees’ powers nor is there any doubt as to what the trustees want to do, but they think it prudent and the court will give them their costs of doing so, to obtain the court’s blessing on a momentous decision. In a case like that there is no question of surrender of discretion and indeed it is most unlikely

---

76. [1968] 1 WLR 866, 874.
78. Thus, in *Dominica Social Security Board v Nature Island Investment Company Limited & Anor (Dominica)* [2008] UKPC 19 (2 April 2009), their Lordships [at page 10] denied the possibility of viewing the interposition of a company, to manage the assets in question, as a mere matter of form. They would add (to avoid any misunderstanding) that trustees or other fiduciaries cannot of course use a limited liability company as a means of insulating themselves from responsibility for recklessness in the conduct of a business (see *Bartlett v Barclays Bank Trust Company Ltd* [1980] Ch 515). DSSB, and in particular its Director and its Investment Committee, will have a heavy and continuing responsibility for monitoring the way in which the new company’s board of directors carry on its business. So, in a rather more remote way, will the Minister. But in doing so they will be taking care of an investment, not running a business.

that the court will be persuaded in the absence of special circumstances to accept the surrender of discretion on a question of that sort, where the trustees are prima facie in a much better position than the court to know what is in the best interests of the beneficiaries.

On the other hand, the beneficiaries in Gregson v HAE Trustees\(^{81}\) claimed their trustee had failed to take the steps it ought to have taken in respect of the old, established family furniture business which—like the trustee, whose directors were being sued in a ‘dog-leg’ claim—had become insolvent. The estimated deficiency for shareholders was £70 million.

The court ruled that the directors of the corporate trustee owed fiduciary duties to that company alone, and not to the beneficiaries of the trust which it had been administering. Nonetheless, the court noted what would have been in issue had it ruled against the directors:\(^{82}\)

I should also say what is not in issue on these applications. The defendants say that they did in fact consider the question of diversification of the Courts [Bros (Furnishers) Limited] shares from time to time and had good grounds for concluding that the shares should be retained. They say it was always the wish of the Cohen family, including the claimant and the other appointees of the Settlement, that Courts should remain substantially a family owned and managed company. They rely on letters of wishes by which the settlor stated in 1988 that the shares should not be sold except in the case of a takeover. They point out that the holdings of the various family members in Courts, which together comprised a majority holding, continued until late 2004, and that diversification would have risked eliminating the family’s controlling holding. They also refer to the terms of shareholders agreements affecting the shares, to potential tax liabilities from a sale of the shares and to the possibility of a disposal of Courts or its business during 2004, all of which they say were good reasons not to diversify. They also allege that the claimant, with full knowledge, consented to and concurred in the retention by HAE of the Courts shares. It is common ground that I cannot deal with these issues on the present applications, and that the application is restricted to the two narrow points I have already identified. However, this brief survey shows that if this case is to continue there will be a reasonably substantial trial.

Irrespective of the outcome of the dog-leg claim, the parties fully argued, and asked the court to decide, whether the trustee had been dispensed from any duty to act as the trustee of the Repus Trust had done. Although expressed in terms of provisions of the Trustee Act 2000, the decision accords with the general prudential trustee obligation:\(^{83}\)

Fifth, the imposition of the duty to review diversification of the trust investments under section 4(3) of the 2000 Act is not, in my view, inconsistent with, or inimical to, the...notion that this was a trust of shares in a family company, or the settlor’s letters of wishes, or any other indications that the settlor wished HAE, if possible, to retain the Courts shares. I reach this view for several reasons.

In the first place, the settlor did not, as he could have done, insist that the Courts shares never be sold. He gave the Trustees a power to sell them and, as already explained, this meant that they were always ‘available for investment’.

The second reason is that section 4(3)(b), which deals with diversification, contains the qualification ‘in so far as is appropriate to the circumstances of the trust’. This important qualification is echoed also in section 5(3), where the exception to the need to obtain advice

---

81. [2008] WTLR 999.
refers to ‘all the circumstances’. In my view, the nature and purposes of the Settlement, the existence of cl 2, the letters of wishes, and, indeed such matters as the shareholdings of other members of the family or family trusts in Courts, are all ‘circumstances of the trust’ for the purposes of section 4(3)(b) capable of qualifying the appropriateness of diversification. Hence, all the arguments that the settlor intended HAE to hold the Courts shares and reflected this in cl 2 of the Settlement come into play in the exercise of the section 4(3) duty. This approach appears to me to be far more consonant with the statutory purpose of requiring trustees to review the trust investments and to consider diversification than the argument that these factors serve to oust the duty altogether.

The third reason is that the section 4(3) duty is a duty to review and consider diversification of the investments of the trust, it is not a duty to diversify. In my view, it is not inimical to or inconsistent with the terms or purposes of the Settlement to require HAE to review the diversification of the investments of the trust from time to time, where the circumstances relevant to their review might well justify deciding to retain the entire block of Courts shares.

That approach must be right. Of course the sentimental attachments to the particular enterprise must be weighed in the balance. The identity of the family may be closely entwined with the business of the estate, and that is not to be ignored. But that does not absolve the trustee from her Re Lucking’s Will Trust, Bartlett v Barclays Trust Co (No 1) duties. If you have all your eggs in one basket, you need to keep a close watch on the basket. And at some point, her vigilant discharge of these duties shall have brought her to the point at which she must make a decision to bail out, then she must do so—first applying to the court for confirmation where beneficiary dismay makes that wise.

**When failing to diversify is inexcusable failure to balance the portfolio**

Save for cases like these—where the trustee has undertaken the trust on the basis that all or most of its eggs are intended to be in the one basket—the tension between hazard and prudent risk must be resolved by balancing diverse investments. Prof. Langbein identifies:

But, he quickly adds:

When, however, the trust investor starts with cash in hand, *failing to diversify is inexcusable* [sic].

Loring J. certainly thought so in the Massachusetts case, *Warren v Pazolt*. The trustees had managed to tie up 92% of the trust estate in a single investment. The learned judge held that:

The fundamental objection to the erection of the Carney Building being an act in the exercise of a sound discretion lies in the large proportion which

---

84. [1968] 1 WLR 866, 874.
86. Cf Dominica Social Security Board v Nature Island Investment Company Limited & Anor (Dominica) [2008] UKPC 19 (2 April 2008), where, at p. 10, their Lordships refer to the trustees’ ‘heavy and continuing responsibility for monitoring the way in which the new company’s board of directors carry on its business.’
87. In ‘English Fiduciary Standards and Trust Law (The Rise of the International Trust)’ 32 Vanderbilt Journal of Transnational Law 555, 558 (1999), Professor David Hayton pointed out that ‘the need to diversify arises from the duty to act as a prudent person would in investing for others’.
90. 89 NE 381 (1909).
91. 89 NE 381, 388 (1909).
that investment bears to the whole trust estate... The value of the land when the new building was determined upon was therefore $403,000. The new building cost about $450,000 all of which was borrowed on mortgage. This single investment was an investment of $850,000 out of a trust principal of a little over $920,000. We do not see how this can be justified as the exercise of a sound discretion... 

... The error made by the trustees was adding to this land then worth $375,000 another lot worth $28,000 and erecting upon it a $450,000 building, when the whole trust amounted to no more than $920,000, in place of selling the land valued at $375,000 with the old buildings then on it as they stood.

Taking a like view in Estate of Rodney B. Janes, the New York Surrogate Judge found against a trustee bank which had maintained 71% of the trust estate in a single blue chip stock (Eastman Kodak) which had long been experiencing a decline in value. The witness for the trustee, Mr Patterson, testified that the testator’s widow had told the bank that she ‘loved’ Kodak.

Patterson testified that Mrs Janes agreed with each of the Patterson recommendations to the extent that she ‘loved Kodak’ and her husband ‘loved’ Kodak. As appears later, the bank’s reliance on these expressions was part of the basis to retain a concentration in EK. The loose statements made by Mrs Janes can hardly be equalled [sic] with a consent to the retention. The record is devoid of any signed consent, further communications [sic] by her, acknowledged or otherwise.

The Surrogate Judge said:

Notwithstanding turbulent worldwide economic conditions including an OPEC oil embargo, all of which resulted in a monumental and precipitous decline in the stock market during the 1973–74 period, the bank’s position continued to be one to retain the Eastman Kodak stock in its concentrated form. In that one year the EK stock dropped from approximately $115 a share to about $60 a share. In summary, the Bank’s position in demonstrating prudence is that the retention of the EK was part of a conscious and studied investment plan. In reality, the Bank’s responsiveness to the admittedly turbulent and precipitous tenor of the times (1973) was to do nothing. To assert that mere review, analysis, and monitoring satisfies the standard of due care by a prudent person where action and activity are indicated, tests the Court’s sense of reason and logic and more importantly flies in the face of the surcharge cases heretofore cited.

The decision of the learned Surrogate Court judge on liability was affirmed by the Court of Appeals, New York. That Court held that:

First, petitioner failed to consider the investment in Kodak stock in relation to the entire portfolio of the estate... , ie, whether the Kodak concentration itself created or added to investment risk. The objectants’ experts testified that even high quality growth stocks, such as Kodak, possess some degree of volatility because their market value is tied so closely to earnings projections.... They further opined that the investment risk arising from that volatility is significantly exacerbated when a portfolio is heavily concentrated in one such growth stock.

Second, the evidence revealed that, in maintaining an investment portfolio in which Kodak represented 71% of the estate’s stock holdings, and the balance was largely in other growth stocks, petitioner paid insufficient attention to the needs and interests of the testator’s 72-year-old widow, the life beneficiary.
of three quarters of his estate, for whose comfort, support and anticipated increased medical expenses the testamentary trusts were evidently created. Testimony by petitioner’s investment manager, and by the objectants’ experts, disclosed that the annual yield on Kodak stock in 1973 was approximately 1.06%, and that the aggregate annual income from all estate stockholdings was $43,961, a scant 1.7% of the $2.5 million estate securities portfolio. Thus, retention of a high concentration of Kodak jeopardized the interests of the primary income beneficiary of the estate and led to the eventual need to substantially invade the principal of the marital testamentary trust. Lastly, there was evidence in the record to support the findings below that, in managing the estate’s investments, petitioner failed to exercise due care and the skill it held itself out as possessing as a corporate fiduciary . . .

Notably, there was proof that petitioner:

1. failed initially to undertake a formal analysis of the estate and establish an investment plan consistent with the testator’s primary objectives;
2. failed to follow petitioner’s own internal trustee review protocol during the administration of the estate, which advised special caution and attention in cases of portfolio concentration of as little as 20%; and
3. failed to conduct more than routine reviews of the Kodak holdings in this estate, without considering alternative investment choices, over a seven-year period of steady decline in the value of the stock.

Since, thus, there was evidence in the record to support the foregoing affirmed findings of imprudence on the part of petitioner, the determination of liability must be affirmed . . .

Senator Janes’s widow might have been a sweet and complaisant little old lady who could live on the smell of an oily rag, but the court was not going to condone the bank treating her that way. Referring again to the hapless bank witness, the learned Surrogate judge had said:94

That the EK stock in 1973 had a yield of 1.1% is again uncontroversial. The Patterson testimony and indeed the thrust of the bank’s position vis-a-vis this income level is that yield in its broader form involves not only the actual dividend ratio to the price but also involves the growth nature of the stock and the probabilities for future appreciation. . . . With this position, the Court does not agree. Given the age, health and status of Mrs Janes in 1973 and the fact that the ultimate beneficiaries were charities, the income yield was insufficient and unacceptable.

Sweetness and complaisance may well have been lurking somewhere deep in the character of the widow in *Re Mulligan*,95 but she seems to have suppressed any urge to reveal those qualities. She was the life tenant. She was one of the trustees. The other trustee was a trustee corporation. Although her personal solicitor gave evidence—the relevance of which is unclear—that she ‘was not obdurate or unreasonable in his experience’,96 the officers of that corporation seem to have seen her as something of a Madame Lash. The court found that ‘she was a person of some business acumen’, that she had been ‘alive to the wisdom that a share portfolio historically and into the future would provide a measure of protection against inflation’, but that ‘she was quite hostile to any suggestion of diversification when that issue was raised’ by officers of the trust company.97 She turned her income situation into the reverse of that from which the New York courts rescued the widow in *Janes*.

---

94. 214 NYLJ 31 (5 July 1995).
95. [1998] 1 NZLR 481.
96. [1998] 1 NZLR 481, 505.
She outlived her farmer husband by 41 years. The farm was sold after 16 of those years, and she then received the balance of a substantial legacy, which enabled her to buy a home, a rental apartment, and (although the trustee knew nothing of this) to make significant investments in shares.

The $108,000 balance remaining in the hands of the trustees would have sufficed to purchase 14 average residential properties in the city of Christchurch in 1965. From that year, until the widow’s death 25 years later, the trustees invested it entirely in fixed interest securities such as mortgages and central and local government stock.

The life-tenant-widow-trustee had a very good income as a result. The realty and shares on which she spent her legacy were worth $686,000 when she died in 1990.

Thanks to the investment policy, the trust capital was then worth only $102,000: $10,000 short of the average price of a single residential property in Christchurch at that date.

The question identified by the court was ‘whether exclusive investment in fixed-interest securities to the exclusion of equities constituted a breach of trust in the circumstances of this case’. On behalf of the defendant trustees, expert evidence was given that their investment policy had been ‘in line with the then current thinking and practice’. That evidence may have evoked in the mind of the court the celebrated comment by Bowen LJ that ‘Bona fides cannot be the sole test, otherwise you might have a lunatic conducting the affairs of the company, and paying away its money with both hands in a manner perfectly bona fide yet perfectly irrational’. At all events, the court found the trustees to have been in breach of duty by not having ensured that, by 1972, the estate had been invested in equities to the extent of 40% [or $43,200] of the fund: A fund of only $43,000 was never going to be enough to construct and manage a fully index-matched portfolio. The trustees would have to have made choices:

Investment at that level would have enabled the purchase of a reasonable spread of blue-chip shares, whereas the options would have been limited with any appreciably lower level of investment. A reasonable spread would have comprised about ten shares, selected on the basis of performance and with long-term retention in mind. Other considerations would also have been at play. In 1972 the rate of inflation was of the order of 10 per cent and the trend in relation to mortgage interest rates was upwards. These factors would have underscored the need for a decisive move into the sharemarket.

Turning to the question of whether the assumed estate portfolio would have increased in value in line with the Barclays Index, the Court was again confronted with conflicting evidence. On the one hand Mr Nisbet ventured the confident opinion that a suitable mix of blue-chip shares would have outperformed the index. He justified this opinion on the basis that the estate would have been advised to pick the six to ten best stocks out of the 40 that comprised the then Barclays Index. At the other end of the spectrum was the final witness Mr Irvine called for the second defendants. He considered that although the index was probably the most suitable available benchmark, it did not provide a valid base for measuring the performance of a fairly modest portfolio of a private trust. He supported this contention by reference to various factors. The index comprises a basket of shares. An estate could not hope to ‘buy the Index’. The spread of investment over 40 shares would provide, he considered, a lower risk profile than investment in a limited number of shares. In addition, he characterised the index as a ‘winners’ measure. By this Mr Irvine meant that profitable growing companies become part of the index, while declining companies

99. Hutton v West Cork Railway Co (1883) 23 Ch D 654, 672–673.
100. [1998] 1 NZLR 481, 509.
drop out. Accordingly for an estate to match the index, would require a considerable level of trading; conduct inconsistent with that to be expected of trustees committed to the purchase of blue-chip shares on a long-term basis. He pointed as well to the costs involved in acquiring and selling shares, namely commission and duty. It was therefore Mr Irvine’s view that in using the index as a benchmark in the present context, a discount factor of 50 per cent should be applied.

I considered Mr Irvine to be an impressive witness. Largely on the basis of his evidence it is my view that the identified contingencies do require the application of a discount factor, but not at the level suggested. I consider a discount of one-quarter would be appropriate. Mr Irvine’s views were expressed on the footing that the estate would hold a narrow portfolio of two or three shares. I regard that as unlikely. With an investment of $43,200 in 1972 a portfolio of perhaps ten shares would have been obtained. I consider this holding would have been retained intact and would, on the probabilities, have increased in value to the extent of 75 per cent of the growth in the index.

From there, as will appear, the court was driven to conclude that the $43,200 would have increased to $170,640, and effectively to surcharge the trust company with the difference between these figures.

This is not to say that the Trustees can, or must, adopt fixed percentages, or rules of thumb. As the US District Court, Maryland, in Meyer v Berkshire Life Insurance Company held:

the duty to diversify investments cannot be stated as a fixed percentage, because a prudent fiduciary must consider the facts and circumstances of each case.

**Balance mediates between risk and return: portfolio theory**

As Hoffmann J. has put it, trustees now are to ‘be judged by the standards of current portfolio theory’. And in the United States, the Association for Investment Management and Research has declared that:

The investment profession has long recognized that the combination of several different investments is likely to provide a more acceptable level of risk exposure than having all funds in a single investment.

For the larger trust estate, ‘buying the index’ may be feasible and desirable. For the smaller estate, as in Re Mulligan, as few as ten stocks may suffice. The important thing is that they are truly diverse in the sense of being minimally correlated. Stocks are not relevantly diverse if they are ‘co-variant’—all likely to go belly-up at once.

---

102. Under ‘Consequences of authorized, but negligent, investment,’ p. 557 below.
Justice Richard Posner of the US Court of Appeals for the Seventh Circuit, writes extensively of portfolio design in his *Economic Analysis of Law*.108 His comments include these basics [for ease of reference, I have inserted subheadings, and have incorporated the footnotes into the text]:

**[Risk and expected return]**

A security has two dimensions: risk and expected return. The expected return is constructed by multiplying every possible return by the probability of its being the actual return, and then adding the results of the multiplication. Thus, if there is a 50 percent probability that a particular stock that sells for $10 today will be worth $12 one year from now, a 40 percent probability that it will be worth $15, and a 10 percent probability that it will be worth nothing, its expected return is $2 \([\frac{1}{2} \times 2 + \frac{4}{10} \times 15 + \frac{1}{10} \times 0]\) [The expected value is $12 \([\frac{1}{2} \times 12 + \frac{4}{10} \times 15 + \frac{1}{10} \times 0]\), and the current price is $10. To simplify analysis, it is assumed that no dividends will be paid. The expected return of a stock includes, of course, both appreciation and dividends.]

**[Usual preference is for the lower risk for the same return]**

Although the expected return of a 100 percent chance of obtaining $10 is the same ($10) as the expected return of a 50 percent chance of obtaining $20 or a 1 percent chance of obtaining $1,000, we know that people are not indifferent to the various ways of combining uncertainty and outcomes to yield the same expected return. In choosing among securities that have identical expected returns, the risk-averse investor will choose the one having the least uncertainty unless the prices of the others fall, thereby increasing their expected returns, to the point where he feels adequately compensated for bearing greater risk.

The prevalence of risk aversion in investing is illustrated by the normally lower rate of return on bonds compared to the common stock of the same company. Suppose that the expected return (dividends plus appreciation) on a company’s common stock is 10 percent. Risk-neutral investors would demand 10 percent interest on the company’s bonds as well. Although there is less risk to being a bondholder, since he has the cushion of the equity shareholders, who would have to be wiped out completely before he could lose his interest, his additional safety is offset in an expected-return sense by the fact that he cannot earn more than the interest rate specified in the bond. The difference between a company’s bond interest rate and the (higher) expected return to owners of the common stock is compensation to the stockholders for the extra risk they bear. [(There) is one risk that bondholders bear that shareholders do not (to the same extent). (It is, of course, inflation.)]

**[Negatively correlated risks can cancel each other out]**

It follows that there should also be a systematic difference among the expected returns of common stocks that differ in their riskiness; but this point is subject to an important qualification. Suppose the expected per-share returns of two stocks (A and B) are the same, $2, but the expected return of A combines a 50 percent probability of no return with a 50 percent probability of a $4 return, while that of B combines a 50 percent probability of a $–6 return with an equal probability of a $10 return. B is the riskier stock. Let there be a third stock (C) that, like B, has an expected return of $2 resulting from a combination of a 50 percent probability of a $–6 return with the same probability of a $10 return—only the fortunes of C and B are reciprocal, so that when B does well C does poorly and vice versa. [That is, there is a 50 percent probability that B will yield a $–6 return and C a $10 return, and a 50 percent probability that B will yield a $10 return and C a $–6 return.]

Then a portfolio composed of B and C will be less risky than one composed solely of A, even though A, considered in isolation, is less risky than either B or C. The investor will not insist on a risk premium for holding B and C in his portfolio. Their risks cancel; the portfolio itself is risk free.109

[Portfolio design proceeds accordingly]

This illustrates the fundamental point that portfolio design can alter the risk characteristics of securities considered individually. And in a world in which the risks of different common stocks were negatively correlated, as in the preceding example, there would be few if any differential risk premiums among common stocks. Less obviously, this would also be true if the risks of common stocks, instead of being negatively correlated, were uncorrelated, ie, random; for in a portfolio consisting of many different common stocks, the randomly distributed risks of the securities in the portfolio would tend to cancel out. By way of analogy, observe that while the riskiness of every individual life in this country is nonnegligible, the country’s death rate—the performance of the ‘portfolio’ of all individuals—is extremely stable. It is, in fact, much more stable than the stock market. This suggests that the risks of different common stocks are neither negatively correlated nor random but in fact have a strong positive correlation. This in turn makes it necessary in portfolio design to distinguish between two components of risk. One is the component that is positively correlated with the risk of the whole flock of securities, the market, and therefore cannot be eliminated simply by adding more and more securities. The other component is risk that is negatively correlated, or uncorrelated, with the risk of the market as a whole, and therefore can be diversified away. Diversification is an important goal of portfolio design because it allows the investor to get rid of a form of risk that is uncompensated (precisely because it can be eliminated at slight cost, through diversification) and is therefore a deadweight loss to the investor who is risk averse. But diversification does not eliminate all risk; some risk, as we have seen, is undiversifiable, and to bear that risk the risk averse investor will insist on compensation. Because systematic risk—the risk component that is positively correlated with the risk of the market as a whole—is also compensated risk, the portfolio manager who wants to reduce it must be prepared to pay a price in the form of a lower expected return. [Stocks that differ in systematic risk have been found empirically to differ in expected return, and the correlation between systematic risk and return has been found to be positive as expected. The evidence is summarized in James H Lorie & Mary T Hamilton, The Stock Market: Theories and Evidence, chs 11-12 (1973), but remains controversial. Compare Eugene F Fama & Kenneth R. French, Common Risk Factors in the Returns on Stocks and Bonds, 33 J Fin Econ 3 (1993), with Fischer Black, Beta and Return, J Portfolio Mgmt, (1993), p 8.]

Trustee reliance on funds110

To that end—following the discussion of basic portfolio theory, in his Economic Analysis of Law111 cited


Diversification, the holding of many securities to lessen risk, is the most important concept introduced in this chapter. It means that portfolio managers or individual investors balance their investments among several securities to lessen risk. As a portfolio manager or individual investor adds more stocks to his portfolio, the additional stocks diversify the portfolio if they do not covary (ie, move together) too much in concordance with other stocks in the portfolio. Because stocks from similar geographic regions and industries tend to move together, a portfolio is diversified if it contains stocks from a variety of regions and industries.

... While the principle of diversification is well known, even by students new to finance, implementing mean-variance analysis—for example, coming up with the weights of portfolios with desirable properties, such as a portfolio with the lowest variance—requires some work.


111. 7th edn (2007).
above, and a discussion of leverage as a, risky, means of increasing portfolio returns—Justice Posner canvasses the considerations bearing on whether this duty to balance risk and return requires the trustees to engage in constant attempts to ‘beat the market’ by identifying and purchasing undervalued shares, and by identifying and selling overvalued shares, and thus maximizing the return to the trust estate. His view is that the game is not worth the candle. Research is expensive. Transaction costs are high. Much expensive trustee time is consumed. Above all, the public availability of the information, on which assessments of under and overvaluation fail to be made, entails a sufficient degree of market efficiency to frustrate the attempt to beat it.

So what about managed funds? The trustee thinking in that direction would need, also, to heed Justice Posner’s pessimism whether fund managers, and their specialist analysts, are any better than analysts in general when it comes to beating the market.

...empirical studies have found that mutual funds, despite their employment of security analysts and portfolio managers for the purpose of outperforming the market, fail to do [The early studies are summarized in Lorie & Hamilton, The Stock Market: Theories and Evidence at ch 4. See also Burton G Malkiel, “Reflections on the Efficient Market Hypothesis: 30 Years Later,” 40 Fin. Rev 1 (2005); RA Brealey, An Introduction to Risk and Return from Common Stocks, ch 3 (2d ed 1983); Richard A Ippolito, Efficiency with Costly Information: A Study of Mutual Fund Performance, 1965–1984, 104 QJ Econ 1 (1989). The empirical research has concentrated on mutual funds because they are required by federal law to report in detail on their performance; but all indications are that common trust funds, pension funds, and other

---


Why have the professional investment managers performed so poorly? Modern Portfolio Theory supplies a crisp answer to that question. In a nutshell, the insight is that the professional portfolio managers are not incompetent bunglers, indeed, just the opposite. They are so good at what they do that they effectively cancel each other out.

To understand why, start with the basics. The price of a security represents the present discounted value of its future earnings. Furthermore, for every buyer there must be a seller—someone who has formed an opposite judgement about the value of that future earnings stream at the security’s current price. If all investors agreed that a particular security was a bargain at its current price, no one who owned the security would sell it at that price. Only an increase in price would induce sellers to sell. This is why we can say that, presumptively, any security is correctly priced at its current trading level.

To outperform the market—that is, consistently to identify undervalued or overvalued securities in advance of other investors—an investor must predict future earnings with superior speed and accuracy. But here the task becomes daunting. New information about individual companies is disseminated rapidly as a result of modern communications systems. The securities laws have largely choked off inside information as a source of advantage in trading. Economic developments, technological innovation, foreign affairs, political events, social changes—all profoundly affect the prices of securities, yet these phenomena are notoriously difficult to foresee.

Professional securities analysts are thus largely limited to interpreting information already in the public domain and available to other analysts. In order to outperform the market the portfolio manager has to be consistently better at making such interpretations than the thousands of competing professionals who are interpreting the same data. The theory of efficient markets posits that everything that is known or knowable about the price of a publicly traded security is already fully reflected in its price. The securities markets are so efficient in discounting information and pricing securities that not even the professionals can consistently identify undervalued and overvalued securities before other investors get there. The indifferent performance record of professional investment managers is, therefore, ‘exactly what we should expect in an efficient market.’

institutional investors likewise fail to systematically outperform the market portfolio. They do no better than the blind market portfolio.

Although it has been argued that the proper comparison is not between all mutual funds and the market but between the most successful mutual funds and the market, the studies suggest that there are no consistently successful mutual funds. Some enjoy shorter or longer runs of success, but generally the degree of success observed is no greater than one would expect if luck, not skill, is indeed the only factor determining the fund’s performance.

In *Nestle v National Westminster Bank*117 Dillon LJ noted in the Court of Appeal that:

as Hoffmann J pointed out,118 that the evidence showed that if the BZW Equity Index was applied over the period from July 1974 to December 1986 to ‘growth’ unit trusts (as opposed to ‘income’ unit trusts) it appeared that 12 of the ‘growth’ trusts had done better than the index, but 21 had done worse.

So is the solution for the hapless trustee to go passive; to run with Underhill and Hayton’s advice on the alternative to the *Re Mulligan*119 approach, and120 ‘bear in mind the possibility of investing small trust estates in “tracker finds” which track and reflect the index, so obviating the need for a discount based on the size of the fund in question? Here Justice Posner is more positive:121

The studies support an even stronger conclusion: When brokerage costs and management fees are taken into account, the average mutual or common trust fund yields a lower net return than a broadly based market index such as the S&P 500. This comparison was long derided on the ground that the S&P 500 is a hypothetical fund and hence has no administrative costs. Now that there are, and indeed for some years have been, real market-matching funds in operation…, it is possible to evaluate—and reject—this criticism. The administrative costs of a market fund turn out to be so low (on a $500 million portfolio, perhaps 10 percent of the costs of conventional management) that the expected return of a market fund is only trivially different from that of the S&P 500.

In a dramatic sign of the changing legal environment, trustees will now even invest portions of the funds entrusted to them in index funds. A typical index fund buys and holds a 200 to 500 stock portfolio designed to match the performance of the New York Stock Exchange (or perhaps some weighted average of domestic and foreign securities markets), performing no securities analysis and trading only insofar as necessary to maintain diversification, handle redemptions, and invest its shareholders’ cash. It epitomizes passive investment—thus raising such questions as what if every investor adopted the passive strategy implied by the concept? Then the market would cease to be efficient… But long before this happened, some investors would abandon the passive strategy to take advantage of the opportunities, which today are rare, for obtaining positive profits from securities analysis and active trading. How many active traders are necessary to keep the market efficient is a difficult question (need it be answered?). But observation of other markets, for example the housing market, where transactions are relatively infrequent and the products traded are heterogeneous (no two houses are as alike as two shares of the same class of the same company’s stock), suggests that the

---

stock market would remain efficient even if most investors were passive.

Prof. Langbein adds his weight to this.\footnote{Langbein "The Uniform Prudent Investor Act and the Future of Trust Investing," 81 Iowa L Rev 641, 656-658 (1966).}

One response to the lesson that you cannot beat the market is that you might make a considered judgment to cease attempting it, especially if you can pocket the savings from not trying. A vast proportion of all fiduciary investing is now conducted 'passively,' in so-called index or market funds. These funds undertake simply to replicate the performance of the broad market indexes. In the mid-1970s when market funds first appeared, they attracted only a few hundred million dollars, most of it from the AT&T pension funds. Today, hundreds of billions of dollars in American equities are indexed.

Modern Portfolio Theory has taught us that the game of stock picking is costly and futile for most investors, especially small investors, while emphasizing the large and essentially costless gains that are to be had from maximizing diversification. These twin insights point the fiduciary investor—that is, the prudent investor—strongly toward the use of pooled investment vehicles that are large enough to achieve high levels of diversification at reasonable cost. The investment path of the future for trusts, especially smaller trusts, is the mutual fund or the bank common trust fund.

But while an investor of another person’s money could prudently invest in a tracker fund in theory, it is clear that such an investment might not automatically be prudent in practice.\footnote{Cf Womack, 'When tracker funds go off the rails,' Mail on Sunday, 14 January 2008:}

Apart from anything else, a prudent trustee would not simply hand the relevant part of the fund over to the tracker fund manager, without considering, and regularly verifying, for example, the basis on which it proposed to maintain diversification.

Nor would a prudent trustee necessarily and always concentrate on stocks and bonds, but ignore land\footnote{For example, the American Law Institute's authoritative Restatement of the Law, Trusts—Prudent Investor Rule (1992) 54–55 lays down that:}

Tracker funds are supposed to take the guesswork out of investing. But a saver who five years ago picked the wrong UK tracker for their £10,000 investment would today be more than £8,000 worse off than someone who chose the top tracker.

These funds aim to reproduce the gains, or losses, of a stock market index by holding a representative mix of the shares that make up the index. The process is largely automated, with no room for the human judgement calls made by the high-earning fund managers who run active funds.

In theory, savers can invest in a tracker and expect it to give them returns in line with their target index. But in reality the funds deliver widely varying returns with differences in charges and management styles leaving investors in some funds 17% behind others who were aiming for the same target.

Someone who invested five years ago in both St James's Place Tracker and Fidelity Moneybuilder UK Index would expect both to track the FTSE All-Share Index. But while Fidelity Moneybuilder has generated a return of 101.1%, St James's Place Tracker has delivered just 83.8%.

Worryingly for savers, no tracker fund was able to keep pace with its target index over the past five years. All were index laggers rather than index trackers.

Charges and fees explain most of the differences in performance between funds tracking the same index. The cheapest trackers, such as Fidelity’s Moneybuilder, have annual charges of just 0.1%. But others—such as St James’s Place Tracker, charge 1.25% a year—12 and a half times as much.

Ben Willis, head of research at financial adviser Whitechurch Securities in Bristol who compiled the figures for Financial Mail, says:

‘Over time initial charges and annual management fees will eat away at returns and it is only to be expected that most trackers will lag some way behind the index.’

Because of its importance as a part of the country’s capital markets, real estate is a potentially valuable ingredient of a diversification strategy, especially in light of its limited covariance with publicly traded equity and debt securities. Historically, land has also tended to provide long-term protection against inflation. In addition, diversified real estate holdings have tended to offer, with less apparent volatility, returns comparable to those of a diversified portfolio of marketable securities. Furthermore, with thoughtful selection of properties or structuring of ownership positions, a trustee can organize the elements of the return toward the enhancement of either income productivity or principal appreciation, as might be desired for a particular trust portfolio.

Despite the potential advantages of investing in real estate, it would not be prudent for a trustee to disregard the complexities, burdens, and special risks associated with a decision to commit a portion of the trust estate to such investments. High transaction costs are to be expected. In addition, the absence of regulated and efficient central markets that deal in largely uniform assets creates specialized problems and significant extra risks.
as a harbour in which to invest some of the trust estate.

**Retaining an investment is ‘investing’: the necessity for review**

The ready comparability of funds can burden the trustee who has not been diligent with the uncomfortable onus of proving that his actions had been prudent:125

Consider, therefore, a simple case. Suppose that a trustee determines to invest twenty percent of the trust in an intermediate-term bond fund. Suppose, further, that the particular intermediate bond fund that the trustee chooses persistently underperforms other intermediate term bond funds on account of drastically higher expense ratios. In view of the trustee’s duty to monitor, the burden will more easily shift to the trustee to explain why the trustee chose that particular fund. Under the prudence standard, the comparability of increasingly standardized fund types will allow trustees (and the courts who oversee trustees when beneficiaries are unhappy) greater precision in examining investment performance. The point is not that a disappointing fund or fund year is ipso facto imprudent—far from it. The point is that the growing comparability of fund types provides a more precise and objective benchmark for evaluating claims that a certain fund is so manifestly inferior to competitors that investing in it, or retaining it, is imprudent.

Trustees must always be prepared and able to point to a diversified investment strategy; must be able to explain how it was developed for this Trust, and why they considered it to be prudent under the circumstances; and, where those circumstances have changed from time to time, how they adjusted the strategy to meet those new circumstances, or why they considered that no adjustments were necessary on the particular occasion.

It is challenging enough to find an answer to the question ‘what would be a properly balanced portfolio in the light of, among other things, the state of the domestic and international economies; inflation or deflation prospects; the taxation matrix; the balance of special beneficiary income needs; and capital appreciation or at least capital protection?’126 But finding an answer is only the beginning, not an end, of the challenge. The answer will require constant review.127

---

In *Estate of Rodney B. Janes*, the New York Surrogate Judge held that, as well as keeping under surveillance ‘the risks of a portfolio, the marketability of the holdings, its volatility, and the market conditions then and there prevailing’, a trustee must consider whether, in the circumstances, he has:

invested in or maintained an unusually large proportion of the fund in a single type of security. . . . Generally allied with the consideration of an unusually large portion retained in a single security which may be termed a concentration (to be developed later in this decision) is the issue of diversification. In that respect it is clear that the failure to diversify by itself is not an act of imprudence. . . . Courts have tended to apply a different (more relaxed) standard when the fiduciary retains assets owned by the decedent as distinct from those that the fiduciary has acquired. . . . Such retention, however, does not exempt the fiduciary from the Prudent Man Rule, so where a fiduciary retains assets it must exercise prudence in doing so.

Where the trust estate does include assets derived from the settlor, the ‘more relaxed’ attitude will extend only so far as to treating them as authorized. There will be no relaxation in the standard of vigilance required to ensure that their retention does not become imprudent.

Because, as Berry V-C held, in the Court of Chancery of New Jersey, in *Dickerson v Camden Trust Co*., ‘retaining investments is in effect making them’, review is not an end in itself. Thus, in *Estate of Rodney B. Janes*, the New York Surrogate Judge held also that:

Notwithstanding turbulent worldwide economic conditions including an OPEC oil, embargo, all of which resulted in a monumental and precipitous decline in the stock market during the 1973-74 period, the bank’s position continued to be one to retain the Eastman Kodak stock in its concentrated form. In that one year the EK stock dropped from approximately $115a share to about $60a share. In summary, the Bank’s position in demonstrating prudence is that the retention of the EK was part of a conscious and studied investment plan. In reality, the Bank’s responsiveness to the admittedly turbulent and precipitous tenor of the times (1973) was to do nothing. To assert that mere review, analysis, and monitoring satisfies the standard of due care by a prudent person where action and activity are indicated, tests the Court’s sense of reason and logic and more importantly flies in the face of the surcharge cases heretofore cited.

Writing extra-curially, Lord Nicholls of Birkenhead came down firmly against the convenience of inertia:

Trustees’ problems with investments are not over once they have formulated their strategy and acquired their portfolio. Shares carry rights, and part of the duty of trustees is to decide how to exercise the voting and other rights attached to the trust fund securities. The proper discharge of this duty today by trustees of large funds must require more than deciding how to vote on routine resolutions put before shareholders at annual general meetings by the directors. *Inertia is a comfortable pillow, but it is not available to trustees.*

Each trustee carries full responsibility

Each trustee must consider the matter and make up his or her mind. ‘A fiduciary’s independent investigation of the merits of a particular investment is at the heart of the prudent person standard.’

---

128. 214 NYLJ 31 (5 July 1995).
129. See the discussion under ‘Where the settlor wants all the trust eggs in one basket, the trustee had better watch the basket closely,’ p. 535 above.
130. 140 NJ Eq 34, 42; A 2d 225, 231 (1947).
131. 214 NYLJ 31 (5 July 1995).
So, in *Re Mulligan*, the New Zealand High Court held that:

> upon entering office each individual trustee has a separate responsibility to ensure that the terms of the trust are carried out. It is not open for one trustee to defer to the wishes of another trustee in the absence of proper reasons for doing so.

As the decision in that case compellingly illustrates, there cannot be a ‘proper reason’ for minority trustees to permit the majority to make decisions ‘at which no reasonable body of trustees could arrive’. Just as ‘getting along, by going along’ is fiduciary anathema, resignation to clear a path for a breach of trust is itself a breach of trust. It is not an option for the minority.

The safer course for the Trustees, or for those of them on either side of the disagreement, is to apply to the court for directions as in *In the Matter of Repus Trust and Trustcorp Ltd.*

**Consequences of unauthorized investment but for which the trust estate would not have suffered**

Within the ‘limits of what was committed’ to her, no exercise of a trustee’s power will be set aside just because the court would have done it differently itself, or even just because of ‘gross negligence [or] honest blundering or carelessness’ on her part.

However, those limits are critical. The common law requires power holders to exercise their powers for the purposes for which they were conferred.

---

136. Jersey Royal Court, Samedii Division, [2005] JRC 081, 15 June 2005. Considered under ‘Where the settlor wants all the trust eggs in one basket, the trustee had better watch the basket closely,’ p. 535 above.
137. Dundee General Hospitals Board of Management v Walker [1952] 1 All ER 896, 901G per Lord Normand (HL, Sc).
138. See, e.g., *Re Londonderry’s Settlement* [1965] Ch 918, 936G where Salmon LJ said ‘Whether or not the court, if it knew all the facts known to the trustees, would have acted as they did, again I do not know—nor is it material.’ See also *Karger v Paul* [1984] VR 161, 165 (McGarvie J).
140. In *Equitable Life Assurance Society v Hyman*, [2000] 3 WLR 529, 540–541, Lord Cooke made his speech ‘starting from the principle that no legal discretion, however widely worded . . . , can be exercised for purposes contrary to those of the instrument by which it is conferred. As Lord Woolf MR pointed out in his judgment in the Court of Appeal in this case [2000] 2 WLR 798, 806, this principle is common to administrative law (eg *Padfield v Minister of Agriculture, Fisheries and Food* [1968] AC 997) and sundry fields of private law (eg *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821). In an administrative law context, violation of the principle may result in no more than invalidity; in a contractual context, it may result in a breach of contract, which should be rectified.
141. His Lordship’s chosen private law illustration involved a fiduciary power. In *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821, 834, the Privy Council was concerned with the directors’ power to issue company shares:

> Thus, and this is not disputed, the issue was clearly intra vires the directors. But, intra vires though the issue may have been, the directors’ power under this article is a fiduciary power: and it remains the case that an exercise of such a power though formally valid, may be attacked on the ground that it was not exercised for the purpose for which it was granted.
‘Equity follows the law, but not slavishly nor always,’\textsuperscript{141} and requires trustees to act ‘honestly’\textsuperscript{142} [also the requirement of the statutory relief provision\textsuperscript{143}] and within the limits set by the terms in which the power was created.

So, a trustee who pays the trust estate away on an unauthorized investment, is in breach of trust. Because ‘the most important duty of the trustee is to obey the terms of the trust’,\textsuperscript{144} that trustee is not permitted to debit that payment to the account of the trust estate.\textsuperscript{145} But for his unauthorized payment, the trust estate would have continued to reflect its value: which he therefore must restore fully as at the date of the restoration.

Writing extra-curially, Millett LJ has explained the position with characteristic force:

It is misleading to speak of breach of trust as if it were the equitable counterpart of breach of contract at common law; or to speak of equitable compensation for breach of fiduciary duty as if it were common law damages masquerading under a fancy name. Forty years ago, the Chancery Judges bore down heavily on such solecisms. Woe betide a Chancery Junior who spoke of ‘damages for breach of trust’ or ‘damages for breach of fiduciary duty’. The judges knew that misuse of language often conceals a confusion of thought. Nowadays these misleading expressions

\textsuperscript{141. Graf v Hope Building Corp 254 NY 1, 9 (1930) per Cardozo J (dissenting: New York Court of Appeals).}


\textsuperscript{143. Trustee Act 1925 s 61.}

\textsuperscript{144. Youyang Pty Ltd v Minter Ellison Morris Fletcher (2003) 212 CLR 484, 498.}

\textsuperscript{145. Haydon et al, Underhill & Hayton: Law Relating to Trusts and Trustees (Butterworths, London, 2006), 17th edn 89.1(1), 89.3 say that his account must be falsified to delete the unauthorized payment.}
are in common use. It is time that the usage was stamped out.146

Lord Diplock has said that a contracting party is under a primary obligation to perform his contract and a secondary obligation to pay damages if he does not [Moschi v Lep Air Services Ltd [1973] AC 331]. It is tempting, but wrong, to assume that a trustee is likewise under a primary obligation to perform the trust and a secondary obligation to pay equitable compensation if he does not. The primary obligation of a trustee is to account for his stewardship. The primary remedy of the beneficiary—any beneficiary no matter how limited his interest—is to have the account taken, to surcharge and falsify the account, and to require the trustee to restore to the trust estate any deficiency which may appear when the account is taken. The liability is strict. The account must be taken down to the date on which it is rendered. That is why there is no question of 'stopping the clock'.147

... 

Target Holdings Ltd v Redfern148 was concerned with the other side of the account. Where the beneficiary complains that the trustee has misapplied trust money, he falsifies the account, that is to say, he asks for the disbursement to be disallowed. If, for example, the trustee lays out trust money in an unauthorized investment which falls in value, the beneficiary will falsify the account by asking the court to disallow both the disbursement and the corresponding asset on the other side of the account. The unauthorized investment will then be treated as having been bought with the trustee’s own money and on his own behalf. He will be required to account to the trust estate for the full amount of the disbursement—not for the amount of the loss. That is what is meant by saying that the trustee is liable to restore the trust property; and why common law rules of causation and remoteness of damage are out of place.

If the unauthorized investment has appreciated in value, then the beneficiary will be content with it. He is not obliged to falsify the account which the trustee renders; he can always accept it.... Where the beneficiary accepts the unauthorized investment, he is often said to affirm or adopt the transaction. That is not wholly accurate. The beneficiary has a right to elect, but it is merely a right to decide whether to complain or not.


[T]here will be a tendency, wherever possible, to equate the principles applicable to equitable compensation... with the rules relating to damages which have been well developed at law. This is a natural development in a post-judicature world. Its danger is that it may lead to a failure to appreciate the operation, in appropriate contexts, of traditional equitable principles which, in the circumstances of the particular case, more appropriately mirror the equitable right breached.’ [Ibid]

In the first flush of innocence and excitement, there was something of a rush in Canada and New Zealand towards wholesale integration of equitable compensation with the common law of damages by simple adoption of common law principles and rules. ... England and Australia were much more measured, as befits the much keener awareness in those jurisdictions of the doctrinal and historical dimensions of the core of equity jurisprudence. 'Compensation' was understood to be limited and plaintiff-friendly because it was essentially 'restitutionary'.

Gradually, however, it has come to be appreciated that, although in general terms the peculiarity of equity must not be overlooked, the fundamental point is to examine carefully the type and content of any equitable duty allegedly breached, and the nature of that breach. From that examination should flow the answer to how equity will compensate in any case. And so, custodial fiduciary duties can be enforced by performance orders, including in some cases orders for money payments, and their breach can be remedied by a range of orders, including in some cases orders for reparative compensation for loss caused to the estate. The process of compensating is girded by strict rules that cohere with the nature of the duties. Loss caused by breaches of non-custodial fiduciary duties is also compensable, but only by reparation. Strict compensation rules also apply here, not because equitable compensation is automatically strict, but because coherence of response with the nature of the duties breached requires those strict rules. That equitable compensation is not per se automatically strict is most clearly seen in the case of compensation for breaches of duties of care and skill, where there simply would be no coherence between duty and response if a strict regime were adopted. Compensating in equity for loss caused by breach of obligations originating in equity is a process, as is compensating at common law for loss caused by breach of obligations originating in the common law. How can it possibly be otherwise? The consequence is that the rules that equity develops for dealing with compensating for loss caused by breaches of the other equitable duties identified in Part 1 of this paper will be sensitive to the need for coherence between the duty and the reparative compensatory response.

148. [1996] AC 421 (HL)
Where the beneficiary accepts the unauthorized investment, the account must be taken as if the investment were fully authorised in every respect. The investment is shown as a trust asset and the cost of acquisition as an authorised disbursement. But the converse is equally true. Where the beneficiary elects to falsify the account, the unauthorized investment is not shown as an asset, the disbursement is disallowed, and the trustee is accountable in every respect as if he had not disbursed the money. He is liable to restore the money to the trust estate; as notionally restored it remains subject to all the trusts powers and provisions of the trust as if it had never been disbursed; and the account is taken accordingly.\(^{149}\)

Thus, where the beneficiaries do not elect to accept the unauthorized investment, and the trustee’s account is falsified, her expenditure on the investment is treated as having been from her own funds.\(^{150}\) The proceeds of any resale are to her credit.\(^{151}\) Equity then awards against her such sum of compensation as may be required to fully restore the trust estate to the condition in which it would have stood \textit{but for} her breach.\(^{152}\)

The principles embodied in this approach do not appear to involve any inquiry as to whether the loss was caused by or flowed from the breach. Rather the inquiry in each instance would appear to be whether the loss would have happened if there had been no breach.\(^{153}\)

Of course, that assumes that the beneficiaries can show a loss that would not have occurred, or that would have been avoided, but for the trustee’s breach. As long as they can do that, it is not open to the trustee to claim that the loss really had been caused by some unforeseeable intervening factor such as the value of the Australian currency dropping below that of the New Zealand currency, as in \textit{Re Dawson (deceased); Union Fidelity Trustee Co Ltd v Perpetual Trustee Co Ltd}.\(^{154}\) In that case it sufficed that, but for the trustee’s breach, the New Zealand estate would not have been deprived of the funds. As Professor Rickett has described it:\(^{155}\)

\[\text{The defendant was a defaulting custodial fiduciary who had control over assets that formed a trust estate, ie, the equitable obligations of the trustee to the plaintiff beneficiaries related to an estate. Thus, the relief sought was substitutive compensation. The primary liability of the defaulting fiduciary was to restore the property in specie. If that were not possible, then the monetary compensation payable in lieu (which might be termed equitable compensation) must reflect the economic position had restoration in specie been possible. This was not a case where reparative compensation was being sought, no matter the loose references to ‘breach’ or ‘loss’}.\]

Street J held that:\(^{156}\)

\[\text{The form of relief is couched in terms appropriate to require the defaulting trustee to restore to the estate the assets of which he deprived it. Increases in market values between the date of breach and the date of recoupment are for the trustee’s account: the effect of such increases would, at common law, be excluded}\]

\[\text{Norberg v Wynrib [1992]} 2 \text{SCR} 226, 295 \text{per McLachlin J (Supreme Court, Canada)}.\]

\[\text{Re Dawson (deceased); Union Fidelity Trustee Co Ltd v Perpetual Trustee Co Ltd [1966]} 2 \text{NSWLR} 211, 216.\]

\[\text{Equitable Compensation: Towards a Blueprint?} \text{[2003]} \text{Sydney Law Review 3}.\]

\[\text{[1966]} 2 \text{NSWLR} 211, 216.\]


\(^{151}\) This follows from Millett LJ, ‘Equity’s Place in the Law of Commerce’ (1998) 114 LQR 214, 226. See also Hayton et al, \textit{Underhill & Hayton: Law Relating to Trusts and Trustees} (Butterworths, London, 2006), 17th edn 89.2–89.6; 89.35, and Street J in \textit{Re Dawson (deceased); Union Fidelity Trustee Co Ltd v Perpetual Trustee Co Ltd [1966]} 2 NSWLR 211, 216: ‘Increases in market values between the date of breach and the date of recoupment are for the trustee’s account: the effect of such increases would, at common law, be excluded from the computation of damages; but in equity a defaulting trustee must make good the loss by restoring to the estate the assets of which he deprived it notwithstanding that market values may have increased in the meantime.}

\(^{152}\) Norberg v Wynrib [1992] 2 SCR 226, 295 per McLachlin J (Supreme Court, Canada).

\(^{153}\) \textit{Re Dawson (deceased); Union Fidelity Trustee Co Ltd v Perpetual Trustee Co Ltd [1966]} 2 NSWLR 211, 215.

\(^{154}\) [1966] 2 NSWLR 211.


\(^{156}\) [1966] 2 NSWLR 211, 216.
from the computation of damages; but in equity a defaulting trustee must make good the loss by restoring to the estate the assets of which he deprived it notwithstanding that market values may have increased in the meantime. The obligation to restore to the estate the assets of which he deprived it necessarily connotes that, where a monetary compensation is to be paid in lieu of restoring assets, that compensation is to be assessed by reference to the value of the assets at the date of restoration and not at the date of deprivation. In this sense the obligation is a continuing one and ordinarily, if the assets are for some reason not restored in specie, it will fall for quantification at the date when recoupment is to be effected, and not before.

The award is one of substitutive\(^{157}\) performance: i.e. the payment of money, including interest,\(^ {158}\) as a substitute for performance of the trustee’s core duty\(^ {159}\) of staying within the terms of the trust:\(^ {160}\)

As against a trustee who, on the accounts being taken, is shewn to have improperly applied part of the trust estate, the right of a cestui que trust is to have those accounts set straight—that is, to compel the trustee to pay such a sum as will make them balance.\(^ {161}\)

Compensation under this head effects restoration of the trust estate: making not only the ‘common law rules of causation and remoteness of damage’—mentioned by Millett LJ in the passage just cited—out of place, but also rendering irrelevant negligence, contributory negligence, and dishonesty.\(^ {162}\)

Thus, as Lord Lyndhurst LC put it in \textit{Clough v Bond}\(^ {163}\)

It will be found to be the result of all the best authorities upon the subject, that, although a personal representative, acting strictly within the line of his duty, and exercising reasonable care and diligence, will not be responsible for the failure or depreciation of the fund in which any part of he estate may he invested, . . . yet, if that line of duty be not strictly pursued, and any part of the property be invested by such personal representative in funds or upon securities not authorised, or be put within the control of persons who ought not to be intrusted with it, and a loss be thereby eventually sustained, \textit{such personal representative will be liable to make it good, however unexpected the result, however little likely to arise from the course adopted, and however free such conduct may have been from any improper motive}. Thus, if he \textit{omit to sell property when it ought to be sold, and it be afterwards lost without any fault of his, he is liable; . . . or if he leave money due upon personal security, which, though good at the time, afterwards fails . . . . And the case is stronger if he be himself the author of the improper investment, as upon personal security, or an unauthorized fund.}

The strict approach of equity to substitutive compensation is necessary to protect the trust estate from dealings in breach of trust. It reflects the exclusive jurisdiction of equity to enforce:


\(^{160}\) Youyang Pty Ltd v Minter Ellison Morris Fletcher (2003) 212 CLR 484, 498.

\(^{161}\) Head v Gould [1898] 2 Ch 250, 266 (Kekewich J)


\(^{163}\) (1838) 3 My & Cr 490, 496; 40 ER 1016.
good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal. This is not intended to be an exhaustive list, but it is sufficient to indicate the nature of fiduciary obligations. They are the defining characteristics of the fiduciary.

... The nature of the obligation determines the nature of the breach. The various obligations of a fiduciary merely reflect different aspects of his core duties of loyalty and fidelity. Breach of fiduciary obligation, therefore, connotes disloyalty or infidelity. *Mere incompetence is not enough.* A servant who loyally does his incompetent best for his master is not unfaithful and is not guilty of a breach of fiduciary duty. 164

As Tipping J held in the New Zealand Court of Appeal in *Bank of New Zealand v Guardian Trust Co Ltd.* 165

Although the relationship between the parties can properly be described as one of trustee and beneficiary, that relationship does not in and of itself dictate how the law should determine issues of causation and remoteness. Breaches of duty by trustees and other fiduciaries may broadly be of three different kinds. First, there are breaches leading directly to damage to or loss of the trust property; second, there are breaches involving an element of infidelity or disloyalty which engage the conscience of the fiduciary; third, there are breaches involving a lack of appropriate skill or care. It is implicit in this analysis that breaches of the second kind do not involve loss or damage to the trust property, and breaches of the third kind involve neither loss to the trust property, nor infidelity or disloyalty.

It is inherent in what I have already written that the existence of the same relationship between the parties ie trustee and beneficiary, does not mandate that the same approach to causation and remoteness should be taken in all cases irrespective of the nature of the breach. In the first kind of case the allegation is that a breach of duty by a trustee has directly caused loss of or damage to the trust property. The relief sought by the beneficiary is usually in such circumstances of a restitutionary kind. The trustee is asked to restore the trust estate, either in specie or by value. The policy of the law in these circumstances is generally to hold the trustee responsible if, but for the breach, the loss or damage would not have occurred. This approach is designed to encourage trustees to observe to the full their duties in relation to the trust property by imposing upon them a stringent concept of causation. Questions of foreseeability and remoteness do not come into such an assessment.

In the second kind of case, the trustee or other fiduciary has committed a breach of duty which involves an element of infidelity or disloyalty engaging the fiduciary’s conscience—what might be called a true breach of fiduciary duty. In... such a case once the plaintiff has shown a loss arising out of a transaction to which the breach was material, the plaintiff is entitled to recover unless the defendant fiduciary, upon whom is the onus, shows that the loss or damage would have occurred in any event, ie without any breach on the fiduciary’s part. Questions of foreseeability and remoteness do not arise in this kind of case either. Policy dictates that fiduciaries be allowed only a narrow escape route from liability based on proof that the loss or damage would have occurred even if there had been no breach.

In the third kind of case, the relationship of trustee (or fiduciary) and beneficiary is, in a sense, incidental. It provides the setting in which the breach of duty occurs, and with it such tortious proximity or

contractual privity as may be necessary. The duty to take care is one which arises as an incident of the relationship, but for the purpose of determining the proper approach to causation and remoteness, it is the failure to take care which is the material dimension, not the fact that the relationship also creates duties of a fiduciary kind. Those duties are not relevantly engaged. It is unnecessary for me to cite the various authorities which support this analysis; they are identified in Gault J’s judgment. The approach of the law to the linked questions of causation and remoteness is influenced by the nature of the wrong which the defendant has committed. If it is a wrong engaging the conscience of the wrongdoer, what has sometimes been called fraud in equity, a stricter approach is justified. That corresponds with the position when there is fraud in the common law sense, at least as far as some of the more recent authorities are concerned. In such cases the greater moral turpitude of the wrongdoer supports a restitutionary ‘but for’ approach, at least on a prima facie basis. But where the wrong amounts in substance to carelessness or breach of contract, the policy considerations underpinning the stricter approach are absent. Hence, whatever the classification of the relationship, the law approaches the questions of causation and remoteness on a different and generally less onerous basis; namely whether there is a sufficient causal nexus and also foreseeability or reasonable contemplation of loss or damage of the kind in suit.

**Losses coinciding with unauthorized investment but which would have occurred independently of the trustee’s breach**

If he would have incurred the loss even if the trustee had not transgressed the limits of what had been committed to her, a beneficiary’s claim will fail. In *Target Holdings Ltd v Redforns*,¹⁶⁶ the defendant solicitors held the plaintiff’s money in trust to pay it out—in exchange for a mortgage charging a particular property—to enable the payee to buy the property.

In June 1989, the solicitors paid it out without having arranged the execution of the mortgage. At that stage, the solicitor had made ‘an unauthorized application of trust money which entitled the plaintiff to falsify the account. The disbursement must be disallowed and the solicitor treated as accountable as if the money were still in his client account and available to be laid out in the manner directed.’¹⁶⁷ ‘The payment was a breach of trust; the solicitor was strictly liable in equity to restore the trust property; and he could not invoke common law rules about causation and remoteness of damage to limit his liability.’¹⁶⁸ In particular, the solicitors would not have been able to claim that they should not be fully liable because, even if they had secured the mortgage, the plaintiff’s recovery would have been reduced by the impact of the recession that began in 1991 and afflicted the UK economy, and property market, until the autumn of 1992.

However, the mortgage was executed the following month. Only with that event was the ‘underlying commercial transaction completed’.¹⁶⁹ With that completion, the plaintiff:¹⁷⁰ had obtained exactly what it would have obtained if no breach of trust had occurred, viz, a valid security for the sum advanced. In the absence of fraud, there was no warrant for awarding equitable compensation for the loss occasioned by the inadequacy of the security, let alone the fall in the property market, since neither loss was attributable to the relevant breach of duty.

This was eminently satisfactory. It put right the error which the Court of Appeal had made in failing to identify the relevant breach of trust, which was not in parting with the money but in failing to obtain

---

¹⁶⁶. [1996] AC 421 (HL)
the title deeds in return. This put the trust fund at risk—but the risk did not materialise.

From being still notionally in the defendant solicitors’ ‘client account and available to be laid out in the manner directed,’ the sum advanced by the plaintiff had become:

so laid out. The plaintiff could not object to the acquisition of the mortgage or the disbursement by which it was obtained; it was an authorised application of what must be treated as trust money notionally restored to the trust estate on the taking of the account. To put the point another way; the trustee’s obligation to restore the trust property is not an obligation to restore it in the very form in which he disbursed it, but an obligation to restore it in any form authorised by the trust.

**Consequences of authorized, but negligent, investment**

Although ‘an unauthorized investment of trust money is still a breach of trust’, nonetheless ‘trustee investment powers are not part of the trusts on which trust money is held.’ While competence is the duty of a fiduciary, it is not a fiduciary duty. On Prof. Finn’s acclaimed analysis:

> It is not the case that the pure negligence of a lawyer, an agent’s excess of authority, a partner’s breach of the partnership contract or a trustee’s improvident investment is, as such, a breach of fiduciary duty, no matter how harmful to the interests of the client, the principal, etc. If no issue of disloyalty is involved, such matters will be actionable through those primary bodies of law which constitute or govern the ordinary incidents of the relationship in question—negligence, breach of contract or breach of trust.

Equity, therefore, has no exclusive interest in ‘maladministration’ such as the authorized but ‘imprudent exercise of a power . . . of investment by failure to employ the care and diligence which equity requires.’ Accordingly, it follows the law. In that case, the position is as Millett LJ describes it here.

If the beneficiary is dissatisfied with the way in which the trustee has carried out his trust—if, for example, he considers that the trustee has negligently failed to

---

177. Equitable Compensation: Towards a Blueprint [2003] Sydney Law Review 3, referring to the text to which note 165 above is attached:

Although the remedy which equity makes available for breach of the equitable duty of skill and care is equitable compensation rather than damages, this is merely the product of history and in this context is in my opinion a distinction without a difference. Equitable compensation for breach of the duty of skill and care resembles common law damages in that it is awarded by way of compensation to the plaintiff for his loss. There is no reason in principle why the common law rules of causation, remoteness of damage and measure of damages should not be applied by analogy in such a case. It should not be confused with equitable compensation for breach of fiduciary duty, which may be awarded in lieu of rescission or specific restitution.


And see Rickett, ‘Equitable Compensation: Towards a Blueprint’ [2003] Sydney Law Review 3, referring to the text to which note 165 above is attached:

As Tipping J stated in Bank of New Zealand v New Zealand Guardian Trust Co Ltd [1999] 1 NZLR 664 at 687, breaches of duty of care and skill ‘involve neither loss to the trust property, nor infidelity or disloyalty’. Where a failure to take care is the material dimension in an alleged breach of duty, trust and fiduciary duties are ‘not relevantly engaged’. [Ibid 688] Gault J said that the ‘but for’ test of causation and remoteness was not appropriate where there was a breach of a duty in equity of equivalent scope to duties owed in contract or tort, unless the breach was dishonest or fraudulent. He stated:

> That the liability arises in equity is no sufficient reason. Surely the stage has been reached in the development of the law where something more substantial than historical origin is needed to justify disparate treatment in the law of those in breach of the obligation to exercise reasonable care.
obtain all that he should have done for the benefit of the trust estate, then he may surcharge\textsuperscript{178} the account. He does this by requiring the account to be taken on the footing of wilful default. In this context ‘wilful default’ bears a special and unusual meaning; it means merely lack of ordinary prudence or due diligence [see, eg, Re Chapman [1896] 2 Ch 763]. The trustee is made to account, not only for what he has in fact received, but also for what he might with due diligence have received. Since the trustee is, in effect, charged with negligence, and the amount by which the account is surcharged is measured by the loss occasioned by his want of skill and care, the analogy with common law damages for negligence is almost exact [see Henderson v Merrett Syndicates Ltd [1995] 2 AC, 205 per Lord Browne-Wilkinson]. Although he is a fiduciary, his duty of care is not a fiduciary duty [see Permanent Building Society v Wheeler (1994) 14 ACSR 109, 157-158 per Ipp J approved in Bristol & West Building Society v Mothew [1997] 2 WLR 436, 448-449]. In this context it must be right to adopt the common law rules of causation and remoteness of damage to their fullest extent. The trustee’s liability is enforced in the course of taking the trust account rather than by an action for damages, but the obligation of skill and care is identical to the common law duty of care.

The common law obligations are put in a nutshell in Waters’ Law of Trusts in Canada:\textsuperscript{179}

The principle of compensation for loss caused is not peculiar to the law of trusts. In the law of contract the party who has breached the contract is liable to compensate the injured party for all the loss which that latter party has sustained, and even in the law of torts the general principle is to make good the loss to the injured party.

The question, therefore, is what is meant in trust, contract, and tort law by compensation for loss or damage. The injured party in a contract action is entitled to restitutio in integrum, and the integrum is made up of those items of damage which at the time of the breach were foreseeable, either in the nature of things or in the special circumstances of the parties. The injured party in a tort action is also entitled to recover for all those items of damage which were foreseeable at the time of the commission of the tort. Items which were not foreseeable are said to be too remote. In both contract and tort, damages may be reduced on the basis that the plaintiff did not act reasonably to mitigate his loss. And in negligence, damages may also be reduced on the ground that the plaintiff was contributorily negligent.

In the law of trusts, however, remoteness of damage issues have not been canvassed. Following a practice begun in the old courts of equity, Equity was content to leave the liability of the breaching trustee on the broad basis of liability to compensate for loss. There was never any inquiry into mitigation, nor into contributory negligence.

None of the common law rules relating to causation, remoteness of damage, or—on the view in Day v

---

\textsuperscript{178} Hayton \textit{et al}, Underhill & Hayton: Law Relating to Trusts and Trustees (Butterworths, London, 2006), 17th edn 89.3.

\textsuperscript{179} Waters \textit{et al}, (Carswell, 2005), 3rd edn 1216–1217.
---

**Mead**—contributory negligence, apply to **substitutive** performance claims in respect of breach of trust.

It would therefore be an error, to the disadvantage of the trust estate, for beneficiaries in a position to assert a **substitutive** claim, for true breach of trust by means of unauthorized investment, to bring it merely as a **reparative** claim based on negligence, when the damages will lie only if the plaintiff can show that the breach of the duty of care was an operative cause of the loss; and when the award will be subject to contributory negligence, and failure to mitigate, and the claim itself will lie only for foreseeable loss—unlike the substitutive claim which is assessed speculatively, using hindsight, as at the time of trial.

---


> In Target Holdings Ltd v Redfern [1994] AC 421, HL the court endorsed Lord Cottenham’s views in Clough v Bond [(1838) 3 My & Cr 490 at 496–497] that if a trustee or personal representative invests funds in unauthorized securities or puts them within the control of persons who are not authorized to be entrusted with them and a loss be sustained, then such trustee or personal representative will be liable to make it good, however unexpected the result, however little likely to arise from the course adopted and however free such conduct may have been from any improper motive. On this basis if trustees delegated management of their investment portfolio to a discretionary manager where not authorised to do so, then the trustees would be automatically liable even if the loss in value of the portfolio was caused by an unforeseeable market crash. The beneficiaries could therefore derive a significant advantage from framing their claim as a substitutive performance claim rather than as a reparative claim, in a case where the trustee’s decision to delegate management of the trust portfolio is negligent as well as unauthorized. In such a case, their reparative claim for breach of the trustee’s equitable duty of care would be subject to principles relating to causation, foreseeability and remoteness that would not apply to their substitutive performance claim.


183. CI In re Pauling’s Settlement Trusts (No 2) [1963] Ch 576, 586, where Wilberforce J referred to the trustees:

> normal duty of preserving an equitable balance, and if at any time it was shown they were inclining one way or the other, it would not be a difficult matter to bring them to account.

In Nestle v National Westminster Bank [1993] 1 WLR 1260, 1279, Stauthon LJ cited that dictum and continued:

> At times it will not be easy to decide what is an equitable balance. A life tenant may be anxious to receive the highest possible income, whilst the remainderman will wish the real value of the trust fund to be preserved. If the life tenant is living in penury and the remainderman already has ample wealth, common sense suggests that a trustee should be able to take that into account, not necessarily by seeking the highest possible income at the expense of capital but by inclining in that direction. However, before adopting that course a trustee should, I think, require some verification of the facts.


> A more appropriate approach would be to break the test down into two questions. The first question is to consider what form of investment strategy the trustees should have adopted when compared to funds of a similar size and nature. The second further question then requires a mathematical measurement of the return which would have been generated by a reasonable fund of the type identified in answer to the first question. The second question ensures that the trustees’ investment decisions are being evaluated according to the nature of their trust before any finding of a breach of duty is made against them. However, if the first question were taken to be whether or not the trustees measured up to an average return on investment, then it can be supposed that something approaching half of the participants in the market place will necessarily appear to have failed to generate an average market return (that is because an average will generally be greater than half the sample and less than the other half of the sample) and so be potentially liable to their customers for breach of some duty of competence. A test which prioritizes mathematical matters over matters of strategy and context, as in this first question, will necessarily increase the incidence of liability for trustees and so encourage those trustees always to invest more adventurously so as to generate a return on capital which will place them in the top half of the market place’s league table. This, it is suggested, would be contrary to the prudence which is typically expected from trustees, in balance with any duty to achieve a good return. In the first part, the question of size indicates the number of investments which could be compiled into a portfolio and also how diverse those investments could be, given that a large fund permits more investments to be acquired than a small fund; and the nature of the investment strategy covers matters such as the level of risk inherent in the investments, whether the investors wish to invest for long- or short-term return, and how risk averse are the investors. The second part, informed by the first, gives a better approximation, it is suggested, of the mean return of participants in the circumstances of the trustees at issue.
all the usual allowances for contingencies, and for such matters as transaction costs in respect of a certain level of periodic shuffling of the portfolio, the High Court held that it had been foreseeable that the $43,200 could have been increased at least to $170,640. Judgment accordingly was given against the trustees personally: effectively surcharging them with the difference between those sums, plus six years’ interest at 8%.

In the other case of failure to diversify which has been referred to above, Warren v Pazolt, the trustees in default escaped liability only because, in the circumstances, they were not in ‘wilful default’ and accordingly fell within an exoneration provision.

There was no such backstop for the trustee in In re Janes, where the life tenant ‘loved Kodak’. The Court of Appeals, New York surcharged the trustee bank with $4,065,029, representing:

- the value of the capital lost through the trustee’s negligent retention of the overweight of Eastman Kodak shares, and failure to diversify the trust investments, after the date by which it should have been sold;
- plus compound interest from that date until the date of judgment, less dividends and other income attributable to the wrongly retained assets;
- less the proceeds of the sale of the stock (or the value of any unsold stock at the date of the accounting);
- plus post-judgment interest, and costs.

The court also falsified the $326,302.66 which the trustee had charged as commission, and for legal fees on the trial.

In Learoyd v Whiteley, the trustees had invested £3000 in a mortgage of what turned out to have been an unsaleable property. They were effectively surcharged with, and ordered to account for, the whole sum.

Negligent investment not actionable without proof of damage—and mere failure to maintain parity with an index is not damage

To repeat Lindley LJ’s restatement, in that case, of the trustee’s obligation:

The duty of a trustee is not to take such care only as a prudent man would take if he had only himself to

---

187. 89 NE 381, 388 (1909), considered under ‘When failing to diversify is inexcusable failure to balance the portfolio,’ at p. 538 above.
188. 89 NE 381, 388 (1909).
189. 681 NE 2d 332, 339–340 (1997), considered under ‘Retaining an investment is “investing”: the necessity for review,’ p. 548 above.
190. 681 NE 2d 332, 339 (1997):

Where, as here, a fiduciary’s imprudence consists solely of negligent retention of assets it should have sold, the measure of damages is the value of the lost capital. . . .

In imposing liability upon a fiduciary on the basis of the capital lost, the court should determine the value of the stock on the date it should have been sold, and subtract from that figure the proceeds from the sale of the stock or, if the stock is still retained by the estate, the value of the stock at the time of the accounting. . . .

191. The Surrogate Judge, which the Court of Appeals New York upheld [681 NE 2d 332, 339 (1997)], on this point, had held that ‘the asset, the EK [Eastman Kodak] stock, should have been sold within a reasonable time. . . . In some instances the courts have held that date of death or as soon as a fiduciary qualifies and has the authority, the securities should be sold. . . . Rodney B Janes died 26 May 1973 and letters testamentary were issued 6 June 1973. The investment officer assigned to the Janes Estate who finalized the investment strategy as of 9 August 1973 was already aware that EK [Eastman Kodak] stock was at a high concentration in the portfolio. EK, which enjoyed an historic high in the market, generated a 1% annual return. It is this Court’s view on the state of the record that the Bank as co-executor was responsible and should have, as of 9 August 1973, sold that portion of the EK stock concentration bringing its presence in the portfolio to the 5% level.

The disposition of the EK on 1 August 1973 would have resulted in proceeds of $1,687,647.30 (12,087 shares sold at $139 5/8).’ (214 NYLJ 31 (5 July 1995).

193. (1887) 12 App Cas 727 (HL) affirming (1886) 33 Ch D 347 (CA) upholding (1886) 32 Ch D 196 (Bacon V-C).
194. (1886) 32 Ch D 196, 204 (Bacon V-C).
195. (1886) 32 Ch D 196, 206.
196. Everything said about trustee negligence in this article must be read subject to the paper, at page 602 of this issue, by David Halpern QC, one of the learned authors of Jackson and Powell on Professional Liability (Sweet & Maxwell, London, 6th revised edn, 2006).
197. Re Whiteley, Whiteley v Learoyd (1886) 33 Ch D 347, 357.
consider; the duty rather is to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide.

And to repeat, also, Hoffmann J’s characterization of that test as: an extremely flexible standard, capable of adaptation to current economic conditions and contemporary understanding of markets and investments. Modern trustees acting within their investment powers were entitled to be judged by the standards of current portfolio theory, which emphasises the risk level of the entire portfolio, rather than the risk attaching to each investment taken in isolation. But care must be taken not to endow the prudent trustee with prophetic vision or expect him to have ignored the received wisdom of his time. A trustee must have regard to the interests of those entitled in the future to capital, and such regard will require them to take into consideration the potential effects of inflation, but a rule that real capital values must be maintained would be unfair to both income beneficiaries and trustees.

The trustee is not an insurer of the trust estate. In Nestle v National Westminster Bank, Stauthon LJ agreed with Hoffmann J: Of course it is not a breach of trust to invest the trust fund in such a manner that its real value is not maintained. At times that will be impossible, and at others it will require extraordinary skill or luck. The highest that even the plaintiff puts her claim is that, if the equity portion in the fund as it stood in 1922 (74 per cent) had been invested so as to achieve no more than the index, the fund as a whole would have been worth over £1.8 m. in 1986.

In the same case, Dillon LJ noted in the Court of Appeal that: as Hoffmann J pointed out, the evidence showed that if the BZW Equity Index was applied over the period from July 1974 to December 1986 to ‘growth’ unit trusts (as opposed to ‘income’ unit trusts) it appeared that 12 of the ‘growth’ trusts had done better than the index, but 21 had done worse. It is impossible to say that those 21 unit trusts must have been managed with a degree of incompetence which, in a trustee like the bank, would have amounted to a breach of trust. The BZW Equity Index is calculated by reference to the performance of the leading equity shares, the composition of the list being changed from time to time with, fluctuations of the companies’ fortunes. It is thus difficult to beat, particularly for a fund which is not large enough to include substantial holdings in all the leading equities. It cannot be the criterion for the degree of performance which is expected of the ordinary prudent trustee.

There was no doubt that the trustee had misunderstood the investment clause, and that, over a long

---

199. Re Mulligan [1998] 1 NZLR 481, 501, ‘I accept that a trustee is neither a surety, nor an insurer of the fund for which he is responsible. Loss of trust money, or . . . diminution in the real value of a trust fund, does not of itself render a trustee liable. It must be shown that the loss of diminution arose from some failing on the part of the trustee, which can be properly characterized as a breach of trust.’ See also Re Whiteley, Whiteley v Learoyd, (1886) 35 Ch D 347, 357 per Lindley LJ:

Whilst on the one hand the Court ought not to encourage laxity and want of care, on the other hand the Court ought not to prevent people from becoming trustees by converting honest trustees into insurers of the moneys committed to their care.

period, it failed to keep the investments under review. But, as Staughton LJ put it:

the misunderstanding of the investment clause and the failure to conduct periodic reviews do not by themselves, whether separately or together, afford the plaintiff a remedy. They were symptoms of incompetence or idleness—not on the part of National Westminster Bank but of their predecessors; they were not, without more, breaches of trust. The plaintiff must show that, through one or other or both of those causes, the trustees made decisions which they should not have made or failed to make decisions which they should have made. If that were proved, and if at first sight loss resulted, it would be appropriate to order an inquiry as to the loss suffered by the trust fund.

It may be difficult to discharge that burden, and particularly to show that decisions were not taken when they should have been. But that does not absolve a plaintiff from discharging it, and I cannot find that it was discharged in this case.

But Dillon LJ pointed out that the appellant’s complaint was not that:

of failure to invest any adequate part of the annuity fund in equities. It is that the part invested in equities was from 1922 to 1960 invested in bank and insurance shares (which were good equities) only and not in a wider spread of equities. Since therefore, for the reasons given above I would reject the suggested use of the BZW Equity Index as proving loss as between bank and insurance shares only and fully diversified equities, the crucial question is whether the onus remains on the plaintiff to prove loss for which fair compensation should be paid, or whether it is enough for her to claim compensation for loss of a chance [as in Chaplin v Hicks ([1911] 2 KB 786) that she would have been better off if the equities had been properly diversified.

The starting point must, in my judgment, be that, as the plaintiff is claiming compensation, the onus is on her to prove that she has suffered loss because from 1922 to 1960 the equities in the annuity fund were not diversified: see Hotson v East Berkshire Area Health Authority [1987] AC 750 and Wilsher v Essex Area Health Authority [1988] AC 1074. In some cases, it is sufficient to prove loss of a chance because in such cases, as in Chaplin v Hicks [1911] 2 KB 786, the outcome, if the plaintiff had not lost the chance, can never be proved. But in the present case, if the annuity fund had been invested wholly in fixed interest securities, it would have been relatively easy to prove, even though the event never happened, that the annuity fund would have been worth much more if a substantial part had been invested in equities. Consequently fair compensation could have been assessed. Equally it would have been possible, even though more difficult and much more, expensive, to prove, if it be the fact, that the equities in the annuity fund would have performed even better if diversified than they did as concentrated in bank and insurance shares. But the plaintiff has not provided any such proof. She has not even provided any material which would enable the court to assess the strength of, or value, the chance which she claims she has lost. Therefore her claim for compensation or damages in respect of the investment of the annuity fund from 1922 to 1960 must, in my judgement, fail.

Leggatt LJ was of the same mind:

The essence of the bank’s duty was to take such steps as a prudent businessman would have taken to maintain and increase the value of the trust fund. Unless it failed to do so, it was not in breach of trust. A breach of duty will not be actionable, and therefore will be

---

immaterial, if it does not cause loss. In this context I would endorse the concession of Mr. Nugee for the bank that 'loss' will be incurred by a trust fund when it makes a gain less than would have been made by a prudent businessman. A claimant will therefore fail who cannot prove a loss in this sense caused by breach of duty. So here in order to make a case for an inquiry, the plaintiff must show that loss was caused by breach of duty on the part of the bank.

... In my judgment either there was a loss in the present case or there was not. Unless there was a loss, there was no cause of action. It was for the plaintiff to prove on balance of probabilities that there was, or must have been, a loss. If proved, the court would then have had to assess the amount of it, and for the purpose of doing so might have had recourse to presumptions against the bank. In short, if it were shown that a loss was caused by breach of trust, such a presumption might avail the plaintiff in quantifying the loss. The plaintiff’s difficulty is in reaching that stage.

The plaintiff therefore had to prove that a prudent trustee, knowing of the scope of the bank’s investment power and conducting regular reviews, would so have invested the trust funds as to make it worth more than it was worth when the plaintiff inherited it. That was a matter for expert evidence. ... No testator, in the light of this example, would choose this bank for the effective management of his investment. But the bank’s engagement was as a trustee; and as such, it is to be judged not so much by success as by absence of proven default. The importance of preservation of a trust fund will always outweigh success in its advancement. Inevitably, a trustee in the bank’s position wears a complacent air, because the virtue of safety will in practice put a premium on inactivity. Until the 1950s active management of the portfolio might have been seen as speculative, and even in these days such dealing would have to be notably successful before the expense would be justified. The very process of attempting to achieve a balance, or (if that be old-fashioned) fairness, as between the interests of life-tenants and those of a remainderman inevitably means that each can complain of being less well served than he or she ought to have been. But by the undemanding standard of prudence the bank is not shown to have committed any breach of trust resulting in loss.

Part 2: The prudent investor in the time of the meltdown

When I was young people called me a gambler. As the scale of my operations increased I became known as a speculator. Now I am called a banker. But I have been doing the same thing all the time.

Edward Chancellor, Devil Take the Hindmost (Macmillan, London, 1999), ix, citing Sir Ernest Cassell, banker to Edward VII.

Where we are now

The sombre state of the environment in which trustees now must discharge their onerous duties has been well described by the Prime Minister of Australia:207

Financial markets have suffered the greatest dislocation in our lifetime. Global equity markets have lost approximately US$ 32 trillion in value since their peak, which is equivalent to the combined GDP of the G7 countries in 2008. Credit markets have all but dried up, with credit growth at its lowest level since World War II. And, at the core of the crisis, house prices are plummeting in many countries, with American prices falling at their fastest rate since modern records began.

The real economy is facing one of its toughest periods on record, with the IMF predicting that advanced economies will contract for the first time in 60 years, causing the number of unemployed to rise by 8 million across the OECD. In developing countries, the International Labour Organization predicts that the financial and economic crisis could push more than 100 million people into poverty.

Furthermore, the crisis is producing unprecedented costs and debts for governments which will be felt for decades to come. It is estimated that the 2009 deficit in the United States will be as high as 12.5% of GDP. And estimates of the combined (actual and contingent) liabilities from the array of bank bailouts and guarantees run to more than $13 trillion—more than the cost of all the major wars the United States has ever fought. What this means for future American international borrowing is equally unprecedented.

Bewilderment, however, rapidly turns to anger when the economic crisis touches the lives of families through rising unemployment, reduced wage growth and collapsing asset values—while executive remuneration in the financial sector continues to go through the roof, apparently disconnected from the reality of recent events. In 2007, S&P 500 CEOs averaged $10.5 million (some 344 times the pay of typical American workers). The top 50 hedge-fund and private equity fund managers averaged $588 million each (19,000 times the pay of typical workers). In 2007, the five biggest Wall Street firms paid bonuses of a staggering $39 billion—huge payments to the executives whose investment banks have since been bailed out by American taxpayers.

These are epic numbers, generated by a greed of epic proportions. For a bewildered and increasingly enraged public, they raise the following questions: How was this allowed to happen? What ideology, what policy, what abuses made this possible? Were there any warnings? And if so, why were they ignored?

Adapting the prudent investor test to ‘current economic conditions and contemporary understanding of markets and investments’

As the world licks these wounds, it may not be long before it becomes apparent to what extent trust funds have been entangled with the investment products and approaches which have brought the international economy to its knees, and which may keep it in that position for perhaps a decade or more.

What care then would Lindley LJ’s prudent trustee have taken if—with an understanding of markets and investments in the present era—he was to have been minded to make an investment for the benefit of other people for whom he felt morally bound to provide?

To begin with, in no era can a trustee invest prudently in that which he does not understand. He must ‘seek advice on matters which the trustee does not understand, such as the making [and reviewing] of investments,’ and he might be imprudent to take that advice unless he can understand it, also. Otherwise he knows not what he does, and that is no way for him to behave with the funds allocated for the benefit of those for whom he has a moral obligation to provide.

A world full of algorithms, computer trading and black boxes

Computer ‘stop-loss’ trading decisions, to dump stock as soon as it reached its historical low, are said to have greatly exacerbated the 1987 crash. Within a few years another form of ‘trading on the basis of mathematical models’, as the then US Secretary of the Treasury, Robert Rubin, described it, was in

full flight. Each form of trading appears to have been a substitute for prudence and judgment in dealing with the money of others. It would be difficult to imagine an approach more deeply antithetical to trustee duty, let alone general social responsibility.

In some of the mathematical models, as will appear, the allegedly significant variables have been quite diverting. Not so the Black–Scholes formula, in the title to this article, which has been at the eye of the recent financial storm. 212

It provides scant consolation for trustees to learn that this formula was created ‘to solve what had previously been considered a difficult problem’, and that it won Scholes a Nobel Prize in 1997. If that is what passes for investment clarity, then, were he still around, Lord Nottingham would be standing by the comment he made 300 years ago in *Uvedale v Ettrick*: 214

I like not that a Man should be ambitious of a Trust, when he can get nothing but Trouble by it.

If nothing else is clear, there can be no doubt that trouble will attend a trustee who invests on the basis of a black box, an Ouija board, or the entrails of a goat; or who uncritically accepts the counsel of an adviser and invests in a fund which uses any of these methods as a substitute for judgment and prudence.

Uncritical acceptance of mathematical formulae to ‘indicate’ a good investment, or a good time to invest, would appear to be just as objectionable: both to St Thomas and to the law.

Yet, in 1994, when Scholes teamed up with other geniuses—including John Meriwether formerly of Salomon Brothers—to form a fund called Long-Term Capital Management, investors were beating down their doors. The perceived brainpower of the team attracted huge investments from the likes of UBS Bank 216 from Switzerland, and Merrill Lynch 217 from Wall Street. For its first four years, returns of around 40% per annum seemed to vindicate the investment decision of each of those who had laid out at least the minimum investment of USD10 million.

Just like the children’s toys that come ‘complete with batteries’, this fund came complete with hubris. By 1998, Long-Term Capital Management was to prove what the sub-prime mania has proved a decade later: that IQ is irrelevant when decisions are driven by testosterone. One thinks of a two year old in the bath, having his scrotum washed: ‘Are those my brains, Mama?’ ‘Not yet, darling.’

Iceland’s new Prime Minister has declared the end of the age of testosterone. 218 The women are pushing the men aside in the investment industry, and they have declared the simple ground rule: ‘we won’t invest in anything we don’t understand’. Certainly, we ‘don’t want to lend to men, they take unnecessary risks, they get drunk and they don’t give back the money’.

The women of Iceland are right to have understood that, when the testosterone develops in the finance industry, it causes merry hell.

First, it feeds on the fantasy that size matters. As Norman Mailer put it, ‘quantity changes quality,
Engels said once, and a hustler of dimensions is a financier.219 Second, testosterone leads ineluctably to leverage. A trader able to generate Long-Term Capital Management’s prodigious initial returns is highly vulnerable to the aphrodisiac effect. The black-box, formulaic approach apparently dulls the brain to the harsh truth that maintenance of—let alone an increase in—the value of an asset which must be sold, if the ‘gain’ is to be realized, depends on the availability of a purchaser who is, both, able and willing to justify, and to fund, payment of the necessary price.

Long-Term Capital Management’s algorithm was to be about as useful as it would have been if it was to have reflected the variables identified and classified by Pettijohn and Jungeberg in their paper to the 15th annual American Psychological Conference in Atlanta in 2003.220 Dr Pettijohn is a leading authority on Attachment and Separation Distress in the Infant Guinea Pig,221 Alleviation and Separation Distress in 3 Breeds of Young Dogs,222 The Effect of Alcohol on Agonistic Behaviour in the Telomian Dog,223 and, in particular, on Reactions of Mongolian Gerbils in the Presence of Urine Stimuli.224 If Dr Scholes could get one, Dr Pettijohn’s hat surely must be in the ring for a Nobel of his own: if not for those studies, then at least for the astonishing economic bellwether which he and his learned colleague presented to that meeting of the American Psychological Conference.

Switching algorithms: the WHR and the BWR

The learned authors first set out their methodology:

Facial features. High-quality photographs that captured a complete, front, facial view of each of the 41 Playboy Playmates of the Year from 1960 to 2000 were located. The majority of the images were downloaded from the Internet (www.playboy.com) and the remaining photographs were found in magazines and books, scanned using a flatbed scanner, and saved as graphic files.

...Eye width was the distance between corners of the visible eye divided by the width of the face at the cheekbones. Eye area was calculated as the product of the eye height ratio and the eye width ratio. Chin length was the distance from the top of the lower lip to the bottom of the chin divided by the length of the face. Chin width was the width of the face at the jaw measured at the middle of the chin height, divided by the length of the face. Chin area was calculated as the product of the chin length ratio and the chin width ratio. Cheek thinness was the inner corner where the lips meet to the outer edge of the cheek divided by the length of the face.225

Each face in this study no doubt would have launched a thousand quips. But the authors’ devotion to

219. The Fight (Penguin Classics, London 2000) 115–116, describing Don King’s promotion of the famed ‘rumble in the jungle’ between Ali and Foreman in what is now the Democratic Republic of the Congo:

Say, it would be hard to prove King was not a genius. A former nightclub owner and numbers king of Cleveland with four years in jail for killing a man in a street fight, he had approached Ali and Foreman with the splendid credentials of a fight manager whose two best fighters, Earnie Shavers and Jeff Merritt, had just both been knocked out in the first round. Still, he offered to promote Ali–Foreman. Each fighter would get five million dollars, he said. Those eyes of true love must have made the sum believable, for they glowed doubtless with the cool delights of lemonade, the fantasies of Pernod, and the golden kernels of corn—somehow, those eyes took him through barriers—he convinced Herbert Muhammad that he could produce this fight. ‘I reminded him of the teaching of his father Elijah Muhammad that every qualified Black man should be given a chance by his fellow Black men.’ ...What skills. Quantity changes quality, Engels said once, and a hustler of dimensions is a financier.


221. 12 Developmental Psychobiology 1979, 73.

222. The dogs, by the way, were Shetland Sheepdogs, Telomians, and Beagles: see 44 Developmental Psychobiology, 2004, 373–381.

223. 60 Psychopharmacology, 1979, 295–301.


225. See n 220 above, at 1190.
hard-nosed scientific scholarship prevented their just looking at faces as if the rest of the person did not exist:

Bust, waist, hips, and height were measured in inches. Weight was reported in pounds. Waist-to-hip ratio (WHR) was calculated by dividing waist measurement by hip measurement. Larger WHRs would indicate less difference between waist and hip measurements than smaller WHRs, hence lesser curvaceousness. Bust-to-waist ratio (BWR) was calculated by dividing bust measurement by waist measurement. Larger BWRs would indicate greater difference between bust and waist measurements than smaller BWRs, hence greater curvaceousness. Body mass index (BMI) was calculated as the product of weight in pounds and the constant 703, divided by height in inches squared (http://www.cdc.gov/nccdphp/dnpa/bmi). Larger BMI values indicate greater body fat. 226

The economic conclusions of Pettijohn and Jungeberg were more rigorous than much of what evidently has been passing for investment analysis these past few years:

Consistent with the Environmental Security Hypothesis predictions, when social and economic conditions were difficult, older, heavier, taller Playboy Playmates of the Year with larger waists, smaller eyes, larger waist-to-hip ratios, smaller bust-to-waist ratios, and smaller body mass index values were selected. Conversely, as indicated with the prescribed correlations, as social and economic conditions improved, younger, lighter, shorter Playboy Playmates of the Year with smaller waists, larger eyes, smaller waist-to-hip ratios, larger bust-to-waist ratios, and larger body mass index values were preferred. Mature features and a more tubular body shape were preferred to a relatively greater extent when times were bad and neotenous227 features and a more curvaceous body type were preferred when times were good.228

There was no ducking of the really hard questions:

Although there was overall support for the Environmental Security Hypothesis predictions, Playmate of the Year chin size and facial thinness did not follow the predicted pattern of relating positively with hard social and economic conditions. The measures of facial thinness, chin length, chin width, and chin area showed no relationship with the General Hard Times Measure, whereas the eye measures were significantly negatively related to social and economic hard times.229

From this crystalline thought came the amazing answer:

One way to explain this discrepancy may lie in the weighted importance of body features over facial features for this particular sample. Nude models are selected for their beauty, but the significance of physical attractiveness may be connected more with body features than facial features for Playboy centerfolds. Having a strong chin or a thin face may be of smaller consequence for Playmates, whereas body features ... may be of larger consequence in determining attractiveness.230

The data before them thus brought the authors full circle. They seem to have established, scientifically, the existence of a type of woman who is defined from the neck down, and who, for all any male scientist notices, might as well be headless. Had they been aware of it, Pettijohn and Jungeberg might have attempted to invoke a certain Papal occasion to fortify this brilliant conclusion of their scientific endeavour.

226. Ibid.
227. 'Neoteny', of course, is synonymous with pedomorphosis.
228. See n 220 above, at 1193.
229. Ibid.
230. Ibid.
In his biography of *Pope John XXIII*, Thomas Cahill wrote that, for Cardinal Roncalli, then Papal Nuncio in Paris:

His own, exceedingly simple engagement with Parisians took the form of strolls around his beauquartier and animated conversation with those he met…. For this he was upbraided by [Pope] Pius, who judged it undignified for a papal nuncio to be seen walking the Paris streets and rubbing shoulders with the unclean masses as if they were all on the same level.

But the nuncio, now nearing seventy, was becoming evermore easygoing and, in his own playful way, fearless. The fight against his weight was decisively lost…and he was not infrequently seen at diplomatic receptions with a glass of champagne in one hand, sometimes with a cigarette in the other. At one of these gatherings, so the story goes, he was approached by a woman of considerable décolletage, who wore a large crucifix between her mountainous breasts. ‘Quelle Golgothe!’ (‘What a Calvary!’) exclaimed the nuncio merrily.

Finally, as well as having demonstrated that not even scientists read *Playboy* for the articles, Pettijohn and Jungeberg showed a thing or two to those trustees who make a hash of their investment decisions because of excessive credulity towards prospectus statements:

We recognize the limitations of using the *Playboy* Playmate of the Year competition as a source of preferences for female attractiveness over time. *Playboy* is in business to sell magazines. They would not be able to sell magazines if they featured unattractive women who were not desirable to their subscribers. Therefore, it is in the company’s best interest to know what the public wants in order to be successful. Some have speculated that model photos are airbrushed and ‘corrected’ in editing. To the extent that any alterations are made, we would argue that they would be in the direction of the current societal trends. Furthermore, if images are always corrected in the same fashion, this practice could not account for the current pattern of changing preferences with social and economic conditions.

As Brian Viner has shown, this analysis can be readily transposed to economies other than that of the United States—certainly to the UK:

But I love the theory all the same, and it certainly holds particular resonance in Britain, where in 1979, unequivocally a time of grave economic crisis, we embraced not Donna Michelle or Anna Nicole but the even more mature-looking Margaret Hilda.

Maybe there is more to the theory than even Dr Pettijohn thinks. Maybe the kind of women that men find attractive at any one time is not so much a reflection of economic conditions as an anticipation of them. Thus the popularity of Jordan might mean that we are in for a period of unnatural inflation. Or the fleeting fame of David Beckham’s alleged lover Rebecca Loos might suggest that the balance of payments will shortly start swinging both ways. It’s not as ridiculous as it sounds. After all, wasn’t the tricky business of economic forecasting once defined as trying to work out in which direction a car is heading by looking in the rear-view mirror? Far easier to consult page three of *The Sun*.

I don’t mean to be disrespectful towards either Dr Pettijohn or his theory, into which a lot of thinking, and looking, has obviously gone. But at the same time, I can’t help thinking about Hugh Hefner holed up in the Playboy Mansion in Los Angeles, picking his Playmate of the Year and labouring under the delusion that for the last 40-odd years he has been the embodiment of hedonism, when it now
emerges that he should have been fronting *The Money Programme.)*

Unlike Scholes’ theorem, the Pettijohn/Jungeberg thesis is being constantly refined by further rigorous, peer-reviewed, studies. Thus, Webster* makes a number of important points. First—because women’s hormones get in the way—reflecting that the economic cycle should be regarded as *men’s work.*

Second, although Playmates of the Year:

may reflect current popular preferences, the initial pool of playmates is probably far more homogeneous in their bodily characteristics than a random sample of women. . . . Finally, the present study specifically focused on men’s preferences for women’s bodies rather than faces. Although both social and evolutionary psychologists have made great strides in understanding what makes faces attractive and why (eg, *Cunningham, 1986; Rhodes, 2006*), to speculate on whether distinguishing between economic and existential threats are important to shifts in men’s preferences for women’s facial features remains premature and is beyond the scope of the present research.

For whatever modest value it may have, it is my own view that this shift to facial features is unlikely to occur until, with aging of the male population, *Playboy* does, indeed, become read for its articles.

Finally, and critically for trustee-investors, Webster opines that:

As with any correlational investigation of archival data, this present study has a few potential limitations. First and foremost, the critical-thinking mantra of ‘correlation does not imply causation’ cannot be stressed enough.

---


235. Although women’s preferences for men’s body types may exhibit shifts over the menstrual cycle (*Thornhill, Gangestad, and Garver-Apgar, 2004*), it appears that men’s preferences for women’s body types may exhibit their own shifts as a function of changes in existential threats and the resource availability. Thus, the ESH remains a viable theoretical perspective that deserves attention from evolutionary and social psychologists alike. It is hoped the present research will not only expose evolutionary psychologists to the ESH, but also inspire them to examine its efficacy in novel contexts using a variety of innovative methods: ibid 37.

236. *Idem.*

the trader. As Rubin points out, markets have an ‘inherent tendency to excess’.238

The bust for Long-Term Capital Management came when Russia defaulted on its debt obligations in August 1998. Panic, and a flight to quality, ensued. The geniuses at Long-Term Capital Management were totally unprepared for it. It destroyed the fund. As Prof. Ferguson put it in The Ascent of Money: a Financial History of the World,239 Long-Term Capital Management’s:

value at risk (VaR) models had implied that the loss Long Term suffered in August was so unlikely that it ought never to have happened in the entire life of the universe. But that was because the models were working with just five years’ worth of data. If the models had gone back even eleven years, they would have captured the 1987 stock market crash. If they had gone back eighty years they would have captured the last great Russian default, after the 1917 Revolution. Meriwether himself, born in 1947, ruefully observed: ‘If I had lived through the Depression, I would have been in a better position to understand events.’ To put it bluntly, the Nobel prize winners had known plenty of mathematics, but not enough history. . . .

It might be assumed that after the catastrophic failure of LTCM, quantitative hedge funds would have vanished from the financial scene. After all, the failure, though spectacular in scale, was far from anomalous. Of 1,308 hedge funds that were formed between 1989 and 1996, more than a third (36.7 per cent) had ceased to exist by the end of the period. In that period the average life span of a hedge fund was just forty months. Yet the very reverse has happened. Far from declining, in the past ten years hedge funds of every type have exploded in number and in the volume of assets they manage. In 1990, according to Hedge Fund Research, there were just over 600 hedge funds managing some $39 billion in assets. By 2000 there were 3,873 funds with $490 billion in assets. The latest figures (for the first quarter of 2008) put the total at 7,601 funds with $1.9 trillion in assets. Since 1998 there has been a veritable stampede to invest in hedge funds (and in the ‘funds of funds’ that aggregate the performance of multiple firms). Where once they were the preserve of ‘high net worth’ individuals and investment banks, hedge funds are now attracting growing numbers of pension funds and university endowments.

This enormous investment pool was created by a small band of traders who had made massive returns by the arbitrage of inefficiencies in the currency and commodity markets. Because it was their own money, money provided by friends and associates, or advanced by banks, they escaped the discipline of formal prospectus disclosure. As long as they kept making money, they could do what they liked, and charge what they liked, without having to explain or justify themselves.

The foundation of the structure was the leveraging of credit by way of financial engineering of derivatives. These were priced according to formulae such as that included in the title to this article. Mathematics emits a comforting aura of certainty and predictability. A formula perceived to have made a lot of people a lot of money is readily accepted as a black box that ‘just works’.

We do not have to understand how the microchip works before we turn on our iPods, or how the internal combustion engine works before we drive our cars. So with derivatives: you do not have to think about them. You just apply the formula. If it is thought to ‘work’ in practice, why bother about whether it works in theory? Why spoil the party by asking whether it accords with common sense?

Sooner or later in the cycle, as George Soros has pointed out, there are no longer any others to whom one can pass the parcel:

The typical sequence of boom and bust has an asymmetric shape. The boom develops slowly and accelerates gradually. The bust, when it occurs, tends

---

238. Ibid. p. 196.
to be short and sharp. The asymmetry is due to the role that credit plays. As prices rise, the same collateral can support a greater amount of credit. Rising prices also tend to generate optimism and encourage a greater use of leverage—borrowing for investment purposes. At the peak of the boom both the value of the collateral and the degree of leverage reach a peak. When the price trend is reversed participants are vulnerable to margin calls and, as we’ve seen in 2008, the forced liquidation of collateral leads to catastrophic acceleration on the downside.

Bubbles thus have two components: a trend that prevails in reality and a misconception relating to that trend. The simplest and most common example is to be found in real estate. The trend consists of an increased willingness to lend and a rise in prices. The misconception is that the value of the real estate is independent of the willingness to lend. The misconception encourages bankers to become more lax in their lending practices as prices rise and defaults on mortgage payments diminish. That is how real estate bubbles, including the recent housing bubble, are born. It is remarkable how the misconception continues to recur in various guises in spite of a long history of real estate bubbles bursting.

... Bubbles always involve the expansion and contraction of credit and they tend to have catastrophic consequences. Since financial markets are prone to produce bubbles and bubbles cause trouble, financial markets have become regulated by the financial authorities...

It is important to recognize that regulators base their decisions on a distorted view of reality just as much as market participants—perhaps even more so because regulators are not only human but also bureaucratic and subject to political influences.

Myopic regulation is a big trustee risk in this area. Virtual absence of regulation is much worse.

One reason for lack of regulation is easy to see. The boom sequence described by Mr Soros puts an economy on something like a cocaine high. While it is in that state, politicians come to be viewed more benignly. Recall again what Pettijohn and Jungeberg found, about these good times:

Consistent with the Environmental Security Hypothesis predictions,...as social and economic conditions improved, younger, lighter, shorter Playboy Playmates of the Year with smaller waists, larger eyes, smaller waist-to-hip ratios, larger bust-to-waist ratios, and larger body mass index values were preferred....neotenous features and a more curvaceous body type were preferred when times were good.

So while the testosterone-charged market makers are basking in silicone, and the community is feeling wealthy and optimistic, the politicians are on easy street.

The market is providing the bread and circuses. These ensure that there are no hard decisions that cannot be postponed. If it is working, why snatch the drug away and expose themselves to a possible unfavourable reaction from their constituencies?

Another reason is doctrinaire abhorrence for regulation. The cover story for the 15 February 1999 issue of Time was the ‘Committee to Save the World’. The sceptical approach to doctrine of US Treasury Secretary Robert Rubin, Federal Reserve Board Chairman Alan Greenspan and Deputy US
Treasury Secretary Larry Summers, was contrasted with its antithesis:

In the Reagan Administration economic policymaking was guided not by analysis but by conclusions—specifically a belief in so-called supplyside economics. No matter what the data showed, the results among Reagan-era economists like Arthur Laffer were always the same: tax cuts and less regulation were the solution.

Allied with that second reason is the understandable desire, if regulation is being considered, to ensure that it applies only to what might go wrong in the economy, and that it does not damage what is going right. At the time that magazine story was written, the US economy appeared to have the wind in its sails, while a number of other economies were in the doldrums or worse.244 The ‘Committee to Save the World’ was trying to do just that without spoiling the party in the USA:

In late-night phone calls, in marathon meetings and over bagels, orange juice and quiche, these three men—Robert Rubin, Alan Greenspan and Larry Summers—are working to stop what has become a plague of economic panic. Their biggest shield is an astonishingly robust US economy. Growth at year’s end was north of 5%—double what economists had expected—and unemployment is at a 28-year low. By fighting off one collapse after another—and defending their economic policy from political meddling—the three men have so far protected American growth, making investors deliriously, perhaps delusionally, happy in the process.

To help resolve the riddle of imperfect markets, the committee has spent six years working on an experiment. It’s called the US economy. The current boom is as much a part of the committee’s legacy as is its battle to stem global turmoil. It was Rubin—via the 1993 deficit reduction plan—who navigated the Clinton Administration into budgetary agreements that helped create the first surplus in 29 years. This fiscal responsibility helped lower interest rates, which kicked off a surge in business spending. Greenspan, who dovetailed his own monetary policy with those goals, let the economy build up its present head of steam.245

The titles of Rubin’s 2003 book, *In an Uncertain World*, and of Greenspan’s 2007 book *The Age of Turbulence*, suggest that this triumvirate was feeling its way, and that the economy—which was ‘making investors deliriously, perhaps delusionally, happy’—therefore was being run, without the comfort of dogmatic certainty.

A diet of ‘bagels, orange juice and quiche’ might well lead to delusions: there could be another project for Pettijohn and Jungeberg in that. Nonetheless, to Rubin:

One of the issues the three of us returned to again and again was the strong performance of the American economy. By mid-1996, the expansion was well established and was still going strong. The growth rate was higher, and unemployment lower, than prevailing views would have said was possible without igniting inflation and putting upward pressure on wages and prices. People were throwing around the phrase ‘new economy,’ suggesting that advances in technology had revised the familiar rules and limits. Some investors appeared to be falling prey to the timeless boom-era temptation to believe that the business cycle had been tamed, that companies would never fail in their earnings, and that the next economic slowdown would never come.

Yet... real signs suggested that something had indeed changed for the better. With unemployment so low, a Fed chairman’s normal instinct would be to raise rates to prevent inflation. But there were no signs of

244. E.g. Thailand (1997), Russia and Brazil (1998), were languishing.
increased inflation. The question was whether the American economy could safely grow faster than through the previous few decades.

This apparent change in the so-called speed limit of economic growth strongly suggested that productivity growth—which had greatly slowed from the early 1970s through the early 1990s for reasons not fully understood—had now picked up again. Productivity increases work wonders on an economy, allowing faster growth without inflation. . . .

...Greenspan was the first of the three of us to reach the tentative conclusion that productivity growth did explain the absence of expected inflation. 246 That meant the speed limit on economic growth was higher than we’d thought. Larry and I followed in agreement somewhat later.

...But did these seemingly real changes in America’s productivity growth justify the tremendous rise in stock prices that was taking place? Again, Alan, Larry, and I reached a similar, tentative, conclusion: something real was happening in the economy, but at the same time the markets were probably overreacting to that real thing.247

For Greenspan:

My idea was that as the world absorbed information technology and learned to put it to work, we had entered what would prove to be a protracted period of lower inflation, lower interest rates, increased productivity, and full employment. ‘I’ve been looking at business cycles since the later 1940’s,’ I said. ‘There has been nothing like this.’ The depth and persistence of such technological changes, I noted, ‘appear only once every fifty or one hundred years.’

To suggest the global nature of the change, I alluded to a new phenomenon: inflation seemed to be ebbing all over the world. My point was that monetary policy might now be operating at the edge of knowledge where, at least for a while, time-honoured rules of thumb might not apply.

...The fast-paced high-tech boom is what finally gave broad currency to Schumpeter’s idea of creative destruction.248. . . .The reigning powers of technology—giants like AT&T, Hewlett-Packard, and IBM—had to scramble to catch up with the trend, and not all succeeded.

...Business now had an enormous capacity to gather and disseminate information. This accelerated the creative-destruction process as capital shifted from stagnant or mediocre companies and industries to those at the cutting edge. . . .

To take a more recent example, compare Google and General Motors. In November 2005, GM announced plans to terminate up to thirty thousand employees and close twelve plants by 2008. If you looked at the company’s flows of cash, you could see GM was directing billions of dollars it historically might have used to create products or build factories into funds to cover future pensions and health benefits for workers and retirees. Those funds, in turn, were investing the capital where returns were most promising—in areas like high tech. At the same time Google, of course, was growing at a tremendous rate. The company’s capital expenditures increased nearly threefold in 2005 to more than $800 million. And in the expectation that the growth would continue, investors bid up the total market value of Google stock to eleven times that of GM’s. In fact, the General Motors pension fund

246. For his account of this, see Greenspan, The Age of Turbulence: Adventures in a New World (Allen Lane, Australia, 2007), pp. 172–173.
owned Google shares—a textbook example of capital shifting as a result of creative destruction.

Why should information technology have such a vast transforming effect? Much of corporate activity is directed at reducing uncertainty. For most of the twentieth century, corporate leaders lacked timely knowledge of customers, needs. This has always been costly to the bottom line. Decisions were made based on information that was days or even weeks old.

Most companies hedged: they maintained extra inventory and backup teams of employees ready to respond to the unanticipated and the misjudged. This insurance usually worked, but its price was always high. Standby inventories and workers are all costs, and standby ‘work’ hours produce no output. They produce no revenue or added productivity. The real-time information supplied by the newer technologies has markedly reduced the uncertainties associated with day-to-day business. Real-time communication between the retail checkout counter and the factory floor and between shippers and truckers hauling freight has led to shorter delivery times and fewer hours of work required to provide everything from books to factory gear, from stock quotes to software. Information technology has released much of the extra inventory and the ranks of backup workers to productive and profitable uses.

...Overall, the tech boom also had a major positive effect on employment. Many more jobs were being created than were being lost. Indeed, our unemployment rates fell, from over 6 percent in 1994 to less than 4 percent in 2000, and in the process the economy spawned sixteen million new jobs. Yet...millions of Americans found themselves exposed...to the dark side of creative destruction. Secretarial and clerical functions got absorbed into computer software, as did drafting jobs in architecture and in automotive and industrial design. ...

The swifter the spread of technological innovation, and the broader its impact, the more we economists had to scramble to figure out which fundamentals had changed and which hadn’t...

...

Both the economy and the stock market continued to boom. Output as measured by GDP grew at a superhot pace of over 6 percent in the spring of 1966....Something extraordinary was happening, and the challenge in trying to figure it out as it was happening, in real time, was considerable.

...

Even rising productivity could not explain the looniness of stock prices....Though economic growth was strong, we worried that investors were getting carried away. Stock prices were beginning to embody expectations so exorbitant that they could never be met....

The concept of irrational exuberance came to me in the bathtub one morning as I was writing a speech....

On the podium that night I delivered the key passage....

But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions, as they have in Japan over the pasty decade? And how do we factor that assessment into monetary policy? We as central bankers need not be concerned if a collapsing financial asset bubble does not threaten to impair the real economy, its production, jobs, and price stability. Indeed, the sharp stock market break of 1987 had few negative consequences for the economy. But we should not underestimate, or become complacent about, the complexity of the interactions of asset markets and the economy.
The ‘Committee to Save the World’ thinks ‘something’ is happening in the economy, to which ‘time-honoured rules of thumb might not apply’

This is getting close to the heart of why life got so hard for trustees. The serpent is whispering to them:

come on, prudence is different nowadays. Rubin’s saying that ‘something real’s happening in the economy.’ Greenspan’s telling anyone who’ll listen that ‘something so extraordinary’s happening, that the time-honoured rules of thumb don’t apply any more.’ They don’t know how it works. They just know that it ‘works’. If it’s good enough for them, it should be good enough for you. Do you know more than the Committee to Save the World? Pile in or you’ll miss out.

With the other ear, hopefully, the trustee is listening to Thomas Aquinas telling her that prudence is the antithesis of impulsive or heat-of-the-moment decision-making: ‘non solum ex impetu aut passione’.249

For all the intellect, brainpower and resources represented by the ‘Committee to Save the World’, and its bottomless pit of advisers and resources, they could not agree that leverage might be a problem in respect of hedge funds. Recall that, after only four years, Long-Term Capital Management commanded USD 134 billion in investment. This was ventured on leveraged betting involving in excess of USD 1 trillion.

Rubin was worried that this leverage might be troublesome:250

All the disclosures in the world won’t help if investors don’t care about risks or valuation, The boom in Internet stock prices in the late 1990s occurred despite full disclosure by companies with no real earnings.

Given the limits on what could be accomplished through disclosure requirements, I thought limiting leverage was also necessary both to constrain market excesses and to mitigate the harm they can create. For many years, banks and registered broker dealers had lived with capital requirements, and all investors were subject to margin requirements when they borrowed against stocks. But other kinds of financial institutions, including hedge funds, had no regulatory leverage constraints other than the margin requirements, if any, associated with the instruments they bought or sold short. My own view was that it wasn’t necessary to impose special leverage rules on hedge funds as a class of investor. I still think [he is writing in 2003] that is right, though as they become a larger and larger part of trading activity, policy makers may revisit that question, if some systemic risk is thought to be at stake. I do think, however, that derivatives, with leverage limits that vary from little to none at all, should be subject to comprehensive and higher margin requirements. But that will almost surely not happen, absent a crisis.

While economically useful under most circumstances for more precise risk management, derivatives can pose risks to the system when market conditions become very volatile. That occurs because of various technical factors that can cause derivatives users to suddenly need to buy or sell in the underlying markets to maintain appropriate hedge positions. With the truly vast increase in the amount of derivatives outstanding, it is at least conceivable that the effect on already disrupted markets could be vast. Some evidence of that potential appeared in the third quarter of 2003, when a rapid spike in interest rates changed the hedging requirements for mortgage-backed securities. The result was substantial exacerbation of that spike. Similarly, in 1987, some traders estimated that ‘portfolio insurance’ selling of stock index futures added substantially to the October 19, 1987, stock market collapse. In a later speech at the Kennedy

249. Summa Theologica I–II Q 57 a 5 c.
School at Harvard, Larry characterized my concerns about derivatives as a preference for playing tennis with wooden racquets—as opposed to the more powerful graphite and titanium ones used today. Perhaps, but I would still reduce the leverage allowed on derivatives substantially.

The broader public policy question arising out of the LTCM mess was whether anything could be done to reduce the probability and severity of this kind of event in the future. This was a frequent topic of discussion among Larry [Summers], Alan [Greenspan], and me, with some of the discussion taking place in meetings of the Financial markets Working Group, which also included Bill McDonough; SEC chairman Arthur Levitt; Brooksley Born, the chair of the Commodity Futures Trading Commission; the heads of the other principal financial market regulatory bodies; and Gene Sperling from the NEC. Some members of this group thought that derivatives—instruments such as options, futures, and forwards whose value depends on the performance of an underlying security, currency, or commodity and whose value can change in complicated ways that is hard for even experienced traders to anticipate—by their nature could pose a systemic risk. Others thought the unrestricted leverage available to hedge funds such as LTCM was a problem. Some thought neither was a problem.

I thought both derivatives and leverage could pose problems. I had been involved with derivatives from the pioneering days of the founding of the Chicago Board Options Exchange. Derivatives serve a useful purpose by providing a means to manage risk more effectively and precisely, but they can create additional problems when the system is stressed. One way to contain those risks is by limiting the permissible leverage of buyers and sellers of derivatives. If you think periodic market excesses are inevitable because human nature is likely to lead to excess, you should try at least to limit the damage to the system.

Capital requirements and margin requirements—both leverage limits—help to do that, both by decreasing the size of positions and by increasing the amount of money backing each position.

Larry thought I was overly concerned with the risks of derivatives. His argument was characteristic of many students of markets, who argue that derivatives serve an important purpose in allocating risk by letting each person take as much of whatever kind of risk he wants. That is right in principle, but it is not the whole story. Throughout my career, I had seen situations where derivatives put additional pressure on volatile markets (for example, through the additional selling in the stock market that can occur when portfolio managers sell calls to arbitrageurs, who in turn hedge by shorting stock against the calls for protection as the market falls). I also thought that many people who used derivatives didn’t fully understand the risks they were taking—the situation we had found ourselves in at Goldman in 1986. Larry’s position held together under normal circumstances but seemed to me not to take into account what might happen under extraordinary circumstances. Of course, Larry thought I just wanted to keep markets the way they were when I’d learned the arbitrage business in the 1960s—his point about ‘playing tennis with wooden racquets’ again.

So the world was to be ‘saved’ by a Committee, one member of which had well-founded convictions, but no courage to stand up for them; another member of which seems to have been controlled by testosterone, and in turn exercised control over that uncourageous first member with jibes that only sissies play tennis with wooden racquets; and the third member of which knew all the rules of thumb, but thought that maybe gravity had been repealed and that they no longer applied.

The ‘tailors’ in Hans Andersen’s tale of the Emperor’s New Clothes convinced all and sundry that their ‘magical cloth’ was invisible only to fools.

251. Risks being taken with the money of other people to whom the risk takers may have felt little or no moral obligation.
The people gathered to watch the emperor parade in his very costly ‘new suit’. None was prepared to back the evidence of her own eyes. To cover their chagrin at finding the ‘cloth’ invisible, and their stupidity therefore proven, all expressed rapture at the magnificence of its colour and texture. It took a single child, who had no concept of seeming foolish, to pipe up that the Emperor was naked.

‘Fool!’ his father reprimanded, running after him. ‘Don’t talk nonsense!’ He grabbed his child and took him away. But the boy’s remark, which had been heard by the bystanders, was repeated over and over again until everyone cried: ‘The boy is right! The Emperor is naked! It’s true!’

By then, the tailors had decamped with their bonuses, and respect for the emperor had started to melt down, although, no doubt, it was the closest acolytes who were the last to admit the evidence of their own eyes.

Mr Greenspan now has admitted—‘I screwed up’—that he had completely misconceived the peril in which the system stood in the face of the subprime mortgages and the bonds sold against them. No wonder, the sadness in the tone of the article, already cited, by the Australian Prime Minister: 253

George Soros has said that ‘the salient feature of the current financial crisis is that it was not caused by some external shock… the crisis was generated by the system itself’. Soros is right. The current crisis is the culmination of a 30-year domination of economic policy by a free-market ideology that has been variously called neo-liberalism, economic liberalism, economic fundamentalism, Thatcherism or the Washington Consensus. The central thrust of this ideology has been that government activity should be constrained, and ultimately replaced, by market forces.

In the past year, we have seen how unchecked market forces have brought capitalism to the precipice. The banking systems of the Western world have come close to collapse. Almost overnight, policymakers and economists have torn up the neo-liberal playbook and governments have made unprecedented and extraordinary interventions to stop the panic and bring the global financial system back from the brink.

Even the great neo-liberal ideological standard-bearer, the longserving chairman of the US Federal Reserve Alan Greenspan, recently conceded in testimony before Congress that his ideological viewpoint was flawed, and that the ‘whole intellectual edifice’ of modern risk management had collapsed. Henry Waxman, the chairman of the Congressional Committee on Oversight and Government Reform, questioned Greenspan further: ‘In other words, you found that your view of the world, your ideology, was not right; it was not working?’ Greenspan replied, ‘Absolutely, precisely.’ This mea culpa by the man once called ‘the Maestro’ has reverberated around the world.

As recently as 31 January 2008, Mr Rubin was denying a meltdown: a denial from which he did not retreat until 9 January 2009 in his statement released by Citigroup on his retirement: 255

My great regret is that I and so many of us who have been involved in this industry for so long did not recognize the serious possibility of the extreme circumstances that the financial system faces today.

His conclusion that ‘no systemic risk is thought to be at stake’ was extraordinary. There cannot have existed anywhere else on the face of the earth any better informed and resourced group than the ‘Committee to Save the World’. If they did not understand the problem, how could trustees have understood it? And if trustees could not understand it, but invested anyway, how stands their investment in the light of

the duty Lindley LJ identified, ‘to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide’?

**Investment and gambling**

In a sense, all investments are bets. But much betting is off limits to a trustee. A bet on a race, for example, or on the outcome of a game of two-up. As Rowlatt J noted in *Graham v Green*,256 that sort of bet is:

merely an irrational agreement that one person should pay another person something on the happening of an event. A agrees to pay B something if C’s horse runs quicker than D’s, or if a coin comes one side up rather than the other side up. There is no relevance at all between the event and the acquisition of property. *The event does not really produce it at all.* It rests, as I say, on a mere irrational agreement.257

When the trust estate is invested in a portfolio of stocks, there is always a gamble, but not of the sort described in the italicized text above. Companies in the *real economy* make real products that real people need and will buy. Real money can be made.

From the accounts Greenspan and Rubin have given of their ruminations and discussions, it seems to emerge that naked gambling lay at the heart of the financial markets. We had a system in which:

- Loans which the borrowers had no chance of repaying were sliced, diced, and packaged into ‘securities’.
- Other financial products such as the scandalously mismanaged258 $50 trillion259 synthetic Collateralized Debt Obligations market. The director of a leading litigation funder has described the lack of transparency that would be an absolute barrier to any prudent trustee dalliance in such products: ‘No one has a clue around the world—including the banks or the regulators. No one has a clue what the amount in value of CDOs is, who’s got them, when they are due to mature, what the terms of them are, and what will cause a total loss…God only knows—or maybe even he doesn’t.’260
- Funds were accepting money from investors and placing them into further Funds, many of which were feeder funds for the likes of Mr Madoff and his Ponzi scheme. Mr Picard, the liquidator of Madoff’s empire, said on 21 February 2009 that he had ‘found no evidence to indicate that securities were purchased for customers’ accounts for perhaps as much as 13 years. It was cash in and cash out. Picard also said he found no separation between the company’s broker–dealer division and its investment advisory unit, which prosecutors

---

256. [1925] 2 KB 37, 39–40.

7 Warren Buffett is best known for his description of derivatives as ‘weapons of mass financial destruction’ but, around the same time as he made that comment, he also pointed to the circumlocution of derivative documentation—‘and CDO squareds—I figured out on a CDO squared you have to read 750,000 pages to understand the instruments that were underneath it.’
8 Buffett seems to me to be a straight talker and the arch enemy of circumlocution. I think he arrived at his weapon of mass financial destruction comment, in large part, because of their complication.
9 The best known sub prime CDO in Australia is the Federation CDO promoted by Lehman Brothers. I have tried to reverse engineer that CDO and I can vouch for Buffett’s number. The federation CDO includes tranches from forty different residential mortgage backed securities which in turn sit above tens of thousands of residential mortgages. No one in their right mind would try to carry out a full due diligence on such a structure.
10 As will become apparent from what follows, I believe that jargon has played its usual role in synthetic CDO’s ie to obfuscate and to leave the reader in a position where he must rely, almost totally, upon the author.
have said was at the center of an alleged $50 billion Ponzi scheme at Madoff’s New York-based firm. We have found nothing to suggest there was any difference, any separateness, Picard said at a meeting yesterday with Madoff clients in US Bankruptcy Court in Manhattan. It was all one.261

Trustees who were putting trust funds into this market could not have known anything useful about the reality of these ‘securities’.

It is remarkable how the best and brightest are attracted to schemes of this type. Calkin v Commissioner of Inland Revenue262 is an example. The appellant had been the Chief Executive of a substantial company at the material times. At the time, he no doubt considered himself a prudent business person. Like many others of similar status, he soon came to see that initial high ‘returns’ had sucked him deep into a Ponzi scheme. The returns were the residue—after the promoter’s deductions to cover the lifestyle to which she had become accustomed—of the contributions made by later gullible entrants. As in Rowlett J’s dictum, the ‘returns’ had not been produced by the ‘investment’. They had more the quality of a gift or a finding.

**The efficacy of prayer**

Between the trial and the appeal, Mr Calkin became a clergyman. Notwithstanding the cold water which the House of Lords has thrown on the justiciability263 of the efficacy of prayer,264 this change of occupation may have had some effect. In the Court of Appeal, Sir Robin Cooke, as Lord Cooke then was, decried the Revenue’s Berkeleian argument that the losses had not been tax deductible because the business ‘undertaking did not exist; there was merely an accumulation of data received by the taxpayer’s mind which led him to believe that one did.’265 The learned judge held that:

> If our function on the appeal were to decide the facts de novo, I would respectfully regard the approach that treats as decisive the bogus nature of Mrs Pilmer’s activities as rather narrow and unreal.

I would see the undertaking as a somewhat unusual one involving diverse investments, in which Mrs Pilmer’s personality and supposed abilities were a key feature but the appellant himself played an active part. He raised the money, partly by the sale of assets and borrowing, and he made certain repayments of loans; he supplied the money to her; he travelled to Wellington and Masterton from time to time for consultations with her; he spoke with her solicitor from time to time; he inspected properties and approved or disapproved proposed transactions. He did all this with the undoubted intention of making a profit. Indeed it was his sole motive. The fact that the profit was to come from investments made by her on his behalf does not, as I see it, compel a finding that he had not commenced the undertaking. On the contrary, he had done a great deal in the undertaking—everything in truth that was required of him.

Similarly I would be at least disposed to regard the various intended transactions, although relating to different kinds of property, as sufficiently part of an organised and coherent plan, and sufficient in time, scale, volume and the commitment of money and effort, to warrant calling the whole an undertaking. Considerations of this kind have been laid down by this Court as relevant in determining whether a taxpayer is in business in the ordinary sense of that word.266

---

262. [1984] 1 NZLR 440 (CA).
263. ‘[A] non-justiciable question . . . is a question which is not susceptible of determination by any legal yardstick.’ Curtis v Minister of Defence [2002] 2 NZLR 744, paragraph 28 (CA).
264. Gilmour v Coats [1949] AC 426, 446 per Lord Simonds—’manifestly not susceptible of proof . . . the court can act only on proof’, not on belief.
Regrettably for the Rev. Calkin, the function of the Court of Appeal of New Zealand not only was not to decide the facts de novo, but was to disturb a finding of fact only if it was to have been clearly wrong. Invoking Lord Radcliffe in *Edwards v Bairstow*, and deferring to the other members of the Court of Appeal, Cooke J agreed that the case was one of those ‘in which it could not be said to be wrong to arrive at a conclusion one way or the other.’

It followed that the appellant had not been carrying on an ‘undertaking’ within the extended definition of ‘business’. From that it followed, also, that the New Zealand business theft-deduction provision also was inapplicable.

Trustees who discover that they have been Ponzi victims may have paid tax in previous years on the ‘income’ from their ‘investment’ of the trust estate. Their ability to obtain refunds of the tax may depend on whether their taxing authority can be compelled to reopen assessments to which objection may not have been taken within a certain time from the making of the assessments.

Former Pro Vice-Chancellor of Oxford University, and distinguished philosopher, Sir Anthony Kenny, retired from the Roman Catholic priesthood in 1963 when he found that he had become agnostic. A keen mountaineer, he has been quoted as suggesting that, were he to lose foothold on a steep face, he might, nonetheless, still find it natural to pray during his rapid descent to the rocks below.

The trustee who, having failed to ask the hard questions, discovers that he has landed the trust estate, and himself, in a Ponzi scheme, also may find that prayer comes naturally. But however natural this might be, it is even less likely than the prayers of enclosed nuns to evoke a benign judicial response.

God appears to be mercifully impartial here. While Mr Madoff was busy converting wealthy Jews into paupers with his $50 billion Ponzi scam, 82-year-old Richard Picoli, having advertised to good effect in the New York Catholic press, was doing the same—albeit to the more modest tune of $17 million—for Catholic priests and their parishioners.

Investment advisers presumably attracted trustee clients because the latter would have taken it for granted that the advisers would have done due diligence on Mr Madoff and all their other ‘investments’. A test for the efficacy of the advisers’ prayer soon might come to pass:

UK investors are planning legal action against HSBC, UBS, Barclays and Nicola Horlick’s Bramdean fund over advice received before the Bernard Madoff $50 billion (£36.8 billion) investment scandal.

One of the British victims had £36m invested in Madoff funds, according to a lawyer acting for the claimants.

Ten wealthy investors have approached the law firm Edwin Coe with a view to suing bankers, fund managers and other intermediaries for the full value of the money they have lost in the Madoff collapse.

The 10 claimants are said to include some of Britain’s richest people, with combined losses of about £87m. While their identities remain shrouded in secrecy, it is understood that most are entrepreneurs who amassed their fortunes by selling their businesses.

An investment trust overseen by Bramdean recently announced that it had written off £12.4m invested in two hedge funds run by Madoff.

HSBC and Bramdean declined to comment yesterday. Barclays Wealth said: ‘Barclays Wealth has a small

269. Land and Income Tax Act 1954 s 129CF.
number of clients with exposure to the alleged fraud by Bernard Madoff through a third-party hedge fund.\textsuperscript{272}

One of the miracles that no doubt will be urged on the Prayee will be the provision of a plausible way of reconciling the advisers’ alleged due diligence with the recent revelation that Mr Madoff’s ‘auditors’ were the one man ‘firm’ of Friehling & Horowitz, operating out of a 13’ × 18’ office in a small plaza 30 miles out of Manhattan. This ‘firm’ had not been reviewed by the American Institute of Certified Public Accountants for the last 15 years. The reason for this lack of supervision was that, in each of those years, the ‘firm’ had certified to the Institute that it did not perform audits.\textsuperscript{273}

Not even the regulators seem to have noticed. The regulators’ failure to notice calls in question the value of the hue and cry for more regulation, and it suggests that not much has improved since the author of \textit{Isaiah} wrote, two and a half thousand years ago:

\begin{quote}
My watchmen are blind, all of them unaware;  
They are all dumb dogs, they cannot bark;  
Dreaming as they lie there, loving their sleep . . .  
The shepherds also, they have no understanding;  
They have all turned to their own way,  
each to his own gain, one and all.\textsuperscript{274}
\end{quote}

The lenders of the funds which were providing the leverage, for the advisers’ schemes to put their clients aboard the Madoff wealth wagon, likewise might be installing \textit{prie dieux} in their offices:

\begin{quote}
The feeder funds’ returns were augmented by billions of dollars in loans from some UK banks—and the bankers want to know why these advisers recommended Madoff in the first place. . . .
\end{quote}

Much of the SFO’s investigation will concentrate on the managers of so-called feeder funds responsible for attracting many European investors to Madoff Securities International, Madoff’s UK enterprise.

Attracted by Madoff’s outstandingly consistent returns, these financiers had the global connections to introduce a fresh batch of money-hungry investors to the apparently infallible BMIS [Bernard Madoff Investment Securities]. . . .

He consistently beat other fund managers with his seemingly simple strategy of buying shares in large companies and selling options on the same names to mitigate the risk. But as legend of his fund’s miraculous performance spread—and, it is alleged, his friends and family network became inadequate to satisfy investors’ craving—Madoff’s operations looked farther afield for cash.

These included international investors such as Swiss and Austrian private banks, hedge funds owned by large insurance companies such as MassMutual’s Tremont Capital Management and several charitable organisations.

Some of these groups, particularly the charities and the prominent individual investors who now face ruin, accessed Madoff’s operations through the more traditional route of their longstanding financial advisers. They will be keen to understand what due diligence was undertaken on their behalf and why these advisers appear to have relied upon paper proof of returns created by MSI itself. Were they negligent?

\begin{quote}
Some of Britain’s largest banks and financial institutions are among several banks across Europe that lent billions of dollars to funds that were feeding Madoff’s operations, some even creating special notes to provide a guarantee.
\end{quote}

\begin{quote}
\textsuperscript{274} Is 36: 10–11.
Given the scale of the losses, the victims of the scheme will be keen to explore every avenue in an attempt to minimise their exposure. This could lead to the possibility of litigation against financial advisers and others involved in the investment process, both in America and in Britain. Without doubt, this case will be one to watch in 2009.275

Ten rules of thumb

An attempt to link Mr Madoff with The 10 Commandments would be futile, but he has helped to establish 10 useful rules of thumb.

Rule of thumb #1

Of these, the first is: do not invest the trust estate in a fund that makes out it does not want to accept you, or to accept all you wish to invest:

When he added an investment arm to his broking firm more than a decade ago, Madoff limited investors to friends and acquaintances from the tightly knit circles of Manhattan’s Upper East Side synagogues and charitable organisations and Palm Beach’s exclusive Country Club.276

For one such investor:

All we knew was that my wife’s entire family had been in the fund for decades and lived well on the returns, which ranged from 15% to 22%. It was all very secretive and tough to get into, which, looking back, was a brilliant strategy to lure suckers. . . . There were the usual warnings prior to investing—we all knew it was a risk, we were told to make sure we were diversified, blah-blah—but, my God, it had been going strong for so long and with such fantastic returns, we had to get in.277

Mr Madoff’s playing hard-to-get made his ‘fantastic returns’ irresistible to many with money to invest. He would have approved the approach of the female appellant as described by Ward LJ in Sutton v Hutchinson.278

She worked at the Spearmint Rhino Club. The respondent was a businessman. He appears to have thought that the Beatles’ ‘money can’t buy me love’ refrain was untrue. In search of distraction from the cares and tensions of his daily round, he visited the club one evening. During his visit, he managed to obtain the telephone number of the appellant with a view to having dinner with her sometime.

The learned Lord Justice thought this probably was not going to be the traditional boy-meets-girl, ‘let us have dinner, darling,’ kind of invitation. That was purely obiter of course, but his Lordship might have had a point. Certainly, like—but presumably better looking than—Mr Madoff, the appellant knew a thing or two about being hard-to-get. She suggested, and the respondent paid, around £1000 per night for the pleasure of her company. In fact, it appears that he did so night after night after night, until a considerable sum of money had changed hands between them.

Unhappy differences supervened. They seem to have brought the respondent to the sad conclusion that the Beatles might have been right after all. He claimed that the money which he had paid to the respondent had been by way of loan. He sought repayment. The respondent saw things differently. She had rather thought that they had

276. Ibid.

During that trip I met with 14 French and Swiss private client banks and hedge fund of funds (FOFs). All bragged about how BM had closed his hedge fund to new investors but ‘they had special access to Madoff and he’d accept new money from them.’ . . . I also came to realize that several European royal families were invested with BM. I met several counts and princes during my trip and it seemed they all were invested with BM or were marketing BM’s strategies to noble families throughout Europe. BM had a marketing strategy that appeared to be based on false trust, not analysis."

278. [2005] EWCA Civ 1773.
been payments for the—what Mr Madoff’s above investor might have called—‘fantastic returns’ he had been deriving from her, presumably very active, personal services.

Ward LJ set the scene with an opening to his reasons for judgment that stands alongside Lord Denning’s279 ‘it was bluebell time in Kent’:

The appellant is a lap dancer. I would not, of course, begin to know exactly what that involves. One can guess at it, but could not faithfully describe it.

The [trial] judge tantalisingly tells us, at paragraph 21 in his judgment, that the purpose is ‘to tease but not to satisfy’.

As far as his Lordship was concerned, that was the limit of judicial speculation:

Whether or not Rule 2 of the Spearmint Rhino Club had been breached, requiring that you could get no satisfaction, we do not know and fortunately do not have to decide.280


280. There are occasions on which such judicial reticence is unfortunate. This may have been one. With a little more thought, their Lordships surely would have seen the case for what it was: the canary in the mine for the global financial system—which was only three years away from the meltdown of 2008. The reasons for this regret are obvious. First, as Justice Oliver Wendell Holmes said in ‘The Path of the Law’, 28110 Harvard L Rev 457 (1897). For the rational study of the law the black letter man may be the man of the present, but the man of the future is the man of statistics and the master of economics.’ Second, there is Eliot Spitzer:

In March, in the wake of revelations that Spitzer, 49, had met with a $1,000-an-hour call girl named Ashley Alexandra Dupré and patronized a high-priced prostitution ring multiple times, the Democrat announced that he would resign his post as governor [of New York]. ‘I cannot allow for my private failings to disrupt the people’s work,’ Spitzer said at a news conference in New York City, with his stricken-looking wife, Silda, by his side. Months later Spitzer was working in his father’s real estate firm and Dupré was telling People magazine, ‘I think he’s been punished enough.’ To his wife, Dupré said, ‘I’m sorry for your pain.’

[Time, 'Top 10 Scandals', http://www.time.com/time/specials/2008/top10/article/0,30583,1855948_1863946,00.html (last accessed 29 July 2009)] Think:

Until the 1960s, economists were happy to assume that economic agents were more or less perfectly informed. While this was obviously simplistic, it was not appreciated that deviations from this assumption could make an enormous difference to the functioning of markets. In particular, asymmetric information, in which one party has more knowledge than another, turns out to be crucial to market performance. . . . [I]t is possible to rewrite much of Keynesian economics as a form of information deficiency in the functioning of a modern economy.


Thus, if only Holmes had not been ignored, there would have been at least one ‘master of economics’ on the Court of Appeal in Sutton v Hutchinson [2005] EWCA Civ 1773. That member would have known of the collaboration between Professor Robert Seymour of University College London and Peter Sozou, of the London School of Economics and Political Science. This collaboration has most recently given us their magisterial ‘Duration of courtship as a costly signal’: Journal of Theoretical Biology 256 (2009) 1. They have found that:

During courtship, both the male and the female pay participation costs per unit time at fixed rates. A courtship process involving a sequence of small gifts fits the assumptions of this model as long as the gifts are ‘costly but worthless’, ie the time-cost to the female in receiving the gifts exceeds her intrinsic (ie noninformational) benefit from the gifts. But the model is more general than this in that it considers a courtship process which involves participation costs but need not involve gifts as such.

A key feature of the model is asymmetric information arising from a binary variable, not completely observable by the female. The female will get a positive payoff from mating only if the male is a ‘good’ male, with respect to his genetic quality, or ability or intention to provide paternal care. If the female mates with a ‘bad’ male, ie one who is low quality or will not provide paternal care, she will get a negative payoff from mating with him.

We have found evolutionarily stable behaviour in which mating occurs after extended courtship. This has the following characteristics: a ‘bad’ male should quit the courtship process at a certain positive rate, whereas a ‘good’ male should persist for longer (indefinately for the specific assumptions in our model).

To the male, the game has some similarity to a war of attrition, with the opportunity to mate with the female constituting the resource for which he is waiting. A ‘good’ male has a higher ratio of fitness benefit from mating to fitness cost per unit time of courting than a ‘bad’ male.

From the female’s point of view, the strategic problem that she faces is one of decision-making under uncertainty (Dall et al, 2005). Whereas the model of Sozou and Seymour (2005) leads to an equilibrium outcome in which the female never mates with a ‘bad’ male, in real mating systems females may sometimes mate with the wrong male. This could be because of random errors in a female’s assessment of male quality (Luttbeg, 1996) or limits on the processing capacity of her neural system (Krakauer and Johnston, 1995).

The extended courtship equilibria in the present study also do not completely eliminate the risk of a female mating with a ‘bad’ male. The female’s strategy is a compromise solution in the face of a trade-off between the costs of mating too quickly (an increased risk of mating with a ‘bad’ male) and the time-cost of delay. The female’s cost of delay can be interpreted as a cost of acquiring information.

Bad males quit at a finite rate; they do not quit immediately. This means that, whilst the courtship cost incurred by a bad male is on average less than that incurred by a good male, it is nevertheless positive. It is therefore necessary for bad males to sometimes succeed in mating in order for an extended courtship equilibrium to be sustained. Appendix C extends the analysis to an arbitrary number of discrete male types of increasing ‘goodness’. The extended model behaves in all essential respects like the binary model: the worst type of male that courts the female constitutes the ‘bad’ male type and has a finite quitting rate, whilst all better male types never quit and collectively constituting the equivalent of the ‘good’ male type. Ibid. pp. 9–10.
Like the lap dancer, Bernie Madoff certainly was a bit of a tease. Because of his guilty plea, the jury will never be empanelled to decide whether he managed ‘to tease but not to satisfy’. He may yet manage to give great satisfaction—after all, former Enron CEO and President, Jeffrey Skilling [the devotee of ‘mark to market’ accounting\textsuperscript{281}], got a 24-year sentence. Even though his appeal has been allowed, the talk is that his resentencing will run somewhere around 15–19.\textsuperscript{282} A comparable sentence for Mr Madoff undoubtedly would give considerable satisfaction to those trustees who invested with him, lost their shirts as a result, and resisted the temptation to suicide.

\textbf{Rule of thumb #2}

This leads to the second useful rule of thumb: do not invest in a name like Bernie. In 1968, Anthony Sampson gave it as the opinion of ‘most financial people’ that Bernie Cornfeld ‘has come to stay’, and that his Investors Overseas Services mutual fund was set fair to ‘challenge the old banking establishment’.\textsuperscript{283} Yet only three years later, in their brilliant analysis of the Cornfeld scheme, Raw, Page and Hodgson were to conclude that:

If you were in the Fund of Funds, you would have done better to keep your money in an old sock. Or better still, to have spent it yourself before IOS got hold of it. . . .

After all the promises, it seems that the best account of the IOS investment operation is the one we were given by the young woman who worked for Cornfeld: ‘Anyone was fool enough to put their money with us,’ she said, ‘that was their problem’.\textsuperscript{284}

\textbf{Rule of thumb #3}

Which leads directly to, and vindicates, the \textit{third} useful rule of thumb. As enunciated by J. K. Galbraith, this rule is that neither prudence, nor even probity, is necessarily to be inferred from apparent wealth. Indeed:

Having money may mean, as often in the past and frequently in the present, that the person is foolishly indifferent to legal constraints and may, in modern times, be a potential resident of a minimum-security prison.\textsuperscript{285}

\textbf{Rule of thumb #4}

The \textit{fourth} rule of thumb is: do not invest in anything the accounts of which are audited by a tin-pot accounting firm, such as Mr Madoff’s above-mentioned Friehling & Horowitz:

‘If you’d seen a PriceWaterhouse [Coopers] or Deloitte as the auditor, you would’ve trusted them,’ Mr Siegel [a lawyer who advises nonprofits at Charity Governance Consulting in Chicago] said. ‘A $50 billion fund is not going to be audited by a three-person firm.’\textsuperscript{286}

\textbf{Rule of thumb #5}

From whence we immediately derive the \textit{fifth} rule of thumb: never allow an outfit with a name like Charity Governance Consulting select your auditor.

---

\textsuperscript{281} The taking of future projected profits immediately on settlement of the transaction designed to make them. He called this the ‘black box’ approach.

\textsuperscript{282} Clark, ‘US Court orders Enron fraudster Jeffrey Skilling to be resentenced’, The Guardian, 6 January 2009.

\textsuperscript{283} The New Europeans (Hodder & Staughton, London, 1968), 186.

\textsuperscript{284} Do You Sincerely Want to be Rich (Penguin, UK, 1971), 458, 460.


The Court of Appeal has pointed out that an auditor is to be a watchdog only. He is not required to be a bloodhound. But while he may not have to be overly suspicious, an auditor does at least have to bark at the obviously worrying signs. Over the eight years that it audited the accounts of the giant Indian listed company, Satyam Computer Services Ltd, it has been claimed that PriceWaterhouseCoopers did not even ask to see bank statements, or any other verification, of its audit client’s reported, but apparently totally fictitious, USD 1 billion ‘cash in the bank’, yet:

‘This is the basics. When you are doing an audit and a client says I’ve got a billion bucks in the bank, you check with the bank that it’s there,’ said Hugh Young, who oversees $30 billion in assets as the managing director of Aberdeen Asset Management’s Asia funds.

Satyam, and the market, appear to have been as happy with PricewaterhouseCoopers as auditor as Enron had been with Arthur Andersen—of which it was said that:

The incident further tars the name of venerable Arthur Andersen, which in June settled allegations of fraud stemming from its audit of Houston-based Waste Management and paid a $7 million fine without admitting any wrongdoing. Last year, again without admitting wrongdoing, Andersen agreed to pay $110 million to settle a class action brought on behalf of shareholders of another client, Sunbeam, which had misstated its financial results during the 1990s. These days, an Andersen competitor observes sardonically, settling a fraud case appears to be good for attracting business from other firms that want a soft touch for an auditor.

With the SEC, the Justice Department and various congressional committees now scrutinizing Andersen’s audit work on Enron, there is little doubt efforts will be made to rein in the industry. ‘The profession has always done just enough to get out of a hole,’ says industry analyst Arthur Bowman. The SEC and Congress are looking into Andersen’s interpretation of accounting rules that allowed Enron to exclude losses at several partnerships from its balance sheets. But the larger issue will be the objectivity of the entire industry. Enron paid Andersen $25 million for its audit last year and $27 million for ‘consulting’ and other services. ‘How can any auditor be independent when his client is paying this kind of money?’ Bowman asks.

Two of Enron’s senior financial executives had previously worked for Andersen in Houston: Richard Causey, Enron’s chief accounting officer, and Jeffrey McMahon, chief financial officer. Although it’s not unusual for auditors to be subsequently hired by their clients, Andersen has an unusual history—in Waste Management’s case, supplying every CFO from 1971 to 1997.

Nonetheless, when the truth emerged, ‘Satyam said... they had appointed Deloitte and KPMG to assist the company in restating its accounts.’ Ernst & Young seems not to have made the cut. Maybe this was because US Federal prosecutors recently had charged four of its partners with participation in a scam to deprive the US Government of hundreds of millions of tax dollars. Ernst & Young was accused of having helped wealthy clients create phoney losses on fictional investments, and then offsetting the losses in the calculation of their taxable income.

292. It was alleged that, for this purpose, they used ‘false and fraudulent factual scenarios’ such as the World Trade Centre attacks, which sent the value of investments plunging across the globe. Ernst & Young allegedly made USD 121.7 million in fees from the bogus tax shelter profits in the form of a cut of the savings that it generated for its clients.
Rule of thumb #6

The sixth rule of thumb is: when you find you have been let down, do not just go off on the rebound with any old sweet talker who happens to cross your path. The first frog or two you are tempted to kiss may turn out to be just another toad, rather than a prince of auditors. In January 2007, it was reported that Deloitte—the first of Satyam’s replacements for PriceWaterhouse—had paid $149 million to settle a lawsuit arising from its audit of a huge Italian dairy company. The company, Parmalat, became bankrupt under €14 billion of debt, after discovering a €4 billion gap in its accounting.293 In September 2006, the other replacement, KPMG, reportedly paid $456 million to settle an investigation into illegal tax shelters. Almost simultaneously, a German bank admitted criminal wrongdoing. It had to pay $29.6 million in fines for its crime of having used KPMG’s so-called ‘tax shelters’ to cheat the US government.

Like investors in Satyam, and in Mr Madoff’s scheme, trustees who spurn rules of thumb four, five and six are doomed to prove the adage that ‘recessions find what auditors miss.’294

Rule of thumb #7

The seventh rule of thumb is that investment advisers who are in demand because of great talent will charge you rapaciously. After all, they model themselves on the Bar.

The trappings of wealth in advisers bring to mind New York of the 1920s. The yacht harbour was a magnetic sightseeing attraction. There were moored there the floating gin palaces of the bankers and brokers. To quote again Raw, Page and Hodgson’s expose of Bernie Cornfeld’s Investors Overseas Services swindle:295

‘That’s Mr Morgan’s yacht on the right,’ the guide would declaim. ‘The one next to it belongs to Mr Rockefeller—that one is Mr Dillon’s.’ One day an innocent tourist is said to have asked: ‘Where are the customers’ yachts?’

So what does a trustee make of it, if an investment adviser is not charging for his advice? James Hedges IV, of LJH Global Investments, ‘a boutique firm that invests in hedge funds and private equity for high-net-worth families,’ visited Mr Madoff in 1997 on behalf of a client investment trust with an interest in possibly investing with Mr Madoff. Mr Hedges saw red flags all over the place. Not the least of them was:

the fact that Madoff was charging no fees other than trading commissions: ‘The notion that something is fee-less—which is what they largely proffered—is too good to be true.’296

Mr Hedges was not the only one for whom this was a warning:

Madoff took no management fees for his investment advisory services. They just earned commissions on the trades which they processed through the market-making side of the business. This amounted to leaving on the table a quarter billion dollars a year Barron’s estimated back in 2001. Why would he do that?297

Rule of thumb #8

The eighth rule of thumb is that fraudulent, untalented, and otherwise useless, investment advisers, who are in demand only because ‘trustees are often at best only accountants, and beneficiaries

---

gaping rustics,’ will charge you rapaciously. After all, they, too, model themselves on the Bar.

The phrase cited in this rule is taken from an earlier edition of *Jacobs Law of Trusts in Australia.* The phrase is not repeated in the current edition, of *Jacobs Law of Trusts in Australia.* Neither the discussion, in connexion with the second rule of thumb, of Enron’s Jeffrey Skilling, nor the discussion—under the fourth, fifth and sixth rules of thumb—of Friehling & Horowitz, PriceWaterhouseCoopers, Deloitte, KPMG, Ernst & Young and Arthur Andersen, leaves room for surmise that the omission of that phrase could have been related to a marked improvement in the fitness of accountants for their professed purpose.

While urbanization may have had some effect on their overall rusticity, there can be no doubt that beneficiaries may gape more than ever these days, if only at the precipitous drop in value of their trust estate and at the fees charged by the trustees for having managed that drop.

**Rule of thumb #9**

The *ninth* rule of thumb: beware over-consistent returns.

Using a strategy called “split strike conversion” which involved selling calls and buying puts on a basket of owned stocks, Madoff reported only three down months between January 1996 and December 2004—a 9 year, 108 month period. Sophisticated investors familiar with the strategy were mystified about how consistent and low volatility his returns were.

A trustee needs to be very wary indeed of an investment adviser who advises him to invest in anything with that sort of record. There must be grave suspicion whether the adviser has done any useful due diligence at all:

Spanish lawyers, who hope to reach agreements with banks without going to court, are working with the US law firm Labaton Sucharow.

The American law firm cited Optimal as one of the ‘feeder funds’ who channelled funds into Madoff Securities in return for what it calls ‘lucrative commissions’.

It said, Labaton Sucharow is investigating whether these feeder funds conducted adequate due diligence before investing in Madoff in light of the multiple red flags that are now known to have been evident, including the absence of a serious or reputable auditor, the absence of an outside clearing agent, and the overly consistent returns.

[Spanish bank, Banco] Santander faces loses of €17 million euros (GBP 16m), but its clients were exposed to loses of €2.3 billion euros.

The Spanish bank reportedly praised Mr Madoff weeks before the disgraced financier was accused of the biggest fraud in corporate history.

Spain’s anti-corruption prosecutor is investigating Santander and the BBVA bank to see if they acted correctly towards investors.

Mr Madoff is accused of running a massive pyramid scheme, using cash from new investors to fund payments to earlier clients. A Santander spokesman declined to comment.

Five days after that refusal to comment, the bank offered €1.38 billion in preference shares, with an

---

298. (Butterworths, Australia, 6th edn, 1997), para 1715.
300. See also Austin Mitchell MP and Prem Sikka, *Dirty Business: The Unchecked Power of Major Accountancy Firms* (Association for Accountancy & Business Affairs, 2002).
annual 2% coupon, ‘to compensate its clients’ for their original investments.\textsuperscript{303}

Rule of thumb #10

The tenth rule of thumb: beware secretiveness. It was said that:

Madoff was secretive to the extent of not even wanting his investors to tell anybody they were invested with him. That’s a bizarre marketing strategy!\textsuperscript{304}

It is also an old marketing strategy. Think back to 1720, and the South Sea Bubble mania. The most—but only just the most—extreme prospectus of that era offered 5000 shares of £100 each, on a £2 deposit. It promised that, by payment of this deposit, the subscriber became entitled to £100 per annum per share in:

\textit{A company for carrying on an undertaking of great advantage, but nobody to know what it is.}\textsuperscript{305}

Fuller and better particulars of this venture were promised in a month, when a call was to have been made for the outstanding £98. A thousand of the shares were subscribed in the five hours following publication of the prospectus. At that stage, the promoter was ‘philosopher enough to be contented with his venture, and set off the same evening for the Continent. He was never heard of again.’\textsuperscript{306}

‘Well, thank God I invested the trust estate in a hedge fund, and not in one of those dreadful ponzi schemes!’

Don’t open the champagne yet.

First, annual gains reported by hedge funds, if any hedge funds do report such gains, will be largely unrealized, notional. Hedge funds do not engage in annual liquidation of their assets.

The ‘gains’ also may have been calculated under the influence of some variant of Jeffrey Skilling’s ‘mark to market’ accounting for Enron: the hoped-for profits from the investment being treated as ‘in the bag’ to such an extent as to justify their immediate recognition.

Collateralized Debt Obligations, for example. These were caricatured brilliantly by John Bird and John Fortune in their hedge fund skit in the South Bank Show in mid-2008.\textsuperscript{307}

One interlocutor refers to ‘granting vast numbers of mortgages, to people who can’t afford them, on properties which are diminishing in value’.

By way of explanation, the other, an ‘investment banker’, asks him to:

imagine, if you can, say, an unemployed black man, sitting on a crumbling porch, somewhere in Alabama, in his string vest. A chap comes along and says ‘would you like to buy this house before it falls down; and why don’t you let me lend you the money’.

The dialogue continues:

And is this chap, who says this, a banker?

Oh no: he’s a mortgage salesman. His income depends entirely on the number of mortgages that he can arrange.

So his judgment, to arrange mortgages, is completely objective.

Completely objective. Yes.

And what happens next?


\textsuperscript{306} Idem.

\textsuperscript{307} Reproduced here with the kind permission of the production team at \textit{The South Bank Show} and Vera Productions Ltd, as copyright holders.
Then this mortgage, this debt, is bought by a bank, and packaged together, on Wall Street, with a number of other, similar, debts.

Without going into much detail about what is actually...

Without going into any detail. That’s far too boring. And so this is put into a package of debts, and so then it’s moved on to Wall Street and then, this, this... it’s extraordinary what happens then: this package of dodgy debts stops being a package of dodgy debts and starts being what we call a structured investment vehicle.

An SIV?

An SIV, exactly; yes.

I see. And then someone like you comes along and buys it.

I buy it, yes; and then I will ring up—I don’t know—somebody in Tokyo, and say ‘do you want to buy it?’

Mm?

And they say ‘what’s in it?’; and I say ‘I haven’t the faintest idea.’ And they say ‘how much do you want for it?’ And I say ‘A hundred million dollars.’ And they say ‘fine’. That’s it. That’s the market.

Presumably this package, I mean that kind of thing can happen several times to the same package.

Oh yes

And every time it does, of course, um, then, you, or someone like you, will get a fee, and a markup.

And a profit? Yes. Yes. I can’t be expected to do it for nothing: it’s hard work being...

In view of the fact that, in these packages, there’s a lot of dodgy debt, what is there about it that attracts the financial—you know—risk taker?

Well, because these hedge funds, as they are called, which specialise in these debts... um, they all have very good names.

You mean they are responsible companies?

No. No: it’s nothing to do with their reputation. They have actually very, very, good names. The names they think up are very, very, good. I’ll give you an example: there’s a very well-known American, Wall Street, firm called Bear Stearns who have two of these hedge funds which specialise in these mortgage debts. And they lost so much money—lost so much of its value—that Bear Stearns announced that they would have to put in $3.2 billion into one of the funds to try and keep it afloat.

$3.2 billion?

$3.2 billion. Yes. Yes. And even then they said the investors couldn’t get any money out of it and they were going to let the other fund go: but, one of these funds was called ‘High Grade Structured Credit Strategies Fund’, and the other was called the ‘High Grade Structured Credit Enhanced Leverage Fund.’

Well that sounds very good, doesn’t it.

Yes it’s good, isn’t it.

Very trustworthy.

Yes, this is the magic of the market. What started off lending a few thousand dollars to an unemployed black man in a string vest has become a High Grade Structured Credit Enhanced Leverage Fund

I like the sound of it.
It is good. I mean, it’s got good words in it. It’s got words like ‘high’.

‘High’ is good.

‘High’ is good. Better than low, anyway, isn’t it.

Yes; yes absolutely.

And ‘structured’: is another good word.

Very good.

‘Enhanced’?

I love ‘enhanced’.

‘Enhanced’ is very good.

I’d buy anything if it said ‘enhanced’.

Absolutely, yes. I mean, it might have been different if it had said ‘Unemployed Black Man in a String Vest Fund’, but . . .

Because then, alarm bells might start . . . to ring. But, despite these very plausible names, surely the reality is that the people that lent all this money are being incredibly stupid?

Oh no. No. No. No. The reality is that what was stupid is that, at some point somebody asked how much money these houses were actually worth. I mean, if they hadn’t have bothered to ask that question then everything would have gone on as perfectly normal. But, unfortunately, they did.

I see. But now you see, people are saying that the crisis is likely to turn into financial meltdown. I mean, can that be avoided?

It can be avoided provided governments and central banks give us, the financial speculators, back the money that we’ve lost.

But isn’t that rewarding greed and stupidity?

No. No. It’s rewarding what the Prime Minister, Gordon Brown, called ‘the ingenuity of the markets.’

I see.

We don’t want this money to spend on ourselves. We want this money just to go into the market: so that we can carry on borrowing and lending money as if nothing had happened, and without thinking too much about it.

But even if the hedge fund’s investments were to have been valued a good deal more accurately than Bear Stearns managed, let alone Jeffrey Skilling, a problem still was likely to arise when investors wanted, or needed, to withdraw their investment.

At that stage the fund either sells its most liquid, and most valuable, assets to pay her out; or it pays her out from funds being contributed by new investors. In the former case, because the easiest funds to sell are also likely to be the most valuable, those remaining in the fund are stuck with the harder to sell, and less valuable, assets. They are short-changed.

The latter case is the simple Ponzi situation. So, the trustee who has invested in the hedge fund, will not

have escaped the Madoff sting after all. Furthermore, as Officer\textsuperscript{309} has put it:

Every year hedge funds do have to liquidate part of their profits in order to pay their managers, traders and other support staff. Fund managers typically keep 20\% of (unrealized) trading profits. But first they must realize that 20\% by selling the liquid assets. If a fund is overestimating the value of the illiquid assets, then its manager’s profit is grossly overestimated. In most cases, the profit is at least slightly overestimated because of slippage in the liquid assets. In other words, if a fund liquidated all profits, the supposed 20\% taken out first would actually be larger than 20\% of the total realized profit.

If hedge funds had to regularly liquidate assets, we would not see the spectacular returns reported in the past. One factor of the supposed success of hedge funds is their ability to report unrealized gains and to be flexible in liquidation, since investors who believe they are getting high returns are unlikely to withdraw their money. That was how Madoff was able to maintain his charade for so long.

Wonder why Chicago-based hedge fund Citadel is not allowing investors to withdraw their money until at least March? Citadel has already reported about 50\% losses for its two largest funds. Remember: these are unrealized losses. If Citadel liquidated assets to pay out to investors, losses would be even greater. Barring a miracle, the first investors out would lose less than those going out later. But even in good times, the withdrawal of money from a hedge fund impinges its performance.

Hedge funds are designed to take in more and more investors’ money. Then inefficiencies and performance distortions of withdrawing money for investors and profit-taking for managers are smoothed out.

The recent failures in hedge funds, while rooted in the financial meltdown, have been further fueled by the lack of new investment as well as pressure from current investors to take their money and run. Regardless of a fund’s investment strategy, liquidation tends to make unrealized gains smaller—and unrealized losses larger—when they are finally realized.

By design, hedge funds benefit managers more than investors. Since the liquidation of assets always results in slippage—the more that is sold, the worse the price—managers for every hedge fund always get the ‘best’ 20\% of the profit.

So you see, there could be a little Ponzi scheme in every hedge fund. It is inherent to the model of the modern hedge fund. The only way to avoid these schemes is to regularly liquidate all assets and allow all investors to decide what to do with their cash returns. In the past, this would have meant seemingly diminished returns. With returns seemingly high, investors did not complain about the status quo. Now, given that regular liquidation would mean more transparency and diminished losses, in recent days investors’ opinions would likely differ.

\textbf{Nun sense: Sister Catherine Crowley}

The only person to head off the sparkling Bird–Fortune duo, with a devastatingly accurate assessment of what really was going on, was a Catholic nun, Dr Catherine Crowley. In her past life, she had been a—clearly fearlessly competent—City financial practitioner. Her 2006 book, \textit{The Value of Money: Ethics and the World of Finance},\textsuperscript{310} was the most pellucid, and balanced, account of what was going wrong, where it had the potential to lead us, and why.

\textsuperscript{309} 'The Ponzi Scheme in every Hedge Fund', \textit{Time}, 5 January 2009.
\textsuperscript{310} Continuum, London, 2006.
Dr Crowley sees the good in derivatives. After a jargon-free explanation of their workings, she concludes:311

These considerations show that derivatives can make a valid contribution to the functioning of financial markets. These markets, in their turn, can make a positive contribution to the common good. Derivatives are one of the most flexible and efficient means of transforming unwanted financial risks through the transfer of exposures among counterparties. They can facilitate investment which might otherwise be too expensive or cumbersome to undertake. The popular perception that derivatives have little merit, often fostered by newspapers, is erroneous. This is not to say, however, that they are without major defects, defects which can seriously undermine their contribution to the common good.

So she is decidedly not of the theological school which will ‘blast against “structures of sin” and demand “a prophetic call”’. 312 She considers that Christian critics ‘have often moved too quickly from the description of human and institutional failure to solutions in the categories of biblical revelation of Christian theology’. 313

Nonetheless, she is clear that, for all the value they can have, derivatives also can pose the very systemic risk Robert Rubin feared, and that the other members of the ‘Committee to Save the World’ derided. Sister Crowley enters the ethical phase of her analysis by considering risk and moral hazard:314

I have already drawn attention to a number of risk features inherent in derivative trading. These include the difficulty, indeed the near impossibility, market participants have in gauging either their own true risk exposure or the exposure of other participants. Derivatives have quantifiable benefits but unquantifiable risks. In part this is due to lack of transparency and complexity, together with the dynamic nature of the risks which can spill over into many markets. This is compounded by the market structure and the moral hazard of volatility, whereby the financial sector can generate more business and make bigger profits if assets have a volatile price.

The effects are not, however, confined to market participants. The nonfinancial sector of business bears increased costs in having to buy protection against volatility and must divert resources to managing risks—resources which are not then available for their core business… Whole economies can be destabilized by speculative cross-border capital flows, often in the form of derivatives, together with speculative attacks on currencies not driven by market fundamentals. The analysis in the following sections will have three strands: risk measurement, risk distribution and risk evaluation. I will be rejecting as inadequate the assumption of the financial sector that risk is purely a technical, value-free matter. I also reject the assumption that risk is a professional issue alone. Rather, it is a public issue.

Certainly an issue too important to leave to the ‘experts’ who profit from the trade:315

The next issue is what role to assign to expert opinion. One of the noticeable features of the finance sector is its possession of expert and exclusive knowledge. This may well contribute to the sector being seen by many as ‘ethic resistant’. This is because the combination of knowledge which is both expert and exclusive can lead to the apparent exclusion of others in any discussion about the activities upon which that knowledge bears.

311. The Value of Money: Ethics and the World of Finance, 125.
312. The Value of Money: Ethics and the World of Finance, 151.
313. The Value of Money: Ethics and the World of Finance, 151.
This in turn can give the appearance of any justification of that activity being little more than the creation of an alibi through the sector’s power and isolation from discourse in the public forum. In discussing the role of expert opinion we need, however, to draw a very clear distinction between evaluations of risk magnitude and evaluation of risk acceptability before considering whether expert or lay opinion is the better.

Clearly experts have a greater knowledge and understanding of particular risk probabilities and magnitudes. Some might argue, therefore, that as their knowledge is more reliable, it is experts who are most able to make rational decisions about risk acceptability. This position reflects the de facto situation with derivative risk, but it has major problems. The first problem is reflected in the discussion above on risk measurement. Measurement of derivative risk is neither exact nor objective. This weakens the claim of expert knowledge, although obviously it does not eliminate it. The second problem is that it is difficult to accept the disinterestedness of those judging the acceptability of a risk when they are the ones who receive the benefits but are not the ones who bear the greatest risk. The presence of expert and exclusive knowledge disenfranchises the very persons likely to be risk victims.

The third problem is that, although it is true that society in general has less accurate knowledge of risk probabilities, that is beside the point. Even if risk estimation were objective, the determination of whether a risk is acceptable is not. It is determined by our perceptions and constructs, sensitive to specific assumptions about measuring preferences, determining social choices and quantifying risks, costs and benefits. Decisions about risk acceptability are less a function of knowledge of risk probabilities than a function of the value attached to avoiding potentially catastrophic consequences and to obtaining benefits from taking some risk.

She spoke further of this in an interview with Chris Blackhurst:

Neither does Cowley feel the future shape of the markets should be left to a small group to determine. ‘What we have experienced is a systemic failure, where a failure to appreciate and restrict risk in one area threatened an entire economic meltdown—it’s too big a problem to be left to a few.’

‘What I do want to argue very strongly is that risk is not purely a “sectoral” issue to be decided by a technocratic elite of experts, it’s actually a public issue. Just as nuclear issues, genetic, biotechnical issues used to be seen as the preserve of the expert, we now rightly say, ‘No, the public has got a voice in this’ because of who bears the risk. I don’t think there’s been anything like enough attention to the risk bearers. We know who benefits from the risk—for example, the companies making whacking big profits. They’ve sat and benefited from the risk, but the actual risk bearer was a much, much wider pool of people, of society as a whole.’

Cowley is also a great believer in the frailty of human beings—that no matter how theoretically brilliant the structure, ultimately it is people who will decide the outcome. Critical in that, she argues, is our treatment of money. ‘A large part of what I looked at is: what the mere fact of trading money does to you and does to society; the very nature of money, the way that it brings distance into relationships, the way that it supports particular understandings of independence, autonomy, freedom—whatever word you want to use—and the way that can feed into relatively young, therefore relatively emotionally immature financial practitioners.’

Traders were dealing in derivatives that were ‘so complex that no one understood them’. As a result, ‘no one knew where the risk actually lay. It was assumed it was dispersed but even as far back as

1999, the Bank of International Settlements, in one of its documents dealing with high-leveraged institutions, was pointing out the possibility of risks actually being amplified through the system rather than contained and dispersed by the system.\(^{317}\)

That formed part of her ‘beef’ as she puts it, but Cowley also admits to being taken aback by the scale of the bad or ‘toxic’ banking business that has emerged. ‘I didn’t take sufficient account of how many people in the sector didn’t understand what they were doing. I argued that there were some derivatives that were inherently so complex and dangerous they should not be sold, and I would maintain that still. If you do not understand what you are doing you should not be doing it.’\(^{318}\)

It was there that the seeds for the disaster that followed were sown. ‘They didn’t know who was bearing or buying this risk and therefore their own positions were unstable. If you don’t know who the counter-party is and the risk that counter-party is bearing, how can you possibly assess how much risk there is in the system, in your little slice of the pie? We saw that with AIG [the giant US insurer] with its great default—no one realized how dependent on AIG was the entire market.

The financial experts’ ‘alibi’, of which Catherine Crowley speaks, appears to have been blown by this crisis. She is therefore raising an uncomfortable political question, which trustees should be pressing forcefully. It is an issue which, in a review of two important new books,\(^{319}\) the William Joseph Maier Professor of Political Economy at Harvard probes further:\(^{320}\)

An important question which no one seems interested in addressing is what fraction of the economy’s total returns to productively invested capital is absorbed up front by the financial industry as the costs of allocating that capital. . . . [T]he latest financial crisis is a sharp reminder that the simple operating expense of running the financial system including profits of financial firms is not the only cost if this system also exposes the economy at large to episodic losses in production and incomes, and to the need for taxpayer subsidies. . . . Why is so little said about the trade-off between the goal of allocating the economy’s capital efficiently and the need to shrink the enormous costs of the financial industry in doing so?

That critical issue apart, Sister Crowley’s theme also raises uncomfortable questions in respect of Lindley LJ’s duty ‘to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide’.

‘If it is as bad as you say, I was darn lucky to withdraw a large amount of the trust estate from the fund just before it stopped permitting withdrawals’

Hold the Champagne again! On 16 October 2008 the United States Bankruptcy Court for the Southern District of New York decided *In Re Bayou Group LLC.*\(^{321}\) Redemptions were funded from the

---

317. As to this see Bank of International Settlements, Committee on Global Financial System Paper 34, ‘The Role of Valuation and Leverage in Procyclicality’, which begins: ‘A number of developments in the global financial system seem to have strengthened the linkages between asset valuation and financial leverage. These include: more marketable assets, especially structured credit products with high “embedded” leverage that are accounted for on a mark-to-market basis, and more leveraged position-taking, both inside and outside the regulated sector (offbank balance sheets—structured investment vehicles (SIVs) and asset-backed commercial paper (ABCP) conduits—broker-dealers, asset managers).

These changes in the financial system and in related market practices seem to have amplified business fluctuations and exacerbated financial instability during the current cycle (“procyclicality”). While procyclical mechanisms are particularly disruptive during periods of market strain, they may encourage excessive risk taking in the expansion phase. Hence, mitigating the procyclical interplay of valuation and leverage appears desirable to enhance the stability of the financial system.’

318. Cf footnotes 46 and 52.


321. US Bankruptcy Court, Southern District of New York, Case No. 06 B 22306 (ASH), 16 October 2008.
contributions of later investors—fictitiously treated by the hedge fund as ‘profits’—and accordingly were voidable in the hands of the investors.

‘But I relied on a rating agency’\textsuperscript{322}

Ask the Carmelite nuns to pray for you. \textit{Time} magazine’s ‘Top 10 Scandals’ for 2008 included:

Moody’s, Standard & Poors and Fitch stood by their AAA top ratings for Collateralized Debt Obligations (CDOs), which are based in part on pools of subprime mortgages. Some of that stuff was indeed top drawer, but the bottom tranches were filled with junk. So how do you make the call? The agencies, looking backward at the accumulated data, continued to give their top rating to securities that were piling up risk as each week went by and the real estate markets started to wobble. And did we mention that the agencies get paid by the issuers of the CDOs to make their supposedly objective rating? When it all went south—propelled in part by the same folks, who suddenly started slapping bad grades on already fragile firms like AIG—the agencies said their ratings were merely opinions. In our opinion, they’re useless.\textsuperscript{323}

As David Shirreff had pointed out some years previously, the ratings were no better than the stochastic models on which they had been based, and these models had had a shaky performance history.\textsuperscript{324}

**Conclusion**

As Professor Langbein pointed out in the passage cited on page 1, ‘financial assets have become the characteristic asset of the modern managerial trust.’\textsuperscript{325} With the right advice, fully understood,\textsuperscript{326} trustees of large trust estates might have legitimate room for limited prudent investment in some derivative products as a risk-spreading element. How far, if at all, trustees can go beyond that without transgressing Lindley LJ’s rule; and what part exemption clauses and other expressions aimed at limitation of liability will play: will fall to be established over the next few years as the inevitable squaring-off begins between beneficiaries and trustees, and between trustees and investment advisers.

---

\textsuperscript{322}. See The relevance of a ‘good name,’ p. 533 above.

\textsuperscript{323}. \url{http://www.time.com/time/specials/2008/top10/article/0,30583,1855948_1863946,00.html}. Site last visited 30 July 2009.


\textsuperscript{326}. \textit{Cowan v Scargill} [1985] Ch 270, 289. See footnotes 46, 52, and 318, and see text attached to each of them.