Quantum of compensation

David Blayney discusses the law and practicalities of quantifying compensation for breach of trustees' duties related to investments

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'In common law damages claims, fluctuations in the value of property obtained by the claimant as a result of the defendant's wrongdoing are generally ignored as a result of the adoption of a transaction date approach to the assessment of loss. This does not apply in the context of trusts because compensation is calculated at the trial date.'

What is the measure of compensation payable by trustees who have committed a breach of duty relating to their powers of investment? Quantum is often the critical issue in breach of trust claims, particularly in the context of negotiations where the parties' advisers may agree on the claimant's prospects of success on liability, but disagree fundamentally about the compensation payable if the claim succeeds.

In the context of a modest fund, the court may take a broad-brush approach and estimate the trust's losses through the award of a suitable rate of interest. But in other cases, where it is justified by the sums at stake and the availability of the evidence, the courts are prepared to adopt a more detailed analytical approach.

The leading authorities are the English Court of Appeal decision in *Nestlé v National Westminster Bank plc* [1993] (together with the illuminating first instance judgment by Hoffmann J) and the decision of the New Zealand High Court in *Re Mulligan (dec'd)* [1998]. The general principle applied in those cases is that the measure of compensation is the difference between the value of the fund at the date of trial and the value that it would have been likely to have had if invested by a prudent and competent trustee. The requirement for a trial date assessment represents an important difference from the breach/loss date approach generally adopted in the quantification of damages for tort or breach of contract, and can be complex to apply in practice. This article discusses the practicalities of establishing loss and considers two particular areas where difficulties and arguments may arise.

Hypothetical investment performance

The first area of difficulty is 'hypothetical investment performance'. The principle established in the case law requires a comparison to be made between the actual performance of the trust investments and the performance that would have been most likely if there had been no breach.

Nestlé provides a good example of some of the difficulties that may arise in relation to the performance of the hypothetical portfolio. In *Nestlé* the breach of trust was a failure, over many years, to conduct a regular review of, and suitably diversify, the trust investments. The result of this breach was that the equities component of the trust fund remained inappropriately concentrated in insurance and bank shares between 1922 and 1960. Unfortunately for the plaintiff, she adduced the wrong kind of evidence to establish a loss. She relied exclusively on the BZW Equity Index to show that equities generally rose by 659%, whereas the value of the trust fund rose only 419%, and claimed the difference as loss to the trust, for which she should be compensated. But as the defendant bank pointed out, the BZW Equity Index was often not beaten by competently managed unit trusts. This is because the index was calculated by reference to the performance of the leading equity shares, the composition of the list being changed from time to time with the fluctuation in companies' fortunes. The index therefore did not fairly compare with the performance of an actual portfolio of investments held in a trust. The consequence for the plaintiff of exclusive reliance on this index was disastrous, as she failed to prove the alleged investment underperformance, and on that basis

T&E116 p12-16 Blayney.indd 12 09/04/2010 15:15:31

failed in her claim both at first instance and before the Court of Appeal.

The lesson for trust litigators is to obtain suitable expert evidence that paints a realistic picture of how the fund would have been likely to have performed in practice in the hands of competent trustees. This may require more than one expert witness on each side, although it is important to retain a practical perspective as well as a sense of proportion. In *Mulligan*, for example, two of the five expert witnesses called by the successful plaintiffs were academic experts without practical experience and exposure to private trust administration, and their evidence was regarded as of limited value for that reason. The experts selected should be able to speak not only about the performance of investments but also about the investment strategy that would have been adopted by competent trustees at the relevant time. The evidence should take account of all the factors relevant to extrapolating the likely return of the trust assets from the performance of historical indices. This should include, for example, the way the different indices treat the reinvestment of dividends. A total return index that assumes reinvestment of gross dividends may not provide a fair indication of the likely performance of a trust subject to, and unable to recover, withholding tax.

The experts and the legal team will also need to consider what assumptions should be made regarding the investment strategy that would have been likely to have been adopted had a breach not occurred. They will need to assess the approach that competent trustees would have been likely to have taken (having regard to the terms of the trust instrument, the relevant legal duties and the needs of the beneficiaries) to risk, the composition of the portfolio, and geographical or currency bias.

It may also be relevant to consider the legitimate preferences that the actual defendant trustees might have exhibited if they had not acted in breach of trust. For example, the dispute may relate to a particular investment that it is alleged the trustees should not have held, and the trustees' argument may be that if they had not held the disputed investment, they would simply have held more of the other investments held by the trust. If that evidence is credible, the performance of the 'non-breach' investments held by the trustees may provide the most realistic comparator. But it will be necessary to review whether it would have been appropriate for the trustees to take this course, with arguments potentially arising if those other trust investments significantly underperformed the relevant objective comparator.

In this context, the hypothetical investment is not the worst performing

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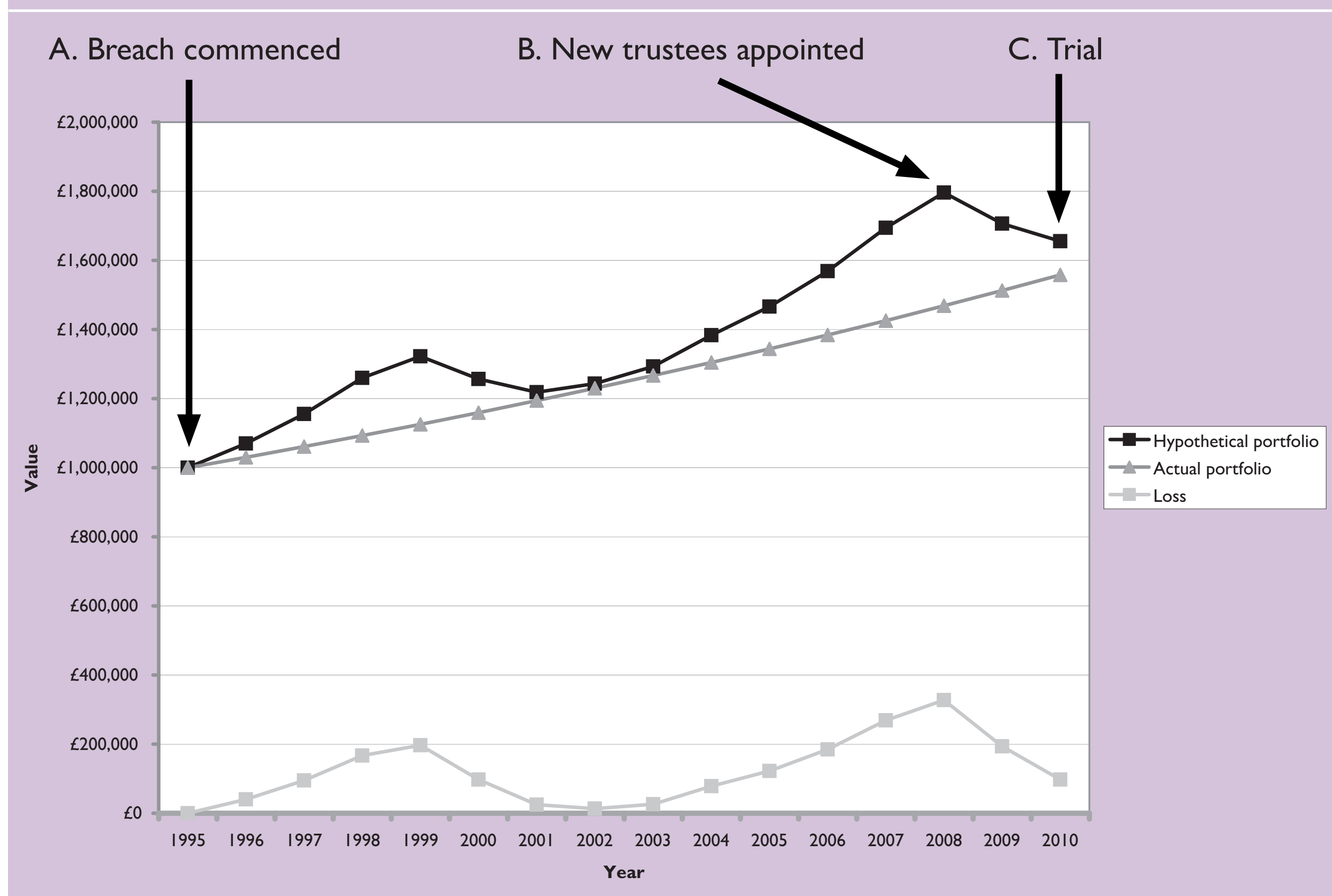
Figure 1: performance of a fictional trust



T&E116 p12-16 Blayney.indd 13 09/04/2010 15:15:35

portfolio that the defendant trustees could have held without being in breach (see *Nestlé*, per Dillon LJ at 1268). The position is analogous to that applied in negligent valuation cases in which a competent valuation could have fallen within a bracket, but the loss should be calculated by reference to the middle of the bracket, this being the valuation most likely to have been given. See Lord Hoffmann's speech at 222-223 in *South Australia Asset Management Corporation v York Montague Ltd* [1997].

In conducting this analysis it is important to ensure that proper account is taken of the trust and investment costs that would have affected the return ultimately received by the trust from its investments. If these would have been the same as the costs incurred on the trust's actual investments, it may be easy to include a suitable figure on both sides of the comparison. But in some cases, the costs that would have been incurred in relation to the hypothetical competent investments may have been different to those actually incurred. In some cases, this may have a significant effect on the ultimate compensation figure.

The loss payable by defendants for a historical breach of trust should not have the effect of rolling up compensation for subsequent breaches of trust by successor trustees.

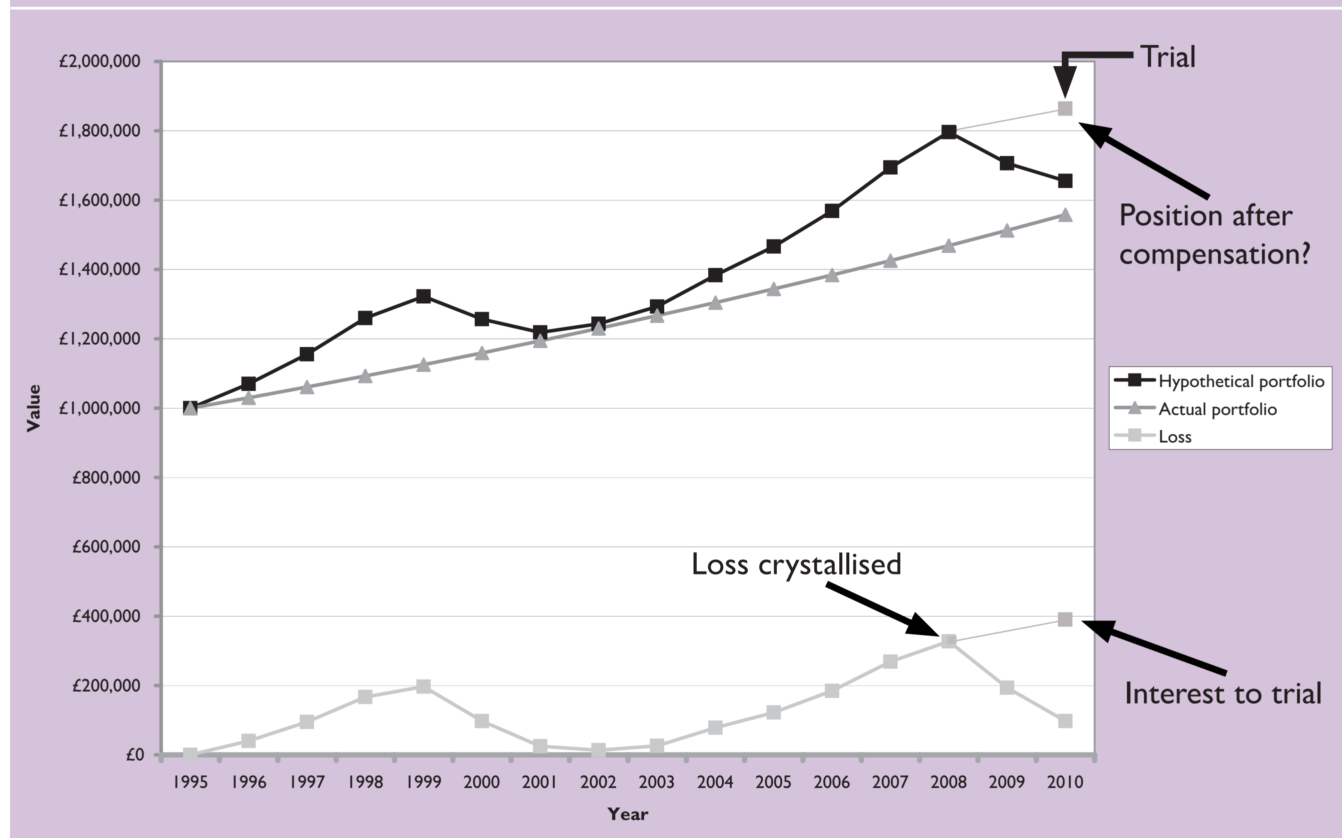
Given the number of potentially controversial variables, it would be prudent for trust litigators and their experts to be on the alert for potential weaknesses in their loss modelling well before trial, so that alternatives can be advanced where necessary. In particular, if exchange of expert reports and meetings between experts indicates serious potential difficulties with the calculations relied on, alternative calculations should be considered, to reduce the vulnerability of the case at trial.

Whether loss crystallised at date of appointment of new trustees

The second area of difficulty is the approach to be adopted where the defendant trustees cease to be trustees substantially before the date of the trial. As indicated above, the general principle is that compensation should be calculated by reference to the diminution in performance of the trust fund as at the date of trial. But it is sometimes argued that the loss should be held to have crystallised at an earlier date, when the defendant trustees were replaced by new trustees or the trust was segregated or wound up.

Figure 1, on p13, illustrates how this can affect the compensation figure. In this example the trustees were in breach from 1995. Their breach consisted of a failure to invest in a suitable medium-risk portfolio, and their decision to instead hold investments carrying a low level of fixed interest. The top line shows the performance that would have been experienced by a medium-risk portfolio. The middle line shows the actual performance of the trust funds. The bottom line shows, on a moving basis, the difference between the two, for which the trustees should compensate the fund (note that all of the

Figure 2: loss claimed by beneficiaries



T&E116 p12-16 Blayney.indd 14 09/04/2010 15:15:36

investment performance figures used in this example are fictitious).

In this example, the loss was at its greatest at 'B', when the new trustees were appointed. The beneficiaries accordingly have an incentive to argue that the loss should be regarded as having crystallised at this point, with interest being awarded thereafter, as shown in figure 2, on p14. On these assumed facts, the 'crystallisation date' argument seeks to ignore (and replace with an interest escalator) the fall in value of the hypothetical investment portfolio after the date in question.

As figure 2 shows, this approach may reward the beneficiaries, once they receive compensation plus interest, with the equivalent of investment performance outstripping not only the investments actually held by the trustees but also the investments that competent trustees should have held. For that reason alone, a 'crystallisation date' approach to the quantification of compensation should be viewed with suspicion.

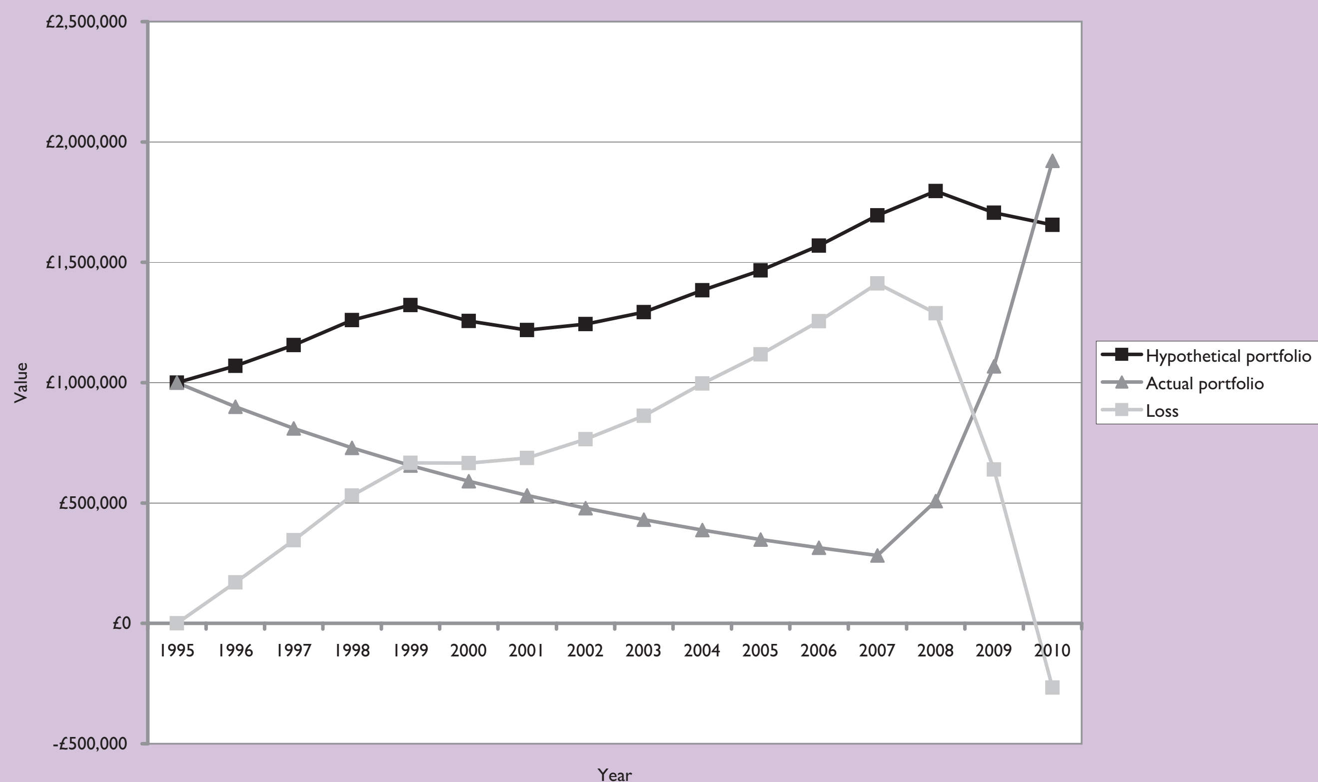
In figures 1 and 2, it is the diminution in the value of the hypothetical portfolio that one party wishes to ignore. In other circumstances, it may be the performance of the 'actual' portfolio that one party wishes to ignore, or it may be both. Figure 3, below, varies the facts of the example to assume an actual portfolio that falls in value substantially until a point at which the defendant trustees are replaced with new trustees, then recovers dramatically while the hypothetical portfolio falls in value. A scenario of this kind may occur where the actual investments held by the defendant trustees are of a highly volatile nature, as might be the case with, for example, investments in shipping or a private company operating in a speculative field. In this example, there is a substantial loss at the point when the new trustees are appointed, but the loss has fallen to nil by the date of trial.

There is reasonably strong authority to the effect that the crystallisation date approach is wrong in principle. In *Bartlett v Barclays Bank Trust Co Ltd* [1980], the property company shares in respect of which the trustee was in breach of duty had become vested absolutely in the beneficiaries in 1974, at the height of the property boom. The value of those shares subsequently fell substantially, before a sale of the company in 1978. The bank argued that the correct point at which to assess the compensation for breach of trust was 1974, when the shares became vested absolutely in the beneficiaries. Brightman LJ disagreed, holding that until restitution was made, the default continued because it had not been made good.

In *Bartlett* the crystallisation date argument was used in an attempt by the defendant trustee to ignore a fall in the value of the 'actual' investment portfolio after it became vested absolutely in the beneficiaries.

The decision in *Target Holdings Ltd v Redferns* [1996] may also be relied on in opposition to the crystallisation date approach. In that case, the defendant solicitors committed a breach of trust by wrongfully paying out money held in their client account for a lender on a property transaction before they had authority to do so, and before security was obtained for the loan. In fact, the intended security was subsequently obtained, but the lender suffered a substantial loss because the charged property had been massively overvalued in the context of a mortgage fraud. The lender claimed restitution of the full amount of money paid and argued that the clock should be stopped at the date of payment. The House of

Figure 3: actual portfolio recovers after new trustee appointed



T&E116 p12-16 Blayney.indd 15 09/04/2010 15:15:36

Lords rejected this argument, holding that the lender had suffered no loss because, having ultimately obtained the same security that it would have obtained if the solicitors had done their duty, it had suffered no loss.

Viewing the *Target Holdings* decision in the context of actual and hypothetical portfolios, the actual portfolio parted company from the hypothetical portfolio when the money was paid away without title to the security being obtained, but then became restored to the position of the hypothetical portfolio when the security was obtained. Thereafter, and before trial, the value of the lender's position deteriorated substantially, in both the actual and hypothetical scenario (which were identical by this stage).

Although these cases suggest that the crystallisation date approach is wrong in principle, they do not deal with several practical issues likely to arise in individual cases.

Probably the most difficult of these issues are those relating to the performance of the 'actual' portfolio in the hands of the new trustees (or the beneficiaries, in a case where the trust has come to an end). In figure 3, the value of the investments wrongly held by the defendant trustees underwent a massive increase in value after the new trustees were appointed. But what if the new trustees sold those investments upon their appointment? Is the performance of the 'actual' portfolio, by reference to which the compensation is to be calculated at the date of trial, to be the performance actually experienced by the trust assets in the hands of the new trustees, or the performance that would have been experienced by the trust assets in the hands of the average competent trustee?

This is a difficulty that rarely arises in the context of common law damages claims, where fluctuations in the value of property obtained by the claimant as a result of the defendant's wrongdoing (involving shares acquired following a vendor's misrepresentation or negligent professional advice, for example) are generally ignored as a result of the adoption of a transaction date approach to the assessment of loss. A transaction date approach prevents the loss payable by the defendant being affected by the free decisions of the claimant (about whether to sell or retain the asset acquired) and operates precisely because those free decisions are regarded as breaking the chain of causation between the wrongdoing and the loss. This does not apply in the context of trusts because compensation is calculated at the trial date. It is therefore necessary to grapple with the question of when, and how, the loss should be affected by the acts or omissions of the claimant (or new trustees) in respect of the assets in question.

It is unattractive that the compensation paid by defendants should be adversely affected by investment decisions taken by others after the cessation of their involvement.

It is probably safe to assume that the effect of the actual investment decisions of new trustees will be excluded from the calculation if those decisions were themselves a breach of trust. The loss payable by defendants for a historical breach of trust should not have the effect of rolling up compensation for subsequent breaches of trust by successor trustees. In figure 3, this might lead to close scrutiny of a decision by the new trustees to sell the volatile investment at the bottom of the market, particularly if the sale was made in order to invest in an alternative portfolio that was expensive in relation to historical trends.

It is more difficult to predict the approach the court would take to decisions that did not amount to a breach of trust in other scenarios, but produced investment performance substantially worse than would have been experienced as a result of the investment decisions that most competent trustees would have taken. In figure 3, if most reasonable new trustees would have retained the asset to give it an opportunity to recover in value, should that performance provide the proper measure of loss even though the actual new trustees' decision to sell was not so unreasonable as to represent a breach of trust?

It would be dangerous to seek to answer this question in abstract terms, because judges are likely to be heavily influenced by the facts before them. There will obviously be a strong incentive for relying on the actual investment performance experienced under the new trustees, because this reduces the need to rely on expert evidence and speculation about hypothetical scenarios. Set against this, as common law damages principles recognise, it is unattractive that the compensation paid by defendants should be adversely affected by investment decisions taken by others after the cessation of their involvement. Ultimately, the court's decision may be affected by the strength of the criticism levelled at the investment decisions made by the new trustees.

Conclusion

Arguments relating to quantum in trust claims, as in other areas of law, can be both difficult and of considerable significance to the outcome of trials or negotiated compromises. It is important, particularly in large cases, for there to be close co-operation between the legal team and expert witnesses to establish the appropriate questions to be addressed and arguments to be advanced. This article seeks to illustrate some of those points, and how they may be answered. In particular, it emphasises the importance of obtaining appropriate evidence of the likely hypothetical investment performance if there had been no breach of trust, and the need to be aware of the issues that may arise where the defendant trustees have been replaced by new trustees, or the trust has come to an end substantially before the date of the trial. ■

Bartlett v Barclays Bank Trust Co Ltd
[1980] 1 Ch 515

Re Mulligan (dec'd)
[1998] 1 NZLR 481

Nestlé v National Westminster Bank plc
[1993] 1 WLR 1260 (CA);
[2000] WTLR 795 (Ch D)

South Australia Asset Management Corporation v York Montague Ltd
[1997] AC 191

Target Holdings Ltd v Redferns
[1996] AC 421

T&E116 p12-16 Blayney.indd 16 09/04/2010 15:15:36