

Evidence and the prudent trustee

'Alice's Adventures in Wonderland' saw the Queen of Hearts applying a simple method for settling legal cases in double-quick time: "Sentence first, verdict afterwards!" – with evidence nowhere to be seen. Now Brian Clarke, Managing Director of Key Financial Reporting Limited (KFR), outlines the importance of maintaining evidence for professional trustees in view of the investment regime provided by the UK Trustee Act 2000.

When Georgina Nestle took her complaint about mismanagement of her trust fund to the courts, her trustee was able to show that it had not acted unreasonably at each stage – notwithstanding that the fund had suffered a significant loss in value over 38 years compared with a recognised equity index. Although the trustee bank, National Westminster, won its case, the Court of Appeal held – with a glancing reference to its “incompetence” – that a trustee was not liable for depreciation in value of a trust fund except in the case of proven default; it was recognised that there was no particular formula which could be applied to guarantee a specific financial outcome. The importance of preserving the trust fund was paramount and outweighed enhancing the value of the fund (*Nestle v National Westminster Bank plc*, 1992).

Security and the prudent trustee

Professional trustees may feel less secure today under the regime of the Trustee Act 2000, which courts are using to guide their decisions on claims against trustees – not only in England and Wales but in other jurisdictions as well. One has to ask: if *Nestle v National Westminster Bank plc* were heard today, would the decision be the same as in 1993 in view of the Trustee Act? Would the evidence that the bank provided to successfully defend the claim against them prove sufficient under the new Act?

In these litigious days, the beneficiaries of trusts and foundations are increasingly making claims against trustees because of the poor performance of investments, even when the investment work was delegated to an independent investment manager. When there is an investment loss, the challenge made against the trustee questions his or her management of the assets.

A trustee has long had a higher duty of care (“...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”, Court of Appeal, re *Whiteley* 1886, Lindley

LJ). Now the 2000 Act has established more rigorous standards that beneficiaries can point to as the minimum expected of a professional trustee.

It has replaced the restrictions on investment of the 1961 Trustee Investments Act with a very broad power of investment. In addition to express powers of investment or exclusion in the trust instrument itself, the 2000 Act enables trustees to invest in anything that they could have invested in if they were the absolute owner of the funds – from equities to bonds and preference shares to land.

The Act requires...

Although trustees may have a relatively unfettered ability to make investments, this does not mean that their powers to invest can legitimately be exercised in an unfettered way.

Section 1 requires the trustee to exercise “such care and skill as is reasonable in the circumstances, having regard to (a) any special knowledge or experience that he has or holds himself out as having, and (b) if he acts in the course of a business or profession, to any special knowledge or experience that it is reasonable to expect a person acting in the course of that kind of business or profession.”

Section 4 requires the trustee when exercising any power of investment, to have regard to “standard investment criteria” and to review the investments from time to time with these criteria in mind. The criteria are (a) the suitability of particular kinds of investment for the trust, and (b) the need for diversification of the trust investments. Modern investment theory counsels balancing the risks of particular investments against the risks of others, and of course a trustee’s chosen investment policy must have regard to the beneficial entitlements under the specific trust. Thus the modern prudent investor is to be judged not by the individual investment vehicles he chooses but on the overall ‘portfolio’ of investments.

Section 5 also requires the trustee, before exercising any power of investment, to take advice from someone he or she reasonably believes is able to provide proper advice of this kind by virtue of their ability and experience in such matters.

Thus in order to evidence that appropriate care has been taken, the prudent trustee should:

- appoint an appropriate Investment Manager for different asset classes;
- agree a written Investment Policy Statement;
- have systems in place to ensure the Investment Manager follows the guidelines; and,

- review and monitor the investment performance in the light of portfolio theory.

Accumulation of responsibilities

The consequence is that professional trustees are not only required to have access to strong investment skills, analytical expertise and third party reporting systems. In addition, they have to be able to evidence a periodic review of their trust fund's performance against appropriate criteria. This can only be achieved if they have comprehensive portfolio monitoring systems in place that take into consideration asset allocation, diversification, performance against benchmarks and the quality of holdings, together with the volatility and risk taken to achieve results.

This is a considerable accumulation of responsibilities, which make it even more important for trustees to *maintain clear evidence* that they have done their duty and have taken adequate care.

In my experience few trust administrators and professional trustees will possess all the necessary skills to make a proper evaluation of portfolio results; evaluating all the elements necessary for this is a highly specialist activity.

It requires access not only to historic data (and it is a grave mistake to rely on historic data alone), but also to specialist external data on market results, sector and peer group information, which will need to be drawn from sources such as Bloomberg, Standard and Poor's, and FTSE. Without these external sources of information to supplement the investment manager's reports, the trustee will not be in a position to demonstrate adequate supervision if challenged by a beneficiary who is disappointed with investment performance.

Demonstrable solution

The best protection for a trustee is to get expert assistance in the writing of the initial Investment Policy Statement, together with ongoing support for an independent professional review of the portfolio. For example, at Key Financial Reporting (KFR) our service includes:

- a formal Investment Policy Statement that ensures the Investment Manager has a clear understanding of what he or she is to do in the best interests of the trust;
- a comprehensive performance evaluation service that gives trustees and beneficiaries an objective analysis of the Investment Manager's results; and,
- comparing those results against the benchmark of the Policy Statement, together with external benchmarks, looking at the risk taken to achieve the returns.

The KFR Report provides:

- independent performance evaluation;
- comparison with appropriate benchmarks;
- analysis summary;
- commentary and review points; and,
- a common platform enabling comparison of several Investment Managers.

Trustees gain the benefit of proactive rather than reactive management, supported by clear evidence of professional supervision and informed decision-making. The result is a value-added service for those who matter most: the beneficiaries.

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