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LEGAL CONSTRAINTS TO TOTAL RETURN INVESTMENT BY TRUSTEES

Two alternative methods with potential to obtain higher incomes for income beneficiaries in a low-income environment are considered. The conferment of trustee powers to readjust capital and income by way of enlargement of the duty of impartiality is first discussed. The most difficult aspect of this method is that it overlooks the duty to maintain capital integrity as an aspect of the duty of preservation of trust capital. The article argues that reform proposals which do not overcome its strictures are flawed. The total return trust or unitrust, which is the second method, is conceptually sounder. But its economic or business foundations, this article argues, must be approved by the settlor when setting up the trust or otherwise by consent of all trust beneficiaries.

TAN Yock Lin
BSc (London), BA BCL Dip Econ Devt (Oxford);
Professor, Faculty of Law, National University of Singapore.

I. Introduction

1 Business experts and financial economists seem convinced that investment markets have undergone a sea change. In a word, the days of high passive investment income are over. Various reasons have been given for saying that investors should no longer expect to earn high passive income. Some point out that people are living longer as a result of medical and nutritional advances and therefore saving more. A higher savings rate lowers the interest payable on savings and in turn the returns that business must pay to attract funds. At the same time, the pace of technological improvements has slowed, reducing the ability of businesses to pay high dividends to investors. These accounts may be somewhat simplistic.[1] They are predictive and conditioned upon premises which may be highly variable. Counter-predictions of higher productivity gains through new scientific breakthroughs cannot always be dismissed.[2] What, however, cannot be denied completely is that in the preceding ten or even 15 years, trustees making passive investments have

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1 For instance, they ignore the impact of monetary and fiscal policies and behavioural factors.

2 Technological innovations are "notoriously difficult to foresee", a phrase used in John Langbein & Richard Posner, "The Revolution in Trust Investment Law" (1976)

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found trust income dwindling significantly.[3] The situation seems to be irreversible for the moment.[4]

2 For trustees who must pay income at rates fixed by the settlor in times of high investment income, there are three prospects: (a) selling assets to make up the deficiency in income; (b) raising income by turning to risky investments; or (c) investing for capital gains and turning gains into income to meet income shortfalls. The option of invading the *corpus*, however, may not be open under the trust. The option of placing more trust funds in risky instruments may open up questions of breach of the duty of care when making investments. The option of investing for gains may only be theoretical if there are formidable legal constraints on converting gains into income. Trustees who, being charged to preserve the trust *corpus*, are mandated to take a medium- or long-term view of investments are particularly affected by the changes highlighted. These include trustees who hold investments for successive interests for any significant duration or must distinguish income and capital, as well as charity trustees who hold permanent endowments or are restricted in the use of their funds to income earned on capital.

3 To such trustees, it has been urged that total return investment as opposed to total income investment is efficacious to sustain income distributions or charitable activities at a level matching previous income payouts or deployments in low-income environments. This article discusses the legal obstacles to the recommended course of action with reference to private law trustees. It does not evaluate the case for total return investment by charities, where special considerations are governing. It will explain why many law reform agencies which have considered the problem of falling incomes in relation to private trusts recommend legislative enactments which will validate and implement total return investment.[5] Without exception, the recommended solution is two-fold and either cumulative (partially or wholly) or disjunctive: (a) conferment of trustee discretion to adjust between income and capital; and/or (b) allowing trustees to adopt or convert to total return trusts.[6] This article argues that such solutions are flawed if they ignore

62 ABA J 887 at 888 to describe political, economic and social changes affecting future earnings of stocks and shares.

3 See Lyman Welch, "Policy Differences in Total Return Laws" *Leimberg.com* (2002) <http://www.leimberg.com/freeResources/truArticles/policyDifferences.html> (accessed November 2019). See also Robert Shiller *Irrational Exuberance* (New Jersey: Princeton University Press, 3rd Ed, 2016).

4 At the time of writing, bond yields have even turned negative.

5 In this article, the author considers in outline the US, Canadian and New Zealand reforms.

6 The option of discretionary allocation trust is not considered in this article.

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the legal impediments posed by trust rules which define trust capital and require maintaining the integrity of trust capital. Any similar reform in Singapore should not leave out addressing these legal impediments.

A. Backdrop to total return investment

4 A simple but important starting observation is that rigid rules of investment will not be appropriate for trustees, apparently at any time. History bears ample record to this. For a long time, the concept of authorised investment imposed by trust law held sway. Trustees not otherwise unconstrained by the terms of the trust were admonished and permitted to invest only in investments listed or considered by judges as authorised or permissible. No lesson is clearer today than that this was a mistaken and wrong turn which the law took very early on in 1719.[7] Whereas this first attempt to permit investment in the South Sea Company was on hindsight ill-conceived, what followed was at the other extreme. The courts in the wake of the collapse of the South Sea Company (which caused untold loss to investing trust funds) devised a court-approved list which initially included only 3% consolidated annuities, later extended to long-term government and corporate bonds and well-secured first mortgages.[8] From the 19th century onwards, several statutes then perpetuated the notion of intrinsically safe legislatively-approved (read as authorised) trust investments by gradually expanding the list of permissible investments.[9] These *ad hoc* and incremental additions culminated in 1961 in UK legislative approval of investment of not more than half of the trust fund in equities generally.[10] The law's intervention to separate intrinsically safe from unsafe trust investments was barely tolerable so long as investment markets remained characterised by stable business cycles, low inflation, and inefficient processing and disseminating of market information. The premises, however, became

7 John Langbein, "The Uniform Prudent Investor Act and the Future of Trust Investing" (1996) 81 Iowa L Rev 641 traced this to 1719 when the English parliament authorised trustee investments in the South Sea Company. The company's collapse a year later, it is surmised, heavily influenced the judicial development of a legal-list jurisprudence.

8 Some aspects of the prudent investor norm were developed under the rubric of the prudent businessman rule in relation to the selection of individual investments within the classes of permissible investments. See Lord Watson's admonition in *Learoyd v Whiteley* (1887) 12 App Cas 727 at 733 that the trustee must "avoid all investments of that class that are attended with hazard". See also *Australian Securities & Investment Commission v Drake (No 2)* [2016] FCA 1552 where Edelman J observed that the prudent businessman rule to avoid hazardous investments developed in an era where trusts were primarily used to preserve property.

9 See D Grosh "Trustee Investment: English Law and the American Prudent Man Rule" (1974) 23 ICLQ 748 at 751–753.

10 See the UK Trustee Investments Act 1961 (c 62).

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false and then "obsolete", especially after World War II. Obsolescence led eventually to abandonment of the statutory list of authorised investments and its resolute replacement by the prudent investor norm, rejecting, *inter alia*, the notion of an intrinsically safe investment.[11]

5 To be fair, even in the US where the prudent investor norm has been in existence since 1830, it took many more years before the present enlightened understanding was reached.[12] Along the way, the courts there supposed that they could generalise types or classes of speculative investments that trustees must avoid.[13] In an ironical sense, the prudent investor norm is now apparently so firmly established that it is a wonder that it was not the norm all along.[14] Conceived in the broadest manner, the modern prudent investor norm is an objective and dynamic requirement to consider and follow the evolving institutional best standards and practices of the investment market (presently committed to Markowitz's modern portfolio theory which emphasises risk diversification).[15] This means that prudent trustees will adhere to investment practices considered efficient by the market. They do no wrong when they do so. They are not required nor expected to do more. They need to neither outguess nor out-perform the market. They are bound by no governing formula but only a method, a process to obtain the requisite propositional contents for investment decision-making from the market. Trustees therefore must seek advice where the market practice so warrants. Similarly, they should employ a strategy if the market practice recognises there are merits in this or act on

11 In Singapore, this occurred in 2004. See the Trustees (Amendment) Act 2004 (Act 45 of 2004).

12 There is little need to discuss American developments in detail. The prudent investor norm was pronounced much earlier in *Harvard College v Armory* 26 Mass (9 Pick) 446 at 461 (1830) and was embodied in the Model Prudent Man Rule Statute 1942 and § 7-302 of the Uniform Probate Code 1969.

13 Professor Halbach observed in The American Law Institute *Restatement Third, Trusts* vol 3 (2007) at p 288 that:

> … [u]nfortunately, much of the apparent and initially intended generality and adaptability of the prudent-man rule was lost as it was further elaborated in the courts and applied case by case. … Based on some degree of risk that was abstractly perceived as excessive, broad categories of investments and techniques often came to be classified as 'speculative' and thus as imprudent *per se*.

14 The Uniform Prudent Investor Act 1994 was the first prominent articulation of its tenets.

15 For the moment, these practices predicate portfolio construction and management with the objective of maximising risk-adjusted return through diversification among asset classes. It is not clear whether the emerging practice of diversifying among risk factors has replaced diversifying among asset classes. Prudential investment must also have regard to behavioural considerations, especially those pertaining to loss aversion and irrational reaction to market declines.

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advice if that be the market practice.[16] In addition to investing efficiently, prudent trustees must choose a risk position or profile suitable for the trust and its objectives (and for the kind of long-term trusts, which are of interest here, this is a risk-averse position, as will be elaborated below).

B. Comparing investment strategies

6 Investment strategies are a significant aspect of the prudent investor norm for several reasons. Trustees manage funds on a premeditated and execute-as-planned basis, not so as to satisfy some statistical ratio, but thematically having regard to the objectives set by the terms of the trust. In the present market practice, without adopting a strategic or goal-based portfolio management suitable for the trust, they will hardly justify their claims as thematic prudent investors. Reinforcing this, the 2004 changes to the Singapore Trustees Act,[17] aimed at underscoring the importance of diversification of risks, in no uncertain terms make investment strategy for trustees imperative.[18] In the absence of a personalised strategy, trustees will fail to have formulated that prudent balance of risk and return which is a first principle, as shall be seen. To relieve them (especially lay trustees) of the onerous duties of keeping abreast of investment market developments and fluctuations, they are permitted to delegate their investment functions to authorised fund managers.[19] The trade-off is that they must formulate a statement of investment policy which will advance trust objectives and establish an *ex ante* yardstick of appraisal.[20] That statement of policy is an essential investment strategy which demonstrates fitness over time and market performance, having regard to the range of intended benefits which the trust may or must provide.

7 For the sake of simplicity of exposition, this article will only consider two broad competing and alternate strategies; namely total income and total return investment.[21] There are intermediate or gradated strategies, of course, since market innovations easily combine features

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16 This is not to say that there is no accommodation of the individual situation of the trustee in question. The trustee is to conduct himself as a reasonable investor in his position and situation would.

17 Cap 337, 2005 Rev Ed. See also the Trustees (Amendment) Act 2004 (Act 45 of 2004).

18 Trustees Act (Cap 337, 2005 Rev Ed) s 5(3).

19 Trustees Act (Cap 337, 2005 Rev Ed) s 41B.

20 Trustees Act (Cap 337, 2005 Rev Ed) s 41F.

21 The term "strategy" is used in a broad sense to cover both strategic asset allocation as well as tactical asset allocation. Strategies other than total return for achieving enhanced returns include the use of momentum analysis to make active investment asset selections, recourse to smart beta strategies, and monetising the volatility risk premium.

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of both strategies.[22] For example, there are unit trusts and real estate investment trusts ("REITs") which invest in growth stocks and pay passive income to investors by selling their growth stocks from time to time. Investors in these instruments seem to be pursuing income strategies but in a significant sense are also indirectly pursuing the strategy of total return investment. A trust could also contemplate isolating some classes of assets for implementing differing investment strategies.[23] But there is little need for this article to take comprehensive account of hybrid or intermediate strategies. When both "prototypes" are understood, a hybrid or intermediate strategy merely calls for *pro tanto* or commensurate adaptation or application of either. The other reason for focusing on just two strategies is a practical one. The vast majority of trusts for which the questions being explored are meaningful are those which invest in commoditised investments and adopt fairly liquid strategies.[24] These are not large enough to pursue costly and actively managed specific investment portfolios, impact portfolios, or multi-alpha portfolios; nor are they so large that they would or could more effectively be restructured as a family office directing investments free from the strictures of trust law as part of an integral complex enterprise of managing the business family's tax and estate planning, business development, philanthropy and relationship management.

8 Total income investment then, to begin with, has been the "as of course"[25] strategy for private law trustees both prior to and after abandonment of the rigid rules of restricted trustee investment known as the "list method". Trustees decide whether to invest in income-yielding instruments such as dividend-paying equities, adopting a portfolio of bonds and equities (such as high-income-yielding bonds and highly rated and stable equities) in order to maximise income return on the

22 This expression is not intended to suggest that total income and total return are extremes on the investment spectrum nor to deny that hybrids are possible.

23 James Hines Jr, "Efficient and Impartial Trust Investing" (August 2016) https://pdfs.semanticscholar.org/aa27/844aa6738cb0517049c26a51364272738e6d.pdf (accessed November 2011) contends that partial investing better meets the requirements of capital and income trusts where income and capital beneficiaries have different risk preferences.

24 Including exchange-traded funds (ETFs) and regulated investment companies (RICs), which are conservative on leveraging and managing liquidity and risk; but private equities, hedge funds and venture capital funds, which are typically highly leveraged, are excluded. *Cf* Philip Ruce, "The Trustee and the Prudent Investor: The Emerging Acceptance of Alternative Investments as the New Fiduciary Standard" (2012) 53 S Tex L Rev 653. In Singapore, investors are regarded as needing greater sophistication as demonstrated by passing a knowledge test.

25 Or traditional strategy. Trusts which employ this strategy are sometimes called "Income Rule Trusts".

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trust assets.[26] The idea underlying the alternative total return investment is that investment decisions should not dwell sharply on the line between income and capital but focus on maximising total financial return (whether this is income or capital does not matter). Supporters of this strategy claim that this maximises the benefits of portfolio investment because the investor can more fully hedge out equity-risks by including, for example, capital growth stocks within as well as across any single investment sector. Capital growth stock investments are said to exhibit non-correlated risk behaviour with dividend-paying stock investments. Thus, the frequency and severity of capital losses in dividend-paying equities can be reduced through diversification in capital growth stocks allowing more efficient compounding of returns even within the same sector. The claimed outcome of such subcategory asset allocations is superior: that, for any given sufficiently long enough time interval, and given adequate diversification, the total return which will comprise actual income and realisable capital gains will exceed the total actual income earned from pursuing total income investment, without incurring any net risk of capital loss.[27] The total income investor, in contrast, will have little option but to select risky instruments to earn the same income in a declining income investment environment, exposing the trust assets to higher risk of capital loss.[28] Supporters of total return investment do not only rely on diversification effects. Arguments are made that investment in capital growth stocks is more likely to generate better capital appreciation or offer enhanced opportunities for better gains than income returns on

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26 The development of the corporate bond market was an especially influential factor in the rapid growth in popularity of total income investment. This gave trustees the added option of investing in higher-yielding corporate bonds alongside lower-yielding but safer and more stable government bonds. Today, bonds are no longer high-yield instruments and are considered good candidates for long-term capital preservation, but the problem is that the lack of a definitive definition of what a bond is means that some bonds such as minibonds and perpetual securities may be highly risky. See Hans Tjio, "Restructuring the Bond Market in Singapore" (2019) 14 *Capital Markets Law Journal* 16.

27 There is a view that:

> Also, often the capital appreciation on a diversified portfolio will exceed the income received; therefore, if an investor needs more than the annual cash flows from his or her investments, the total-return approach is the more prudent, and most likely only viable, long-term spending method.

See Colleen Jaconetti, Vanguard Investment Counseling and Research, "Spending from a Portfolio: Implications of a Total-return Approach *versus* an Income Approach for Taxable Investors" (2007) at p 3.

28 Most claims are based on comparing long-term total income investment and long-term total return investment for a required minimum distribution under a retirement plan. Two observations are typically made. Increasing overall allocation to higher-yielding bonds raises the risk of long-term credit and portfolio volatility. On the other hand, investing in higher-yielding dividend stocks brings smaller capital returns. Total return investing is therefore argued to be likely to be superior in achieving higher income at the same risk level.

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income-paying stocks or bonds. These markets which are less efficient than large cap equities[29] are said to provide enhanced opportunities for purchasing under-priced capital growth stocks.

9 Despite these vigorous claims, detractors could argue that the prospect of more efficient compounding of returns through diversification in growth investments may not eventuate. The associated non-correlation of risks may change over time and become correlated risks when markets are under stress or pressure. Others could maintain that relatively affordable actively managed investment in growth instruments may not be possible. The strategy calls for active subcategory asset allocation but it may be ambitious to expect trustees to be able routinely to seek enhanced opportunities for potential capital appreciation without expensive expert analysis and advice.[30] In the absence of consensus that total return investing can invariably offer higher expected returns without adding a net risk of capital loss,[31] the question under consideration will be whether there are legal obstacles that may deny recourse to total return investment assuming its merits to exist in a given case.

II. Duty to perpetuate trust capital when making investments

10 In one of two alternative formulations of total return investment,[32] the implementation of total return investment is supposedly a simple matter of adjusting between income and capital when distributions of income fall to be made. The second formulation in terms of the total return trust will be dealt with below.[33] In this immediately ensuing part, the simplicity of the first formulation (which will be referred to as "total return investing" to differentiate it from the total return trust) is controverted. If total return investing is to be possible, several legal constraints will statutorily have to be removed or modified. Judicial innovation will not be possible when, as will be argued, the constraints are essential incidents of a conception of trust capital as opposed to trustee duties.

29 For example, real estate investments incur high transaction costs and not all information is equally predictive to market participants of future prices.

30 In some evaluations, the difference boils down to investor risk preferences. Those who feel confident in forecasting price returns will prefer total return investing to those who find income return more predictable.

31 See Gerald Monchek, "The TRU Debate: The Pros and Cons of Using Total Return Unitrusts" (2003) 57(3) J of Financial Service Professionals 41.

32 This dichotomous expression is a little misleading since there are hybrid forms as well, but it is adopted for the sake of simplicity of exposition.

33 See paras 48–56 below.

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A. *Nature of duty to perpetuate in investment context*

11 The nature of perpetuation of trust capital is not obvious and it is necessary to explain the sense in which it is employed in the context of trust investments. There is, first, a more general sense in which the purpose of a trust is to turn over assets of the settlor to the trustee to enable him to provide specified benefits to the beneficiary. Consequently, the trustee is to derive those benefits from the trust *corpus*, while ensuring its continued material existence to the extent necessary for those purposes.[34] This conception of trust capital is a legal one. First, it extinguishes the settlor as the original source of the trust assets. The settlor drops out as owner the moment he creates a trust of the property.[35] Second, it deems the original trust *corpus* to be original property of those appointed or nominated by the settlor or in accordance with his terms of trust as beneficiaries.[36] Third, these deemed assets and the obligations of the trustee with respect to them can thereafter only be rescinded by the unanimous consent of all beneficiaries.[37]

12 There is a second sense in which preservation means the exclusion of creditors and trustee alike from recourse to the trust assets without narrowly prescribed legal cause. In this respect, the trustee's authority to deal and dispose of trust property is both original and undelegated. Creditors who deal with trust property look only to the trustee personally for both performance of any obligation owed to them and satisfaction of liability.[38] Trust assets are thus unlike the property of a corporation, which is available to satisfy debts owed by the corporation to its creditors. The exclusion of the creditor means that losses suffered by the creditor fall personally on the trustee in the first place if they are attributable to his breach of contract or other fault. In the second place, the trust *corpus* is defined as the subject matter in which beneficiaries have juristic rights

34 Hayton AJ in *JW v Morgan Trust Co of Bahamas Ltd* (2002) 4 ITELR 541 calls this an overriding duty. As the case amply illustrates, even when the settlor has expressed a contrary intention in favour of total return investment, there will be little indication as to the intended exact balance of impartiality between income and capital beneficiary. In early case law, the language of preserving the *corpus* can be found. See J C Phillips, "Some Instances of the Trustee's Duty to Act Fairly between Different Classes of Beneficiaries" (1978) 10 U Qld LJ 83 at 92–94.

35 See *Boase v Cluny Rubber Estates Ltd* (1913) 2 FMSLR 130. Thereafter, the original source of trust capital is recognised only to the limited extent of failure to create a valid trust or to exhaust it after due performance. See *Re Vandervell's Trusts (No 2)* [1974] Ch 269.

36 This is a rationalisation of the rule in *Saunders v Vautier* (1841) Cr & Ph 240.

37 Although the analysis hardly accommodates the "massive" discretionary trust which falls outside the rule in *Saunders v Vautier* (1841) Cr & Ph 240.

38 See *Re Johnson* (1880) 15 Ch D 548 at 552. See also *Muir v City of Glasgow Bank* (1879) 4 App Cas 337 at 355.

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of a *quasi-in rem* character to the exclusion of the trustee. The exclusion of the trustee means that the trustee must not increase, diminish or alter the trust *corpus* by fiat or idiosyncratic discretion.

13 From the foregoing principle of segregation and preservation of the trust *corpus*, the third sense which is relevant in the context of the trustee's duty to make prudent investments can be deduced.[39] In the context of investment, preservation of the trust *corpus* essentially means preservation of its original capitalisation when making investments. Preservation of its value from time to time will be meaningless. The value for the time being will be variable depending on market and general economic conditions and, of course, the trustee's investment performance for the sake of profiting from capital. This employment of the trust *corpus* for the sake of making a profit in investment makes it appropriate to describe the *corpus* as the original trust capital. So the third sense of preservation is preservation of the original trust capital. It is not controversial that this preservation is to be done by satisfying the prudent investor norm; which stated generally, requires the exercise of prudence with respect to the choice of risk and expected return trade-off and making efficient investments in the light of that *ex ante* choice. In the case of a capital and income trust, where the enjoyment of capital is deferred for a time to secure temporal and interim pecuniary income for the income beneficiary, the original trust capital is necessarily defined for the sake of capital beneficiaries to signify that they have the ultimate rights to the trust *corpus* in its original capitalisation. That being the case, a prudent capital and income trustee must be risk averse when making investments because the capital beneficiary whose enjoyment of the trust capital is postponed may be presumed to be risk averse with respect to capital preservation.[40] So if a trustee is pursuing a total income investment strategy, it necessarily follows that he must choose a lower risk and lower expected return trade-off, or a lower risk of capital loss over the long term because he has a duty to perpetuate the original trust capital when making investments.

39 This duty is not an irreducible core duty as popularly conceived as in *Armitage v Nurse* [1998] Ch 241 and *Walker v Stones* [2001] QB 902. A trust to make speculative investments is not invalid unless on true construction the settlor intended the trustee to destroy the trust property. A trust to destroy property is contrary to public policy. See *Brown v Burdett* (1882) 21 Ch D 667 which held a trust to render property useless void.

40 He will be mindful that a 20% loss needs a 25% gain to get back to original level. See Michael Oyster, *Success in a Low-Return World: Using Risk Management and Behavioral Finance to Achieve Market Outperformance* (Palgrave Macmillan, 2018) at p 175.

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14 For the sake of argument, it might be argued that a conception that emphasises preservation of the original capital in investment contexts has been superseded or become expendable.[41] Adherents to this view could postulate that this conception was sensible when the prudent businessman rule was conceived, in terms of avoiding speculation and with a focus on securing the safety of the trust *corpus*. But when the prudent investor norm has shifted to being a requirement of efficient investing in an environment of inverse risk and return relationships, a more variable conception of trust capital should be adopted. The focus should be one that prudently tolerates greater risk of capital loss or a lower probability of capital safety in exchange for higher total return. This argument is incorrect in presuming that the concept of preservation of the original trust capital is dependent on change in investment paradigms. The meaning of preservation never changes according to economic conditions because its subject is always the original trust capital. Only its application does; thus, when inflation is high, preservation of the original trust capital means making efficient investments which have a high probability of maintaining the purchasing power of the trust capital in the long run as opposed to just the nominal value of the original trust capital. The argument, though, is correct in appreciating that there is or may be a greater risk or net risk in investing for capital growth. For reasons previously mentioned,[42] the long-run safety of capital in a total return portfolio may be lower compared with a lower risk and lower return (total income) portfolio which aims to preserve the purchasing power of the trust capital. But what exactly is a tolerable prudent higher risk of capital loss under a higher risk and higher return (total return) portfolio? Should the prudent lower capital safety be one with a high probability of maintaining the nominal value of the trust *corpus* or some other value between the nominal value and the purchasing power of the trust *corpus* in the long run? If the market does not have a notion of a prudent higher risk of capital loss, and it does not,[43] is it possible to allow the trustee to exercise a discretion *ex post* to define or redefine what a prudent higher risk of capital loss is? An affirmative answer must be rejected. In part IV below, the reasons will be discussed.[44]

41 Committee on the Modernization of the Trustee Act, "Total Return Investing by Trustees" (2000) 20 Est T & Pensions J 47 at 53–54.

42 See paras 8 and 9 above. See also John Langbein, "The Uniform Prudent Investor Act and the Future of Trust Investing" (1996) 81 Iowa L Rev 641 at 668.

43 Under modern portfolio theories, prudent investing simply means efficient investing in portfolios that are on the efficient frontier. The problem here is one of choice of a low risk low return portfolio *versus* a higher risk higher return portfolio, which is a question of what risk position is a prudent trust objective.

44 See paras 33–47 below.

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B. Authorities on preservation of trust capital

15 It is useful, next, to appreciate that the above concept of preservation of the original trust capital exists, although the same vocabulary may not be used. This terminology of "preservation" is mostly used in codifications of trust law in a manner revealing the absence of any contingency on investment paradigms. For example, Art 21(3) of the Trusts (Jersey) Law 1984[45] as amended continues to state in general terms that:

> Subject to the terms of the trust, a trustee shall –
>
> (a) so far as is reasonable preserve the value of the trust property;
>
> (b) so far as is reasonable enhance the value of the trust property.

16 Aside from codifications (which are uncommon outside offshore trust jurisdictions), proof of recognition or substantiation of the duty of preservation as invariant and fundamental is less forthcoming.[46] But this is only because it is scattered and has to be collected from its various manifestations. In the simplest cases, the duty of preservation of the trust *corpus* which is the most basic duty of perpetuation *eo instante* is recognised where the trustee is charged to hold property for some fixed and stipulated purpose, such as to serve as residence for a beneficiary.[47]

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45 Rev Ed (13.875).

46 *Lutea Trustees Ltd v Orbis Trustees Guernsey Ltd* (1997) 2 SCLR 735 at 737 is an uncommon example. Lord Justice-Clerk Cullen puts it in the context of fiduciary loyalty, saying:

> [W]hile trustees may have a wide discretion, they owe a duty to all who have an interest in the estate, both immediate and in the future. It follows that the duties of the trustees are independent of the interests or wishes of any particular beneficiary or class of beneficiary or, for that matter, the truster himself. The trustees are under an overriding duty to preserve the trust estate.

Cf Estate of Bissinger 212 Cal App 2d 831 (1963) at fn 2, where the court stated that:

> If by the terms of a trust the trustee is directed to pay the income to a beneficiary during a designated period and on the expiration of the period to pay the principal to another beneficiary, the trustee is under a duty to the former beneficiary to take care not merely to preserve the trust property but to make it productive so that a reasonable income will be available for him, and he is under a duty to the latter beneficiary to take care to preserve the trust property for him.

Cf also *Royal Trust Co v Crawford* [1955] SCR 184 at 188 where the Supreme Court of Canada put it like this: "When property is to be enjoyed successively, the testator normally contemplates its preservation for that purpose."

47 Its contents may be variable. If the settlor has not provided a maintenance fund to keep up the property in good repair, the trustee may charge the beneficiary a non-market rental to defray the maintenance charges. In the worst case, he may sell

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17 Where a trust is a capital and income or successive interests trust, which is of paramount interest here, the duty of perpetuation will necessarily connote preservation over time. Thus, the cases on the prudent investor norm or duty of investing with care acknowledge this. This duty of perpetuation was sometimes described as the duty to preserve the trust capital by investing in authorised or permissible investments. There was nothing wrong with the equation. As was said, what was wrong was the supposition that the duty to preserve the capital was reducible to a *per se* prohibition of impermissible investments. In more inflationary times, another problem was exposed. This was the erroneous supposition that the duty meant a duty to "inflation-proof" the capital or prevent its value from erosion due to inflation. The error was highlighted in *Nestle v National Westminster Bank plc*[48] at first instance and repeated in an advice of the appellate court.[49] What was erroneous was the suggestion that the result of actual preservation of the real value was to be achieved. Clearly, however, the best-laid plans are liable to go awry. The intended preservation of value consistent with inflation rates may not occur. As correction of the error, it was therefore stressed that trustees cannot be made responsible for capital loss in real terms, no more than for income loss if the *ex ante* investment plans were otherwise prudent in material respects.[50] The denial of inflation-proof guarantees clearly should not be taken as being a rejection of the duty to preserve capital.

18 Perhaps as something of a complication, the authorities show that the duty of perpetuation of trust capital will have characteristics influenced by perspectives of fiduciary duty. A trustee is required in

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the property and buy a smaller property while setting aside the balance of the sale proceeds as a maintenance fund. To do nothing and simply let the property fall into disrepair is uncontroversially and immediately a breach of trust.

48 [2000] WTLR 795.

49 See Hoffmann J in *Nestle v National Westminster Bank plc* [2000] WTLR 795 and Staughton LJ in the Court of Appeal ([1993] 1 WLR 1260 at 1274) who said: "Of course it is not a breach of trust to invest the trust 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."

50 See Megarry V-C in *Cowan v Scargill* [1985] Ch 270. In *Cowan v Scargill*, Megarry V-C referred to the possibility of misguided trustees making the correct decision. He said at 294:

> If trustees make a decision upon wholly wrong grounds, and yet it subsequently appears, from matters which they did not express or refer to, that there are in fact good and sufficient reasons for supporting their decision, then I do not think that they would incur any liability for having decided the matter upon erroneous grounds; for the decision was right.

This passage from Megarry V-C's judgment was quoted with approval by Dillon LJ in *Nestle v National Westminster Bank plc* [1993] 1 WLR 1260 at 1270. See also J C Phillips, "Some Instances of the Trustee's Duty to Act Fairly between Different Classes of Beneficiaries" 10 U Qld LJ 83 at 92–94.

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this vein to invest not only with prudence but also loyally in the best interests of the beneficiaries, both present and future, and whether for income or capital beneficiaries.[51] Relevant cases include those where trustees made social and ethical investments. Such investments, while morally commendable or even praiseworthy, may yield fewer financial benefits than other less praiseworthy investments. But so be it. Loyalty to the beneficiaries' interest must come before the trustee's own or even society's moral predilections. In a notable decision, *Cowan v Scargill*,[52] Megarry V-C dealt with the fiduciary duty to invest loyally as follows:[53]

> When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests. In the case of a power of investment, as in the present case, the power must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question; and the prospects of the yield of income and capital appreciation, both, have to be considered in judging the return from the investment.

There appears to be an allusion to total return investing when it is said that the trustee must seek the best financial returns having regard to both income and capital appreciation. As if to correct any misimpressions, in *JW v Morgan Trust Co of the Bahamas Ltd*,[54] Hayton AJ, citing Megarry V-C's judgment, added a qualification, saying:[55]

> Judges nowadays expect trustees to consider total return on the trust assets as the yardstick for their investment performance … so long as this will not prejudice the position of a life tenant or remainderman.

19 The reference in the last quoted remark is obviously pertinent to the duty of impartiality of the trustee who has to avoid partiality as between different classes of beneficiaries with differentiable or differentiated benefits. Some cases focus on this, explaining the trustee's duty to choose an overall risk position that will be fair to income and capital beneficiaries as a whole.[56] But some see the duty as an aspect of the fiduciary duty to act in the best interests of the trust.[57] Those who

51 "[T]hey owe a duty to all who have an interest in the estate, both immediate and in the future": *Lutea Trustees Ltd v Orbis Trustees Guernsey Ltd* (1997) 2 SCLR 735 at 737.
52 [1985] Ch 270.
53 *Cowan v Scargill* [1985] Ch 270 at 287.
54 *JW v Morgan Trust Co of the Bahamas Ltd* (2000) 4 ITELR 541.
55 *JW v Morgan Trust Co of the Bahamas Ltd* (2000) 4 ITELR 541 at 544.
56 *JW v Morgan Trust Co of the Bahamas Ltd* (2000) 4 ITELR 541.
57 Megarry V-C in *Cowan v Scargill* [1985] Ch 270 at 286 said: "The starting point is the duty of trustees to exercise their powers in the best interests of present and future beneficiaries of the trust, holding the scales impartially between the different classes of beneficiaries."

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discuss the duty alongside but separately from the trustee's fiduciary duty seldom pause long enough to tease out the salient differences.[58] Others posit the duty to be one of avoiding excessive execution of the power of investment.[59] There is some ongoing debate clearly and there are positions to be taken and justified. In the present view, and without going into unnecessary detailed discussion, the duty of impartiality is not a conduct duty like the fiduciary duty to act in the best interests but a result duty.[60] A trustee faced with income and capital beneficiaries must reach an even-handed result. He is judged objectively by the result he reaches. But the judgment of resultant impartiality is not capable of formulaic expression. One can only say that the trustee has acted even-handedly if the resulting balance is objectively, in the court's opinion, fair and reasonable in the circumstances.[61] All the same, it does not really matter to the conclusion as to choice of the overall risk position whether the perspective is that a prudent trustee is risk averse and will choose a low risk of capital loss or that a fair-minded trustee will be even-handed in balancing the needs of both classes of beneficiaries by choosing a low risk of capital loss. There is no reason to suppose that the same choice will not follow. Since trust capital is defined for the sake of the capital beneficiary's long-term interest, the duty of preservation must necessarily be preeminent in satisfying the duty of care. Unless there are clearly extenuating circumstances, the fair or reasonable income return must be whatever is efficient and based on an investment policy that favours high capital safety.[62]

20 In a bird's eye view then, the trust capital pertinent to a trust for income and capital or successive interests is framed by reference to the three standards of prudence: best interests in good faith and fair and reasonable balance with respect to trust capital and income. The duty of impartiality constrains the trustee to earn a reasonable income whilst maintaining capital safety.[63] This means that a trustee in breach will be

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58 *Ng Eng Ghee v Mamata Kapildev Dave* [2009] 3 SLR(R) 109.

59 Thus in *Edge v Pension Ombudsman* [2000] 1 Ch 602 at 627 the Court of Appeal (E) said:

> Properly understood, the so-called duty to act impartially – on which the ombudsman placed such reliance – is no more than the ordinary duty which the law imposes on a person who is entrusted with the exercise of a discretionary power: that he exercises that power for the purpose for which it is given, giving proper consideration to the matters which are relevant and excluding from consideration matters which are irrelevant.

60 See Wilberforce J's remarks in *Re Pauling's Settlement Trusts (No 2)* [1963] Ch 576 at 586. But the best proofs are found in the capital and income classification rules discussed at paras 21–25 below.

61 *Nestle v National Westminster Bank plc* [1993] 1 WLR 1260 at 1279.

62 *Lutea Trustees Ltd v Orbis Trustees Guernsey Ltd* (1997) 2 SCLR 735 at 737.

63 *Re Smith* (1970) 16 DLR (3d) 130 where the power to retain investments did not absolve trustees from failing to be impartial in convert them into investments which

(cont'd on the next page)

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accountable personally to level up or restore the imbalance. He will not be permitted to make re-adjustments by recalling excessive payouts, if any, from the income beneficiary. The duty of good faith means, *inter alia*, that the trustee must ignore moral considerations when earning the highest reasonable income consistent with capital safety. This is also primarily about the trustee in breach topping up to the highest returns that he ought in good faith to have produced. Finally, the duty of care constrains the trustee to endeavour to achieve the highest reasonable income through objective efficient investment consistent with high capital safety. All three duties which have slightly variable focus make up the duty of perpetuation of trust capital.

C. Accounting affirmatively for capital augmentation

21 Probably the best implicit evidence of the duty of preservation is to be found in the classification of capital and income, also known as the trustee capital and income accounting rules, which form the contents of the trustee's duty of financial administration. Derivatively from the original capital, a second source of capital will or is expected to come into existence in the medium and longer term in the form of increase in capital generated through trustee investment activities. There must, however, be no distinction between original and augmented capital as a matter of law. Separation or segregation between original and augmented capital will not be required. The augmentations melt imperceptibly and materialistically into the original trust capital by way of accounting representations.

22 It will be enough to say that accounting representations of the trust capital are similarly materialistic and derivative. Regard is had to the intermediate purpose of making income distributions in interim intervals with capital distributions postponed to the end of the trust unless otherwise required by the terms of the trust. Income accordingly is not conceived of as the actual increase in trust capital as originally constituted to be distributed in the trustee's discretion. The original capitalisation is predicated to endure to the very end of the trust. Contributions of trustee skill and expertise as intangible human capital must be ignored. Likewise, to be ignored are considerations of current or working capital as a measure of the balance to be maintained between liquid capital and fixed capital. At any time, there are supposedly no cash or other liquid balances which might conceivably be offered as working capital. All of the trust capital, as it were, is the fixed or permanent capital. It changes in composition but remains a singular legal conception throughout the

could produce reasonable income for the life beneficiary. See also *Josephs v Canada Trust Co* (1992) 90 DLR (4th) 242.

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trust's duration. If a trust asset is stocks, the purchase price will be capital and the dividends paid will be income. Thus, the contents of the duty of financial administration with respect to accounting representations are uncontroversial when investments are made in terms of income and capital.[64] One is that the capital costs will be recoverable in capital appreciation. This follows from the rule that expenses incurred for the purchase of capital are borne by capital.[65] Two is that a capital receipt accrues to capital. To apportion it among capital and interest would be to vary the beneficial interest, which is impermissible.[66] Income receipts accrue by the same principle to income. Some may, perhaps with substance, protest against this denial of re-adjustment where there is extraordinary success in capital augmentation. But the answer is the same. The problem is not whether success should be equitably and directly spread out in a different fashion beyond that which predicates income from a safe capital base throughout the entire process of prudential investment. A huge transient gain may be followed by a huge permanent capital loss.

23 Consistent with these predicates, trustee accounting principles must not involve revaluation of trust capital from time to time, or even at any time (this is why they are materialistic). The same accounting principles must reject making adjustments or re-adjustments to accommodate depreciation through wear and tear or other unanticipated surpluses or gains before computation of income as the increase in capital. Depreciation to compensate for loss of capital through wear and tear is legally irrelevant. In the place of income adjustments as allowances for depreciation, rules of equitable apportionment as between capital and income operate to compel the trustee to dispose of wasting, unproductive or underproductive assets and make apportionments to income out of the sale proceeds pre-reinvestment.[67] In similar vein, equitable apportionment rules exist to apportion fresh capital augmentations, not by way of adjustment but as original apportionments *de novo*.[68]

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64 It is, however, also required where they are not so made but where there is a temporal dimension to the trust so that trustees must earn income in the interim.

65 The general rule is that income must bear all ordinary outgoings of a recurrent nature, such as rates and taxes, and interest on charges and encumbrances. Capital must bear all costs, charges and expenses incurred for the benefit of the whole estate. See also *Carver v Duncan (Inspector of Taxes)* [1985] AC 1082, where it was held that although a settlor might provide that capital expenses should be paid out of income, he could not alter the nature of those expenses.

66 See Andrew Butler, "Investment of Trust Funds" in *Equity and Trusts in New Zealand* (Andrew Butler ed) (Wellington: Thomson Reuters, 2nd Ed, 2009) at p 225, referring to *Re Lyell (dec'd)* [1977] 1 NZLR 713.

67 See *Howe v Earl of Dartmouth* (1802) 7 Ves Jr 137; (1802) 2 Ves Jr Supp 14; and *Re Chesterfield's (Earl) Trusts* (1883) 24 Ch D 643.

68 See *Allhusen v Whittell* (1867) LR 4 Eq 295 and the UK Apportionment Act 1870 (c 35).

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24 Perhaps the most egregious example of the rejection of adjustments as between income and capital is the much-criticised rule in *Bouch v Sproule*,[69] whereby company distributions in the hands of the trustee are classified and allocated according to company law. As dividends paid out of current profits are income distributions according to company law, they are thereby income for the purposes of trust distributions. Bonus shares paid out of accumulated profits are capital according to company law and so are deemed to be capital accretions in the hands of the trustee. This may be palatable where capital distributions are such as to lower or reduce the original value of trust funds invested in the stocks and shares in question. But where they are not substantially an indirect return of capital but are only capital in form, they must nevertheless be treated as capital receipts. The result could well be deprivation of income for the income beneficiary when investments in dividend-paying equities become capital growth stocks through shifts in corporate policies outside the control of trustees. Judges do what they can to rationalise out of the rule, but the bottom line is that they cannot approve any overt (or in principle any disguised) trustee's attempt to adjust between capital and income.[70]

III. Maintaining capital integrity

25 The complete denial of capital or income adjustment applies, of course, to an actual sale of capital assets at a profit. Any increase in value must all be reinvested in capital assets without adjustments made to enhance income. There is, on the other hand, a negative aspect of the duty to perpetuate in relation to realised losses of capital.[71] These losses will be recoverable as recovered capital where the trust is entitled and able to exact either restitution or reparation of trust property from the defaulting and unrepentant trustee who fails to observe his duty to perpetuate trust capital and refuses to make voluntary restitution or reparation. More importantly, capital loss may occur despite the observance of duty (which shall be called inevitable (and irrecoverable) loss). One such instance is a sudden unforeseeable exogenous loss of value which cannot be compensated by prior insurance coverage. The other is loss occurring as an incident of investment risk materialising and despite the exercise of prudence; that is, of permanent or irrecoverable capital impairment without fault. As to both recovered and restored trust property and irrecoverable or inevitable loss, the trustee also has no

69 (1887) LR 12 App Cas 385. Restated in *Hill v Permanent Trustee of NSW Ltd* [1930] AC 720.

70 See *Sinclair v Lee* [1993] Ch 497.

71 Unrealised capital losses which are bound to crystallise as out of pocket losses are to be dealt with in the same manner.

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discretion to attribute capital losses, whether recovered or inevitable, to income; or conversely, income losses to capital by way of adjustment. This preclusion against loss-sharing will be denoted as the duty to maintain capital integrity in the ensuing discussion.

A. Accounting for inevitable loss

26 That trust law is decisively preoccupied with separating actual capital loss from income loss is key to accounting for inevitable loss. Income must bear actual income losses exclusively, while capital actual capital losses exclusively, irrespective of the circumstances. The trust capital in the first place is not to be deployed to make profits from a risky endeavour, to be bolstered by making provisions for contingent losses. Accordingly, a capital beneficiary cannot require income adjustments to be made so as to replenish both unrealised and realised capital losses. It cannot be suggested that income beneficiaries must contribute to such losses from their present or future personal funds, nor that they should be required to do so out of undistributed or accumulated income, if any, for income's benefit. Conversely, an income beneficiary cannot demand that his expected income which has failed without fault to materialise should be made up from capital by a capital adjustment through sale of capital assets. His loss of income, being perfectly derivative from realised capital loss, must be borne by him alone. Where capital is lost without breach of the duty of care, income is also lost without breach of duty. Accordingly, there must not be capital impairment by way of making up the loss of income from capital.

27 An important implication arises from the fact that the risks of inevitable loss must be determined at the commencement of every significant income period. The reason is that any capital loss materialising must be borne in accordance with the predetermined risk of capital loss. If this is not done, there will be capital impairment. In time, serious capital restructuring may become the only way to save the trust from total collapse. Even then, the only moderation will be recourse to the court's inherent power to approve a different course, which is an exceptional situation.[72] Such extraordinary circumstances of damage to trust capital will have to be addressed under the inherent jurisdiction to sanction a non-prohibited course of emergency variation of the trust.[73] Where the case falls short of necessary intervention, the duty to maintain capital integrity with respect to loss without fault or blame is governing. This

72 See *Rajabali Jumabhoy v Ameerali R Jumabhoy* [1998] 2 SLR(R) 434.

73 Section 56 of the Trustees Act (Cap 337, 2005 Rev Ed) provides a less demanding statutory jurisdiction to approve *ad hoc* departures from the terms of the trust.

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aspect will be critical in placing limitations on total return investing, which will next be shown, following a short *excursus* on the authorities.

B. Authorities on integrity of capital

28 Aside from trustee accounting rules dealing with inevitable loss, the duty to maintain integrity of capital has received visible attention in the American case law. Some explanation of this distinguishable case law is helpful for the sake of perspective. *Whitfield v Kern*[74] elucidates the genesis and basis of the duty. Under the statutory law of New Jersey, a company may not pay dividends except out of profits. This law is held to have the effect of creating a quasi-trust in respect of the company's capital for the benefit of its creditors as a class. The trust is not real where the company is solvent. Once, however, the company falls into insolvency, directors of the company are deemed to be trustees of the creditors with a fiduciary duty to prevent any further impairment of the capital.

29 The case mentioned exemplifies the negative duty not to impair corporate capital by unlawful or *ultra vires* misapplications or depredations. For the sake of perspective, there should be little use for a generalised duty to maintain capital integrity since the doctrine of proper purposes and duty of good faith to act in the best interests of the company already address and redress improper and disloyal applications of corporate capital as between the trustee and the company. Directors who fail to exercise the powers to dispose of the company's property for the purposes, and in the interests, of the company, will be liable to make good the loss. It is where no such duty exists that the court's characterisation of a duty not to impair capital serves to make the duty relevant to third party creditors. Such deployment of the duty, however, is unnecessary in the common law. It is clear that the common law as opposed to the US law takes the contrary stance to *Whitfield v Kern*. "A director does not by reason only of his position as director owe any duty to creditors or to trustees for creditors of the company."[75] But although directors are not liable as such to creditors of the company, a director may, by agreement or representation, assume a special duty to a creditor of the company.[76] There is nothing more general than this, nor is it needed. Instead of conceptualising a duty of maintaining capital integrity for the sake of creditors, specialised statutes exist to ensure particularised integrity of capital for creditors without requiring proof

74 21 Backes 332 (1930).
75 *Kuwait Asia Bank v National Mutual Life Nominees Ltd* [1991] AC 187 at 217.
76 A director may accept or assume a duty of care in supplying information to a creditor analogous to the duty described by the House of Lords in *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465.

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of fault. These include well-known fraudulent preference provisions as well as the Fraudulent Conveyance Act where fraud may be presumed under certain circumstances.[77] On the other hand, modern company law statutes have made it easier to return capital to shareholders, replacing the notion of capital maintenance by that of solvency.[78] There are many more indications that the original conception of legal corporate capital has been replaced by a business or economic conception of capital which makes no distinction between capital contributed by shareholders and that borrowed from creditors.[79] All these developments are rationalised from the ultimate purpose of the corporation to maximise profits from capital. To that end, even the idea of distributing profits as dividends is characterised as a directorial power. Directors may or may not exercise this power. They will not do so if withholding a part or all from distribution to shareholders by way of capitalisation is in the corporation's best interests for the sake of contributing to earning capacity and maximising profits in the longer term.

30 *Emmerglick v Vogel*,[80] also a decision of the New Jersey court, shows the extension of the duty of maintaining capital integrity to capital devoted to charitable purposes. That was a case where the managing director and another director, in effect appointed by him, reached a deal whereby cemetery land was provided to the second mentioned director as security for advances made by him to the company. The New Jersey Court of Chancery held that directors of a charitable corporation holding cemetery land are trustees under a duty to maintain the integrity of the capital of the corporation as a trust fund for the security of creditors, the benefit of the corporation and those beneficially interested in the charitable trust. Since it was unlawful to use charitable land as security, the court set aside the security as being fraudulent and in breach of the duty of maintaining capital integrity.

31 Much earlier than this, a similar trust fund doctrine in relation to charitable trusts was briefly entertained in the common law. Contrary to *Emmerglick v Vogel*, however, it was eventually repudiated in *The Mersey*

77 See s 73B of the Conveyancing Law and Property Act (Cap 61, 1994 Rev Ed) which enacts the Fraudulent Conveyance Act 1571 (c 5), also known as the Statute of Elizabeth, in modified terms.

78 In fact, it has been argued that capital maintenance notions are out of place, being different, and these statutes should be seen as having solvency as focus. See Meng Seng Wee, "Reforming Capital Maintenance Law: The Companies (Amendment) Act 2005" (2007) 19 SAcLJ 295.

79 Examples include the legalising of no-par capital stock. The only remaining visible evidence of capital maintenance is the restriction of distributions to shareholders to profits from economic capital.

80 30 Backes 257 (1942).

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Docks & Harbour Board v Gibbs.[81] At its lowest, the duty could have been broached as a solution to the problem of non-feasance or conscious inattention of applying capital to the specified purposes leading to capital impairment from the perspective of fulfilment of the charitable mission. But in *Charitable Corp v Sutton*,[82] Lord Hardwick took no heed of this way of characterising breach of the duty by omissions to apply the capital to the specified purposes. He dealt simply with the breach as one of fiduciary duty. The case thereby exemplified what was said earlier. There is no need for a superfluous duty to maintain capital integrity unless the court is seeking to characterise a residual duty which charity trustees should owe to the Government. At its highest, it could be supposed that the duty to maintain the integrity of capital could sensibly and rationally have been presented as a manifestation of the negative duty in relation to funds devoted to purposes of a public nature and intended to preclude trustees from recourse to trust indemnification of liabilities to third parties in breach of duty owed to the Government. But again, even this is unnecessary. In *Re Christian Brothers of Ireland in Canada*,[83] the Ontario Court of Appeal dealt comprehensively with both the defence of charitable immunity from tort liability and the alternative argument derived from the "trust fund theory". The "trust fund theory" suggested that the funds held by charities may not be available in law or equity to pay tort claimants against the charity. But the court reasoned that there was no basis for it.[84]

32 It is not only because the duty to maintain capital integrity is an unnecessary analysis of charitable trust capital that it may be ignored. There is also a perfectly good reason that a trustee who seeks to benefit specified impersonal purposes or persons for stipulated (and therefore clearly discernible) purposes is not subject to a duty to maintain the integrity of capital. Such a trust exhibits two differences from a trust to provide pecuniary benefit to income beneficiaries. First is the fact that the quantum of income payable is determined by the specified purpose. The corresponding duty the settlor imposes on the trustee is thus not the duty of maintaining trust capital integrity. If it makes sense to speak of

81 *The Mersey Docks & Harbour Board v Gibbs* [1864-1866] 11 HLC 686.
82 (1742) 2 Atk 400.
83 (2000) 17 CBR (4th) 168.
84 From the intent of the donor, it could not be argued that it would be a breach of trust to use the funds to pay liabilities incurred in the course of carrying out charitable (good) works. On the basis of the nature of charitable trusts, it could not be argued that they were owned beneficially by the trust purposes and a judgment obtained against the trustee could not be enforced against the assets because the trustee did not own them in his or her own right. The third submission, also rejected, was that if a trustee is not entitled to be reimbursed out of the trust funds, should he or she be guilty of any wrongdoing, neither is the victim entitled to damages by the backdoor.

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maintaining anything, it is the purpose that is to be maintained. Second is the fact that if there is the duty to maintain capital integrity, it must diminish in proportion to the strength of the purpose. Upon desuetude of purpose, and unless gifted over, the trust *corpus* will revert to the settlor or estate. Regard to this matrix thus shows that the settlor does not intend to ensure maintenance of trust capital but to expend all of it, if that be necessary to accomplish his stipulated purposes. The problem of inevitable loss does not go away in the contexts of charitable or specific non-pecuniary purposes trusts; so, it must finally be asked: If there is inevitable loss, on whom will it fall? An answer that capital loss will be borne by capital is not strange when the settlor has indicated that he will tolerate a higher risk of loss if that will accomplish the intended purpose. In conclusion, the rejection of the duty in company and charitable trusts law is a specialised response or reaction to problems of ensuring integrity of purpose rather than capital. In no way does this rejection prove the duty's non-existence in relation to capital and income trusts or trusts for successive beneficiaries.

IV. Ensuring capital integrity under investment strategy

33 In part III,[85] a general account of the duty of perpetuation of trust capital has just been set out with two highlights. First, the duty of perpetuation is negatively manifested where capital loss from breach of duty must be made good by the trustee in default. Second, a trustee must avoid capital impairment. He must not, after the loss-incurring event, require capital to restore to the income beneficiary the loss of income derivative on capital loss. It is mainly this duty to avoid capital impairment as an aspect of the duty of preservation which poses formidable obstacles to total return investing. To this consideration the next part turns.

A. Problems of ensuring capital integrity under total return investing

34 The duty of maintaining capital integrity is easily accomplished under total income investing. "Capital loss" simply means any realised capital loss within any relevant income interval. Deducting that loss, the trust capital will be reset or rebalanced for the next relevant interval without revaluation of capital in a straightforward materialistic, and almost mechanistic, process. This calibration or computation of capital integrity, serious in the case of total income investing, is even more so in the case of total return investing. In the pursuit of total return investment, high growth stocks with high risks of capital loss are or may be included in the

85 See paras 25–32 above.

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trust portfolio. For the reasons mentioned earlier, it cannot be assumed that markets for capital growth stocks are as efficient as for dividend-paying low risk stocks. Capital growth stocks may be more variable and capital returns may be more volatile than dividend-paying stocks. Capital thus ceases to be a constant parameter driving variable income as in total income investing. It is itself fluctuating and its true value can be gauged only after effluxion of time. A first implication of this is that operation of the principle of original capitalisation from the trust's commencement ceases to be valid and possible. It will be necessary to ratchet upwards the present capitalisation by revaluing the trust capital for the purposes of conversion into income where there is capital appreciation. If the simplest scenario is supposed, a trustee will invest in income-yielding investments as well as capital growth stocks. But the income period will be shorter than the capital growth period. The capital growth of an investment will correlate with the fluctuations and trends of general industry, the state of the political and social economy, and the issuer's success in technological innovation and acquisition of intellectual property. The income yield will correspond more immediately to demand for imminent asset exchange values and current performance and prospects of the particular industry or demand for the issuer's products or services. There are or may be other multiple-dependencies but the key point and justification for total return investment is the effect that non-correlated risks have of compounding returns. So separate treatment of investments for capital growth by way of differentiated capital intervals will be necessary to reflect these effects of diversification. Suppose this can be done in some aggregate manner. It will be necessary at minimum to operate on a longer time line so as to ensure that transient capital fluctuations in the form of short-term price swings or performance variability are smoothed over. Too short or frequent an interval may produce skewed results. It may lead to exaggerated income payouts and capital base reduction. It may provoke forced sales, in order to pay income, in a transient crisis leading to locked in and realised losses. A longer period of smoothening over interim fluctuations will be necessary so that average results can be used to form a more accurate picture of annualised total returns. The problem is that experience has shown that capital stocks can be consistently overvalued for extended periods only to undergo sudden sharp devaluations in a sudden moment of time.[86] Income payments which must be made in shorter intervals will turn out to be excessive where capital prices are moving or trending upwards. But when the market drops, high income may have to be paid from selling stocks at a steep loss.

86 In the US, the "tech bubble" in the late 1990s was followed by negative total return over the next decade. See Michael Oyster, *Success in a Low-Return World: Using Risk Management and Behavioral Finance to Achieve Market Outperformance* (Palgrave Macmillan, 2018) ch 1.

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35 The fact that income payments, in effect investment drawdowns, have to be made at shorter intervals thus means that capital preservation over income intervals is significant. Actual losses incurred in this interval will be relevant. If these are not deducted from the trust capital as and when they are incurred at income intervals, capital will in effect be bearing the derivative income loss in the next income interval. Additionally, if these are not deducted, the trust could face liquidity issues in having to make income payments which are investment drawdowns during periods of unforeseen market stress or pressure. Then there is unrealised loss following a downside revaluation. The first problem is uncertainty as to whether all unrealised losses are to be treated as capital losses. If some should really be income losses, the second problem is that there does not seem to be a relatively costless and principled method of conceiving the capitalisation interval for the purposes of writing out unrealised losses from trust capital.[87] If all unrealised losses are deemed capital losses, and the same interval is used as for capital gains, unrealised losses will be determined at the end of each capitalisation interval. Consistent with the duty of preservation of capital, in the next interval, any capital growth should be allocated to restore capital losses incurred at the end of the previous interval before it can be converted and distributed as income. As was said before, the capital level at the start of the very first interval cannot be set at the original trust capital value since that would aim only to preserve the nominal value of the original trust capital. This would be tantamount to setting a risk-free position represented by investing the entire trust fund in long-term government bonds, which is an untenable risk position to hold. Some uplift will be necessary to ensure that more than the nominal value is reconstituted at each capitalisation interval. But if so, what is the proper uplift?

36 The question is as serious as it is difficult. There is a problem that total return investing's higher return comes or could come at the price of a net risk of capital loss. The proper net risk tolerance could be set implicitly by the trustee's targeting a return at the historic level that was obtained previously before the onset of the low-return investment environment. Alternatively, the trustee could set the tolerable actual capital loss at the level of the counterfactual actual loss which would have occurred if the same funds had been invested hypothetically on a low risk total income basis. But then, neither accounting representation

87 *Cf* Committee on the Modernization of the Trustee Act, "Total Return Investing by Trustees" (2000) 20 Est T & Pensions J 47 at 54–55, which recommends a period of periodic valuation that will not be too short and overly costly and not too long so as to short-change either set of beneficiaries as a result of movements in value between valuations. It acknowledges that setting the default percentage is more problematic and recommends adopting the real rate of return on a long-term basis less the rate of general price inflation.

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is straightforwardly approved by trust law's concept of impartiality. In *Nestle v National Westminster Bank plc*, Staughton LJ expressed the view that:[88]

> 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.

This is authority that a higher risk, higher return portfolio is justifiable if the capital beneficiary is not risk averse and the income beneficiary is risk neutral. However, the position of the case under review nowhere approaches the extreme circumstances in which common sense provides a clear answer of fairness. The answer is obvious if higher capital appreciation can be obtained without a net risk of capital loss. But it cannot simply be asserted that the change to a low return environment is an unfairness to an income beneficiary that an impartial trustee must redress by shifting to higher capital appreciation stocks when this comes at a net risk of capital loss to the capital beneficiary.

37 At first blush, the complexity could seem manageable if the trustee can set a ten-year interval for capital growth and rely on the expected profitability over that time frame to pay income within that frame. Over this time frame, various market cycles will play out and, as demonstrated by Shiller, the Shiller P/E or CAPE ratio (the asset price divided by the average of ten years of earnings (moving average), adjusted for inflation) will provide a good estimate of a stock's expected long-term profitability. Put another way, over ten years, the revalued asset prices will neither be overvalued nor undervalued. But it will be impossible to set a ten-year time frame as a rigid capitalisation interval, while relying in the meantime on the expected long-term profitability for the payment of income. Capital growth stocks will have to be sold to produce the necessary cash flow even when their prices are temporarily undervalued within the time frame. In consequence, there is a risk of loss of long-term ability to ride out short-term unforeseeable exogenous events, resulting in illiquidity and inability to meet the cash flow demands of income payouts except by further stock liquidation. When the time for capital distribution comes, there will be inevitable capital impairment.

38 It might be supposed that the problems of capital and income accounting are exaggerated. To an extent, the net risk of capital loss can be removed by recourse to risk management strategies. These include using put options to hedge out the risk of price declines which, of course,

88 *Nestle v National Westminster Bank plc* [1993] 1 WLR 1260 at 1279.

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come at a cost. Unfortunately, as Oyster concludes, whether the cost paid for put options as a hedge is reasonable is answered differently by different investors.[89] The key point is still that there is no clear market answer to what is a prudent risk management strategy.[90] Since the market alone cannot provide the full answer as to what net risk of capital loss is prudent when switching to total return investing, the trustee will need to be trusted to exercise fiduciary judgment to set that level of net risk for the trust in question. Whether we call this an exercise of the duty of impartiality or the duty to act in the best interests of the trust is beside the point. Unfortunately, the trustee is in deep conflict about what that level of net risk should be. On his determination will depend his own liability for loss and the question of inevitable loss. So the ultimate problem is that the trustee will have to be empowered to exercise discretion in deciding in effect when he will not be liable for inevitable loss by determining for himself the extent of his liability for fault-based loss.

39 Aside from questions of conflict of interests, there will be serious moral hazards to consider in any scheme of this kind that depends on generating capital surplus by revaluation and partial realisation within the income interval. The main hazard is that created by opportunities to take advantage of transient gains in capital values as a basis for apportioning and paying higher income. Trustees are incentivised to write up and sell a trust asset whenever it seems to have appreciated and income falls short of the desired mark. On the other hand, as against premature selling, when capital falls, they are tempted to hold off on revaluing capital in order not to reduce net realisable gains for distribution. Capital complacency could set in where the trustee feels compelled to make a show of maintaining high income levels by liquidating capital stocks. The income beneficiary after all is immediately visible and must be appeased. Capital beneficiaries, on the other hand, could be less assertive, being less likely to be aware of capital dippings and depletions over time, while the trustee hopes things will turn for the better when it is time for capital distributions. This means, practically speaking, that the added asymmetrical flexibility is liable to produce benefits for income at capital's expense.

40 It is unlikely that effective revaluation limitations can be put in place to minimise these moral hazards. First, behavioural economists have shown that investment decisions are subject to behavioural and

89 Michael Oyster, *Success in a Low-Return World: Using Risk Management and Behavioral Finance to Achieve Market Outperformance* (Palgrave Macmillan, 2018) ch 3.

90 In a low-income environment, even liquidity-driven investing or duration-matching is a challenge; but in any case, a trust is prohibited from issuing matching bonds that mature on the date of income distribution.

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not only risk-return constraints.[91] Various common cognitive biases which make investment performance irrational have been identified and trustees could even more be susceptible to behavioural shortcomings in loss-making circumstances. To give just one example, their stronger aversion to loss could lead to greater risk taking when faced with a loss.[92] Second, if introduction of more stringent accounting and auditing control of revaluations of trust assets to current cost is suggested, this will have to be legislated. Its implementation by way of external audits verifying the external data and existence of substantiation of any write-up in terms of objective criteria of the net realisable value will be costly. The formulation of objective criteria will be problematic if the revaluation of assets to current cost is to be selective. If it is done across all assets, there will be greater fund retention and the net profits or income will go down, and not up. Finally, it must always be borne in mind that the capital beneficiary is without exit control, unlike a shareholder unhappy with the director's performance. There is no free market for the beneficial interest.

B. Uniform Principal and Income Act and New Zealand reform introducing total return investing

41 For an interim conclusion, two points are proposed arising out of the foregoing discussions and analyses. The first is that such Commonwealth proposals to implement total return investing as have been made are flawed in failing to take distinct and separate account of the duty to maintain capital integrity. Prominent for this purpose is the New Zealand Law Commission's Option A.[93] It is indirectly modelled[94] on the American Uniform Principal and Income Act ("UPAIA") approved by the Uniform Commissioners in July 1997 and amended in 2008;

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91 As recognised by Nobel Prize (for economics) awards to Kahneman and Tversky (2000), Shiller (2013) and Thaler (2017).

92 Daniel Kahneman & Amos Tversky, "Prospect Theory: An Analysis of Decision under Risk" (1979) 47(2) *Econometrica* 263. This could be the reason that Louisiana and a few other states impose percentage limits on the trustee's payout discretion. But other states such as California confer procedures to safeguard trustees who do not consider whether to adjust or choose not to adjust after consideration.

93 See New Zealand Law Commission, *Review of the Law of Trusts: Preferred Approach* (Issues Paper 31, 2012) ch 5 at para 5.17. Option A empowers trustees to determine what is capital and income:

> This approach would allow trustees to then make investment decisions based on total return without having to consider whether the return is income or capital appreciation. Under this option trustees might pick a fund for investment based on total overall growth and then make a reasonable determination as to what portion should be distributed as income.

94 Via the British Columbia Law Institute, Committee on the Modernization of the Trustee Act, *Total Return Investing by Trustees* (BCLI Report No 16, 2001).

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also known as the "Revised UPAIA".[95] This was in turn an update on the Uniform Prudent Investor Act, adopted by the National Conference of Commissioners on Uniform State Laws on 5 August 1994.[96] There is no need to give more than an essential sense of this reform. Section 104(1) of the UPAIA gives a trustee power to adjust between income and principal if three conditions are met: (a) the trustee invests and manages trust assets as a prudent investor; (b) the terms of the trust describe distributions to beneficiaries by reference to the trust's income; and (c) unless there is preference for one or more beneficiaries, the trustee determines he cannot administer the trust impartially on the basis of what is fair and reasonable to all the beneficiaries. In exercising the discretion to make adjustments, the trustee must consider all factors relevant to the trust and the beneficiaries including matters enumerated under s 104(b). Section 104(c) notably withholds the adjustment power if, speaking generally, the consequences of adjustment will not be tax neutral.[97]

42 The idea of trustee discretion to allocate receipts among capital and income is not new. That power was already a familiar occurrence in trust instruments after the first UPAIA 1931 was promulgated to provide statutory definitions of trust capital and receipts. The UPAIA 1947 then introduced a statutory power of allocation along that line of approach. But there was no common standard of evaluation since much depended on the actual terms of the trust. In *Re Houston's Will*[98] the Delaware Chancery Court held that the power in question conferred by the trust instrument did not authorise distribution of capital gains to the income beneficiary. As Scott comments, the prevalent view was that such power merely permitted trustees to modify and adjust within the confines of the principal and income enactments.[99] In some cases, this was established by presuming the existing capital and income rules to be reasonable and putting a trustee to the burden of showing that the departure he proposed was warranted.[100] It may be observed that these discretionary apportionment powers were replicated in some state statutes, but in every instance, whether granted by the trust instrument or the Legislature, it appears that the trustee was not given a power to re-allocate losses, only

95 They are a stronger version.
96 Apparently, the Uniform Prudent Investor Act as adopted in some states required both the production of reasonable income and reasonable capital safety, as well as the expected total return from income and appreciation of capital. This combination proved to be a formidable requirement to meet before the Revised Uniform Principal and Income Act was promulgated in 1997.
97 Such as where adjustments in a tax-exempt trust such as a generation-skipping transfer trust would cause a shift in the beneficial interest from the taxable beneficiary to the tax-exempt beneficiary.
98 165 A 132 (1933) (Del Ch).
99 Austin Scott, *The Law of Trusts* (Little Brown & Co, Boston, 1987) vol 3A at sec 233.5.
100 *Markley Estate* 19 Pa D & C 2d 143 (OC Mont, 1959).

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gains. As if to corroborate this, the comments to s 104 of the UPAIA elaborate that:[101]

> Section 104 does not empower a trustee to increase or decrease the degree of beneficial enjoyment to which beneficiary is entitled under the terms of the trust, rather, it authorizes the trustee to make adjustments between principal and income that may be necessary if the income component of a portfolio's total return is too small or too large because of investment decisions made by the trustee under the Prudent Investor Rule.

There is silence as to adjusting capital losses.

43 The validity of such provisions conferring powers of adjustment, if enacted in Singapore, could be subjected to serious criticism. Criticism is muted if the lowest level of intervention is intended,[102] namely where the power of adjustment is restricted to resolving certain accounting rules which have proved unsatisfactory over time. The rule in *Bouche v Sproule*[103] is one of them, as previously explained.

44 But the firm intention of the UPAIA was to go beyond mere adjustments to classification rules to providing a platform and support for total return investing.[104] All legal commentators have without exception also thus understood the American proposal as going to that length. One commentary puts it like this:[105]

> Therefore a trustee arguably could properly administer the statutory equitable adjustment power without exclusive regard to the incremental impact of investment decisions on trust accounting income. For example, a trustee could use as a guideline in determining appropriate equitable adjustments: (a) a unitrust calculation, (b) an inflation adjusted annuity value, (c) the discounted value of cashflows statistically likely to be distributed to the current and future beneficiaries respectively from a chosen distribution amount or percentage, (d) a floating index determined by the trust's own historic returns, (e) a floating

101 Most US states have adopted s 104 of the Uniform Principal and Income Act with some differences between state legislation. For an update to 2008, see Richard Nenno, "The Power to Adjust and Total-Return Unitrust Statutes: State Developments and Tax Considerations" (2008) *Real Property, Probate & Trust J* 657.

102 As may be indicated by the juxtaposition of the Prudent Investor Rule. Some commentators refer to compensation; saying, for example, that if the trustee's investment decisions reduce income distributable to the current beneficiary below the level the trustee determines appropriate, the trustee has discretion to transfer a compensating amount from principal to income.

103 *Bouch v Sproule* (1887) 12 App Cas 385.

104 The statute of Delaware expressly authorises inclusion of capital gains incurred in distributable net income. See Del Code Ann tit 12 § 6113(h).

105 See Lyman Welch, "Policy Differences in Total Return Laws" *Leimberg.com* (2002) <http://www.leimberg.com/freeResources/truArticles/policyDifferences.html> (accessed November 2019).

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index determined by selected market indicators, or (f) a wide variety of hybrid methods for determining a fair current return. Any of these alternative methods for implementing the equitable adjustment power would still be governed by and literally satisfy the statutory standard of impartiality.

45 The above list of possibilities has been reproduced to show that, with the implicit exception of (d), in none of them was any express consideration taken of the duty to maintain capital integrity.[106] Going back to the terms of the proposal for adjustment, they could be saying that there can be no adjustment of realised and unrealised losses. One reading of it indeed is that while you can adjust the gains, losses must continue to be borne entirely by capital. This means that capital will now be bearing the risk of greater realised and unrealised losses, which this article has argued to be hardly tenable. The alternative reading is that there is nothing to preclude a trustee from applying the powers to adjust income and capital so as to achieve a discretionary sharing of realised and unrealised losses in some fashion. The reason, it could be argued, is that the provisions in question represent a paradigm shift from the duty to maintain capital integrity to the fiduciary duty of impartiality. From what was said earlier about the duty of impartiality being a result-duty (not a fiduciary conduct-duty), the criticism, it follows, is that s 104 converts the duty of impartiality, which is an objective result-duty, to the more malleable and subjective conduct-duty character of a fiduciary duty. The moral hazards with which this process is encumbered have been pointed out earlier.[107]

46 It is not forgotten that the silence on the significance of capital integrity in the UPAIA has been redressed in an implicit fashion by the Uniform Fiduciary, Income and Principal Act ("UFIPA") approved by the Uniform Law Commissioners in July 2018 to supersede UPAIA 1997. Section 201(e) updates s 104(b) by including as factors to be considered the effect of the allocation rules and the desirability of the preservation and appreciation of principal. However, inadequate attention still seems to have been given to the following important points, that (a) total return investing does not unequivocally yield higher return at the same risk of capital loss considered prudent in the long run; (b) there may be a net risk of capital loss which is still borne entirely by capital; and (c) a net risk that actual capital losses may be aggravated by short-term asset stress and mismatch between income payout intervals and capitalisation intervals. These were the demonstrations made in part IV's discussion.[108]

106 The same silence appears in the New Zealand preference for Option A.
107 See paras 39 and 40 above.
108 See paras 34–40 above.

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47 The second point of the conclusion complements the first. Suppose that both the UPAIA and UFIPA on true construction require the trustee also to make adjustments in relation to capital loss. The more fundamental objection is that the preservation of trust capital should be defined by virtue of apriority, not aposteriority of risk of capital loss. There is thus a complete change in the concept of trust capital when realised and unrealised losses are allowed to be adjusted *a posteriori* in the trustee's discretion. The question in truth is not whether a trustee should be given discretion to adjust both gains and losses under, as the UPAIA characterises it, an extended subjective concept of the duty of impartiality. Nor is it whether a trustee should have this discretion under, as the UFIPA recharacterises it, the subjective concept of duty to act in the best interests of the trust. It is whether trust law should adopt a new definition of trust capital, one that is more business-oriented that sees income and capital beneficiaries as engaged in an investment venture in which they share the gains as well as the losses. The final part deals with this question.[109]

V. Total return trusts

48 In this final part, the focus will be on the total return trust. Total return investing is not really synonymous with a total return trust. A total return trust, also known as a unitrust[110] or percentage trust, is more than a strategy of investing for total return.[111] It does not operate on the same premises of an original trust capital in which the capital beneficiary has rights; and for which he may at any time require an accounting of the trustee. The total return trust uses its capital as a single fund, without regard to who owns it or to whom the trustee is obligated in his use of the fund. There is no distinction between expenses and returns as income and as capital. There are only profits or losses after deducting operating expenses and depreciation, if relevant. There is also no notion of original trust capital. Any intangible increase in value of an original asset upon revaluation is also capital so long as it has earning capacity. This conception of an investment fund of assets appearing on the credit side of the trust "business" accounts is a business or economic one. Put another way, from a businessman's perspective, there are only resources and economic value, as opposed to capital as material wealth. The businessman is not concerned with the sources of contribution and his

109 See paras 48–56 below.
110 The terminology appears to have been coined to signify the unity of income and capital interests in relation to investment of the principal.
111 See Anne Werker, "The Percentage Trust: Uniting the Objectives of the Life Tenant and Remainderperson in Total Return Investing by Trustees" (2005–2006) 25 Est T & Pensions J 329.

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obligations in holding the funds. He sees all this as assets on the credit side. On the other side of the ledger, there are liabilities made up of the capital base of the capital beneficiary and income rights of the income beneficiary. The question of liability is one of the proportion of income to capital contributions to the single fund. From this, the proportion of distributions to capital and income is determined. The effect thus is that, in allocating distributions in accordance with this proportion of contributions, expenses incurred are borne by both income and capital in the same ratio. The same ratio, which may be called the "percentage income payout rate" or "payout rate" for short, likewise determines the allocation of any loss in capital, whether realised or unrealised, between income and capital.

49 The fact that only one ratio is needed does not, of course, change the fundamental market principle: the higher the payout, the greater the risk of loss. This inverse relationship between risk and yield does not change where the trust stipulates a fixed payout rate. Consider a simple example of a total return unitrust created by the settlor which provides for a payment of 7% of total net asset value to income. If the trust capital at start date is $1m, and the total net asset value is $1,100,000 at the end of the year of investment, income will receive $77,000 while capital, $23,000. If there is a loss of $100,000, income will bear $63,000 of the loss, being 7% of $900,000. In this way, income and capital share the loss of $100,000 in the ratio 7:93.

50 At first sight, there may seem little real difference between the total return trust and a collective investment trust. A collective investment trust also involves a sharing of losses and gains and can be structured and positioned where the total return trust is on the spectrum of risk and expected return. A collective investment trust will likely be actively managed to secure higher than market returns; but so also will a total return trust which aims to achieve a higher income per capital unit invested,[112] since less actively managed assets are unlikely to provide the requisite boost in income promised by a stipulated attractive payout.[113] However, there is still a fundamental difference between them. The total return trust, unlike the collective investment trust, lacks the market element and in particular the exit strategies that significantly determine whether the collective scheme succeeds or fails. Market discipline is

112 Turnover rates of trust assets rise to generate short-term capital gains and these rates, it is said, could range from 100% to 5% per year.

113 Transaction costs also go up with increase in volume of transactions. There is a suggestion that even if trust law impediments are eliminated, costly aggressive total return trusts are unlikely to be attractive beyond more specific provision for the surviving spouse trusts for the sake of ensuring maintenance of a pre-existing standard of living or trusts of a retirement nature.

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completely absent in a total return trust catering to the temporal division of income and capital. In place of the market, the requisite internal discipline must be fostered and regulated by the duty to foster long-term growth against the sharing of risks of loss. Beneficiaries cannot exit a trust and by doing so pronounce a disavowal of the trust's investment policies and strategies. In other words, the question returns to the proper level of the payout rate.

A. Implementing total return trusts

51 In a total return trust, the payout rate is critical, but can it be determined as a matter of principle? There are both legal and economic considerations but it is submitted that an affirmative answer can be given along the following lines. First, it is pretty obvious the payout rate must be predetermined and cannot lie in the trustee's *ex post facto* discretion. A discretionary proportionate allocation would belie the underlying tenet that income and capital are contributors to the single fund subject to a total return trust. From these contributions emanate the rights to participate in the earnings and the responsibilities to shoulder the losses of trust investments. Second, the payout rate must reflect the proportion of these original contributions. Third, income's original contributions are necessarily notional but can be represented as the present capitalised value of the future streams of income to which the income beneficiary may expect at the payout rate. Fourth, the absolute amount of payout is not significant. The capitalised value does not maintain a material identity but loses its identity when put into the single fund. Fifth, the relative amounts contributed by income and capital to the fund and reflected in the payout rate is what is important. Sixth, the relative risk and expected return profiles of both income and capital beneficiaries must determine the payout rate for the purposes of capitalisation of income contributions.

52 That being the case, total return trusts can only be legitimised by the settlor determining the payout rate as part of his initial trust design and its imposition of the desired risk and expected return trade-off, or by all the beneficiaries of the trust determining the trade-off for themselves under the rule in *Saunders v Vautier*.[114] In the absence of *ex ante* settlor determination or consent by all *sui juris* beneficiaries, trustee adoption of the risk and expected return trade-off without court sanction is impossible. For the same reasons, if the statutory law is to countenance the total return trust, it can only be on the basis of what income and capital beneficiaries as contributors would without doubt have agreed as to the payout rate as a minimum. At the minimum, if it can be presumed

114 (1841) Cr & Ph 240.

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that both will be risk averse, and it is the case, there will be a clear answer as to what can be specified as the default payout rate, namely the real rate of return on a long-term basis plus the rate of inflation.[115] Legislative approval along that line of approach accordingly is justifiable as reflecting the notional agreement that hypothetical risk-averse income and capital beneficiaries would have reached for sharing gains and losses.

53 It may be helpful to reiterate that the difference between the total return trust and total return investing lies in the sharing of gains and losses in a proportion that matches the long run real rate of growth plus inflation. When returns exceed the long run real rate, both income and capital benefit by the same percentage. Similarly, when returns fall below, both share the loss by the same percentage. In absolute terms, capital will gain more but also lose more; this in the long run ensures capital will keep up with inflation as well as appreciate in real terms. In contrast, a total return investing scheme despite targeting the real rate of growth in the long term will not avoid prejudicing the capital beneficiaries who bear the entire loss of capital, which is now higher. As was said, it is impossible to determine the tolerable prudent net risk of loss under total return investing under present economic and financial conditions. In a total return trust, however, that net risk in effect is proportionately shared between income and capital beneficiaries and serves as a rational legislative default position that does not contradict the fundamentals of trust law.

54 It should further be emphasised that while a total return trust in which trustees have *ex post* discretion to decide the payout rate is unprincipled, there is nothing to preclude trustees from exercising in good faith discretion to determine *ex ante* that the capitalisation interval shall be a multiple-year rolling average where this serves to foster greater stability of income; nor that a certain amount may be withheld in the trustee's discretion as an asset cover protection since the net realisable value may be hard to achieve if there has to be forced realisation in response to unusual price swings within each capital interval. The discretionary creation of a buffer against capital base erosion by retention of a percentage of return (by default, the difference between the actual total net asset value and the total net value at the payout rate) as a kind of "working capital" for the trust is merely a liquidity measure designed to facilitate greater stability of income.

115 The gift and inheritance tax complications which are irrelevant in Singapore will not be discussed.

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B. *Concluding by way of the Canadian Uniform Trustee Act*

55 Again, it is apposite by way of conclusion to consider Canadian proposals to install total return trusts by enabling legislation.[116] Some references to the English Law Commission report on total return investing may be helpful, notwithstanding the Law Commission decided against recommending adoption of the total return trust.[117] The New Zealand Law Commission, however, rejected this option which it called "Option B",[118] and little more will be said about it. There is no doubt that the broad inspiration for the Canadian total return trust is also American. The total return trust was not dealt with in the UPAIA because of concerns about incompatible tax consequences in relation to tax-advantaged trusts. Following Internal Revenue Service clarifications in 2003 limiting the payout rate to between 3% and 5% for tax-advantaged trusts, there are now many more state legislative approvals for conversion of a trust to a unitrust[119] as an alternative or cumulative solution to total return investing by adjustment between income and capital.[120] Article 3 s 302(c) of the new UFIPA effective in 2018 has now gone even further to provide for conversion in far broader terms. Conversion to a unitrust may be made regardless of the terms of the trust concerning distributions except where the terms prohibit it,[121] or where the trust falls relevantly within stipulated provisions of the Internal Revenue Code.[122] Article 3 s 303 enacts the starting general proposition that there are no limits on a trustee's discretion to convert to a total return trust with a stipulated percentage payout except where the beneficiaries, who must be notified, enter an objection by the stipulated date. However, if there are

116 See s 40 of the Canadian Uniform Trustee Act.

117 United Kingdom, Law Commission (Law Com No 315), *Capital and Income in Trusts: Classification and Apportionment* (HC 426, 2009). Although the Law Commission considered (at p 5) the total return trust more likely to be effective to implement total return investment policy than conferment of discretion to adjust between income and capital. A positive recommendation was not made only because of tax complications: see p 72.

118 New Zealand Law Commission, *Review of the Law of Trusts: Preferred Approach* (Issues Paper 31, 2012) ch 5, Option B.

119 First adopted in Delaware in 2001 with discretion to set a rate between 3% and 5% payout. New York adopted it about the same time with a fixed payout of 4%. These are the two leading models providing trustees with discretion to convert from income trusts to unitrusts and back again, if so wished upon, giving appropriate notice to current income and remainder beneficiaries. If there is no objection within a 60-day period, the conversion can proceed without court approval.

120 Studies have been conducted in the US indicating that a 3% to 5% payout works well for trusts invested primarily in equities. See Robert Wolf & Stephen Leimberg, "Total Return Unitrusts: the (TRU) Shape of Things to Come" (1998) www.leimberg.com.

121 Uniform Fiduciary Income and Principal Act (2018) Art 3 s 302(b).

122 Uniform Fiduciary Income and Principal Act (2018) Art 3 s 302(c).

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special tax benefits, then payout rate will be limited to 3% to 5 % of total net asset value.

56 The total return trust in the UFIPA seems to have been conceptualised as an example of how the power of adjustment can be utilised. In Canada, however, s 40 of the Uniform Trustee Act, although broadly inspired[123] by the American unitrust law, exhibits a fundamental difference in that the settlor intention is governing. A total return trust can only be set up by the settlor.[124] It is only when in doing so he fails to specify the payout rate in the terms of the trust that the prescribed statutory rate will be applicable. The commentary to s 40 well explains that:

> The specified percentage should be a rate designed to provide a sustainable payout without eroding the value of the trust assets. If there are income and capital beneficiaries, the specified percentage should provide a fair income to the income beneficiaries while preserving the value of the capital. The estimated long-term real rate of return on investment (the nominal interest rate on investment less inflation) provides a theoretically valid benchmark for such a specified percentage, as it represents the rate at which an invested fund would normally be expected to grow after allowing for future inflation. If no more than this percentage is paid out in a given fiscal period of the trust, the value of the trust capital should be preserved. The real rate of return tends to remain relatively stable over long periods of time.

This is, of course, a fundamental difference from the UFIPA.

57 In conclusion, the phenomena of total return investing and total return trusts are less simple than may be imagined. At stake are important conceptions of trust capital. The preservation model conceives of trust capital as material wealth belonging to a risk-averse capital beneficiary. Its identifying features therefore revolve around the duties of perpetuation and maintaining capital integrity and their implementation by means of trustee capital and income accounting rules. There is an uneasy tension between the preservation model of trust capital which must be paid back to capital beneficiaries and a growth (or business or economic) model. The latter assumes that income and capital beneficiaries share in the risks of growing an indivisible fund. The risk tolerance is obviously greater in a business model which posits both income and capital as contributors to a

123 Also via the British Columbia Law Institute, Committee on the Modernization of the Trustee Act, *Total Return Investing by Trustees* (BCLI Report No 16, 2001).

124 A settlor may direct, in a trust instrument, the trustee to adopt a total return investment policy with respect to all or part of the trust property. See s 40(4) of the Canadian Uniform Trustee Act. A total return investment policy means a policy of investing property so as to obtain the optimal return without regard to whether the return is characterised as income or capital: see s 40(1).

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single fund sharing weal and woe. In the course of discussion and analysis, it was noted that the details of how the tensions between preservation and growth should be resolved are in need of rethinking but difficult to resolve as a matter of principle.

58 Proposals to implement total return investing by trustees have painted the positive gains but oddly ignored the asymmetrical preservation effects. Besides the damage to capital integrity, the idea of trustee discretion to strike a fairer balance between income and capital by readjustments is hard to justify in terms of a conception of trust capital to be preserved for the risk-averse capital beneficiary. The idea that trustee discretion can achieve preservation by a judicious selection of capital intervals and selective capital gains realisation may be sanguine. This article argues that the problems of conflict of interests and serious moral hazards are formidable and easy to underestimate.

59 Total return trusts are conceptually sounder. This article has explained its conceptual basis as involving the creation of a single fund in which income and capital beneficiaries are contributors entitled to share in the fruits of investing the fund and obliged to shoulder the burden of such losses as may be incurred. But in the first place, the creation of such a trust for investment within a trust must lie in the settlor's autonomy. He alone must determine the extent to which his beneficiaries are to be participants in a collective investment scheme, as it were. The law and the courts *per se* are not competent to make these decisions; and the trustees even less so. In this respect, the Canadian proposals stand on firmer ground than their American counterparts. These proposals are also sound in specifying the default payout rate by reference to the long-term real rate of return and inflation. It is possible, though, that while such decisions which belong to the settlor should be made by him *ex ante*, where he does not do so, the beneficiaries acting in concert may agree among themselves and with the trustee to constitute the trust capital as a single fund, subject to a total return trust with an agreed payout rate. That agreed rate could be more or less than the real rate of return plus inflation.

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