Risk, law and social change (1999)

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Introductory

You have probably heard it said that the world has changed with the advent of a familiar litany of social phenomena: family breakdown, the internet, mass unemployment, the destabilisation of the welfare state and so forth. This is a view to which I subscribe but my principal focus in this short piece is on the increase in social exclusion and the increase in risk borne by our citizens. It is on this concept of "risk" as a sociological phenomenon that I wish to concentrate most particularly in this article.

The underlying point of this necessarily brief survey of the inter-action between risk and law is that social change is throwing up new kinds of hazard for our citizens which are not yet properly understood by law.

One simple example is in relation to pensions. It is a well-understood feature of the private pension among finance professionals that the investment of pension funds involves risk. The risk-return equation is the bedrock of the financial investment decision – the investment manager decides whether any particular investment is worth the financial outlay for the return which it promises (see Brealey & Myers on Principles of Corporate Finance, and the vast panoply of business administration texts).

However, the social context of risk is less well understood by lawyers. The treatment of the fund manager as a fiduciary officer in relation to the business of the trust fund is on the basis of the duty to obtain the best possible return for the beneficiaries (*Cowan v. Scargill*), to avoid conflicts of interest (*Keech v. Sandford*), and to act prudently (*Speight v. Gaunt*). The law on fiduciaries and finance does not account for two issues, however.

First, the sophistication of the financial decision-making process is not taken into account. In *Bartlett v. Barclays Bank*, for example, Hoffmann J established a requirement that the trustee consider the market practice of using "current portfolio theory" in making investment decisions. Possibly this makes sense in relation to professional fund managers but it is an unnecessarily high standard to set for non-expert trustees. Rather, the pronouncements which the law makes are in happy ignorance of the manner in which modern financial practice accounts for the treatment of such investments – one system is closed off from the other.

Second, the changing nature of risk is not considered. The example of pension funds is instructive here. With the rolling back of the welfare state and the prospect of a continuing reduction in the real level of the state pension, citizens are compelled to take out private pensions to insure against old age. Therefore, instead of considering pension funds as being subject simply to the ordinary principles of trusts, the law

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ought to equate pension funds as occupying a radically different position from private trusts instead of being bundled up with them for legal purposes. Rather than consider the investment of pension funds as a matter of private trusts, the law should consider the true position of the beneficiaries under that trust as people who are to some extent *involuntary* participants in the pension fund.

The remainder of this article will attempt to tease apart some of these ideas – principally by reference both to sociology and to the legal treatment of financial investment.

The multi-faceted concept of risk

"Risk" is a particularly modish concept in modern sociological theory[2] as well as a central concern of modern finance and speculative, financial investment. Those two contexts in which risk is considered are, however, very different. From the perspective of modern financial markets, 'risk management' is a familiar term connoting the quasi-science of measuring risk and volatility attaching to particular financial products which is then factored into the cost of those products.[3] One of the more famous risk management models is the Black-Scholes Model[4] for measuring the volatility attaching to financial options. This mathematical formula provides a quasi-scientific method for the cost of risk to be factored into the cost of investment products by "financial engineers" (itself a common market term for those who price such products which itself mixes finance with a reassuringly scientific imagery). Indeed many financial products are created with the express purpose of managing the risks faced by their buyers.[5] So it is that buyers of interest rate swaps, for example, will frequently be attempting to reduce (or remove) their exposure to market interest rate movements.[6]

The sociological approach is less closely centred on a purportedly scientific means of calculating, accounting for and managing financial risk. Rather than present 'risk' as something which can be measured and expunged or 'managed', the sociological theory conceives of the impact of social modernity introducing ever more risk to the biographies of individual citizens. In particular, this discussion will consider the work of Beck[7] and Giddens[8] in showing how a 'risk society'[9] has emerged from the break-

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[2] The literature in this area is growing apace. See particularly Beck, *The Risk Society* (Sage, 1992); Giddens, *Beyond Left and Right* (Polity, 1993); Beck, Giddens and Lash, *Reflexive Modernity* (Polity, 1994).
[3] On which see the specific, technical literature such as Banks, *The Credit Risk of Complex Derivatives* (Macmillan 1994), and Das, *Swaps and Derivative Financing*, 2nd ed. (Irwin, 1994). The legal context is considered in Hudson, *Swaps, Restitution and Trusts*, (Sweet & Maxwell, 1999), 34 *et seq*., 78 *et seq*..
[4] On which see Black and Scholes, 'The pricing of options and corporate liabilities' (1973) 81 *Journal of Political Economy* 637-653.
[5] Hudson, *The Law on Financial Derivatives*, 2nd edn. (Sweet & Maxwell, 1998), 9 *et seq*..
[6] *Ibid*.
[7] A good, representative sample would include Beck, *The Risk Society* (Sage, 1992); Beck, *World Risk Society* (Polity, 1994); Beck, *Democracy without Enemies* (Polity, 1999).
[8] Similarly, a reasonable sample would range from the early Giddens, *The Constitution of Society* (Polity, 1984) to the more recent focus on institutional reflexivity in Giddens, *Modernity and Self-Identity*, (Polity Press, 1991); Giddens, *Beyond Left and Right*, (Polity Press, 1994); Giddens, *The Third Way* (Polity Press, 1999).

up of social structures (such as the nuclear family, linear work patterns, geographically organised communities and so forth) in the late twentieth century in a way that is said to have created both opportunities for individual citizens and also hazard.[10]

Old wine, new bottles, blah, blah

The initial connotations of the term 'risk' are pejorative. They carry (for this writer in any event) immediate mental images of cliff edges or busy motorways in the rain. In financial terms they are also reminiscent of betting your shirt on a pit pony quoted long odds at Kempton Park. The meaning that is applied to 'risk' in the newer sociology is often positive.[11] It is said that risk is bound up with *choice*: wherever there is risk, there is also a decision.[12] We have more lifechoices than ever before: people are living longer, the average health and education of the population at the start of the twenty-first century is better than at the start of the twentieth, and many members of society (principally women) have greater opportunity to select their own life patterns than before. Thus opportunity and choice are in greater abundance than before. The monetarist economics of the time place a greater premium on this ability to choose than on the responsibility to contribute through taxation to a welfare state which offers security. Risk then, while also reflecting the responsibilities and dangers bound up in the possibility that the choices we make will go awry, contains the possibility that those choices offer the chance of improvement and success. The bulk of lifechoices are built on investment: pensions, the home, education, healthcare. All involve more investment than ever before by individuals, financial service providers or government.

The expression 'risk society' is one used by the social theorist Ulrich Beck.[13] It is avowedly not another brand of postmodernism.[14] For the postmodernists, politics has come to an end - perhaps under the weight of accumulated irony and pastiche.[15] The risk society is said to be one which offers a different kind of modernity: one in which the new arenas of political power are directed at the possibilities and hazards of risk. The key components of this politics for Beck are generally in ecology, gender and labour.[16] In relation to the environment we are said to have moved beyond simply *external risk* in which we fear the dangers of nature (like tidal waves, floods and volcanoes) and into an era of *manufactured risk* in which the principal risks are of our own making (like global warming, acid rain, and nuclear radiation). This risk is

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[9] An expression coined by Beck, *The Risk Society* (Sage, 1992), *op cit.* n.14.
[10] The term "hazard" is used here to connote a particular, typically pejorative form of risk although the philosopher Heraclitus considered "hazard" to be a force more closely associated with the "social chaos" addressed in this book: on which see Fowles, *The Aristos* (Pan, 1974).
[11] Beck, "The Cosmopolitan Society" in *Democracy without enemies*, op cit. .
[12] Beck, "The Reinvention of Politics" in Beck, Giddens and Lash ed., *Reflexive Modernity* (Polity, 1994), .
[13] Beck, *The Risk Society: towards a new modernity* (London: Sage, 1992).
[14] He declares at the outset his concern to get past this prefix 'post', pointing out its unnecessary complexities: 'We have become used to post-industrialism now for some time, and we can still more or less make sense of it. With post-modernism things begin to get blurred. The concept of post-Enlightenment is so dark even a cat would hesitate to venture in.' Beck, *ibid*, 9.
[15] Two of the key components of the postmodern as identified by Jameson, *Postmodernism: the cultural logic of late capitalism* (London: Verso, 1989).
[16] Each of these receiving a separate essay treatment in *Risk Society*, *op cit*..

therefore *reflexive*: our concern is with risk generated by the risk society itself and need to cope with the inherent contradictions of our time.

Financial risk management

For the financier risk is both hazard and opportunity. Without the volatility of financial markets there would be little hope of the profits which the banks and investment institutions expect to generate. Profitability and wealth are dependent on a game of hazards. Banks would only be able to make profits from charging ordinary citizens fees for holding our puny salaries if it were not for the volatility inherent in the money markets and the stock markets which in turn make differing forms of investment by turns more and less profitable. Take the beta co-efficient in bond yields, the volatility priced into the Black-Scholes option pricing model, the arbitrage possibilities offered by the comparative performance of different currencies. Risk in the form of hazard (that is, losing as well as winning) is necessarily a part of financial activity in global financial markets. Risk and volatility are the bloodstream of financial profitability.

The financial industry operates on risk. The investment policies of the speculative, financial investment entities considered in this article are dependent on strategies based on expectations of volatility and movement. Those who manage pension funds (and the future security of every pensioner) are concerned with the exploitation of risk: hence there is risk borne by any pensioner who buys into a pension plan. The finance industry has created a sub-industry which offers management of the risks created by the main speculative activity. Ironically, these risk management strategies are often more risky than the hazards which they are created to control: the best example being financial derivatives. The financial derivative (whether future, option or swap) offers both the possibility of risk management and of speculation: all in the same tablet.[17] For the cynical, the legacy of financial derivatives has been the collapse of financial institutions like Barings and the generation of exceptionally complex litigation to decide how to unpack derivatives transactions once they go wrong.[18]

Law, equity and risk

The law's understanding of risk is typically something very different from the sociological concept of risk. Risk is not a legal concept nor a legal category. That is, social theorists understand "risk" as being a distinct sociological category bound up with modernity, in contradistinction to the common law which has no similarly comprehensive understanding of risk. Instead risk in law in conceptualised only in very particular contexts (such as risk allocation in the law of contract) without any more general understanding of risk as a social phenomenon. Specific commercial

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[17] This discussion cannot encompass the detail of derivatives products: the reader is referred to Hudson, *The Law on Financial Derivatives*, 2nd edn., (London: Sweet & Maxwell, 1998).
[18] On which see the local authority swaps cases considered exhaustively by the authors in Birks and Rose, eds., *Lessons from the Swaps Litigation* (Mansfield Press, 2000).

activities like insurance business and sale of goods necessarily involve risk but the law has not developed any particular theory of risk in that context.[19]

At a very general level it could be said that the allocation of legal liability in any situation necessarily involves the fruition of a risk: the risk that that person would be held liable, that one person will win and that another will lose. In carriage of goods by sea, one person bears the risk that the goods will arrive in suitable condition at the end of the voyage: the contractual allocation of risk mentioned above. Taking advice from a lawyer on the probable legal outcome of a particular form of action requires the client to take a risk on that legal analysis. As citizens we take risks on the performance of the agencies of law and on the future development of the law as part of our lifechoices.[20] We depend on the law (or some legal agency) regulating the activities of those who look after our personal wealth, our health and our homes: whether through the law of contract, tort, or otherwise. Risk in these contexts is concerned entirely with the negative connotations of hazard and of harm to the subject matter of the contract.[21] Generally the concern is with destruction and with the frustration of the purpose of the contract.[22]

In relation to the law on fiduciaries generally there is a wholesale allocation of risk in favour of the beneficiary of the power. By 'allocation' I mean the strict liability which a fiduciary will generally face in relation to the legal obligations not to permit conflicts of interest or to make unauthorised profits from the fiduciary office.[23] The purpose behind this rule is not an allocation of risk *strictu sensu*, but rather a concern to protect the beneficiaries of a fiduciary power. In the law of trusts, the interests of the beneficiary are typically considered to be sacrosanct and the trustee is considered to owe personal obligations based on good conscience[24] to the beneficiary[25] to care for the trust fund and to make the maximum available return on the trust fund through investment.[26]

There is only an awkward recognition in the general law of trusts that a trust will occasionally be a commercial investment vehicle in relation to which the liability of the trustee will be limited by contract. Rather, the law of trusts purports to treat all trusts in exactly the same way regardless of context. So it is that pension funds, ordinary family trusts, trusts of homes, and even constructive trusts are ostensibly

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[19] See for example Sale of Goods Act 1979, ss. 20, 32, 33; Goode, *Commercial Law* , 2nd edn., (Harmondsworth: Penguin, 1995), 248 *et seq*..
[20] Habermas outlines the importance of individuals being conceived of both as citizens under democracy and not merely as clients in relation to the law. The law does not simply stand in judgment of our particular circumstances but is also the result of political activity and a reaction to our communal claims to have moral norms established. 'The mobilising force of adjudication and legislation reminds us that the population supposedly has the role of author, is a public of citizens - and does not just play the role of client': Habermas, *Between Facts and Norms* (Polity, 1996), 395.
[21] Goode, *ibid*. Sealy, 'Risk in the Law of Sale' [1972] CLJ 225.
[22] *Ibid*.
[23] *Keech v. Sandford* ; *Boardman v. Phipps* [1967] 2 AC 46.
[24] *Westdeutsche Landesbank Girozentrale v. Islington L.B.C.* [1996] AC 669, *per* Lord Browne-Wilkinson.
[25] Hayton, 'The Irreducible Core Content of Trusteeship', in Oakley ed., *Trends in Contemporary Trusts Law* (Oxford University Press, Oxford, 1996), 47; Hudson, *Principles of Equity and Trusts*, (London: Cavendish, 1999),.
[26] *Cowan v. Scargill* [1985] Ch 270.

subject to identical principles in the caselaw,[27] whether the trustees are investment professionals or not. The standard legal tests compromise, not by recognising any particular concept of comparative levels risk allocation here, but rather by creating mutable concepts of liability built on the standard of care of a prudent person of business acting for one for whom she feels morally bound to provide.[28] In practice this can permit a judge the flexibility to consider what such a person would have done in the circumstances[29] - the weakness in this approach is precisely that the test itself does not make this malleability explicit. The focus is not on the nature of the trust but rather on an assumed standard of care based on a universal form of beneficiary founded in the protection of family wealth in the nineteenth century.

In other areas, when Equity does acknowledge either this need to cater for the particular context of risk, it nevertheless applies universal standards to all cases oblivious to context. The more modern approach to the trustee's investment obligations (as an example) refer to the need to observe 'current portfolio theory' as practised by investment managers.[30] On its face (and in its own terms) this does not acknowledge any ability in the person of the individual trustee to do the best they can in the context of their own experience: rather it requires all trustees to live up to best market practice, regardless of their expertise. A better approach would have been to *require* trustees to employ professional agents (rather than leaving this as a power available to them under the Trustee Act 1925) or to require trustees to act as prudently as they are able (and either to procure the agreement of the beneficiaries to any investment or to give reasons in advance for their decision in the event of any complaint by the beneficiaries). At no point does this strand of the law really embrace the truth that 'risk' as a possibility for gain or loss is something inherent in the process of trust investment.

Risk has been acknowledged in relation to the personal liability of strangers to the trust to account to the beneficiaries in the event of their receipt of trust property in breach of trust[31] or their assistance of any breach of trust.[32] In the leading speech of Lord Nicholls,[33] it is accepted that liability for assistance in a breach of trust be based on the dishonesty of the defendant: such dishonesty including risks taken which are so reckless as to call into question the honesty of that defendant.[34] In this conception of the issue, risk is seen as something inherent in trust management such that risks taken attract liability only if they involve some level of recklessness.

What is absent from this jurisprudence is an understanding of the world as a web of risks taken and exploited by citizens. Also lacking is an explicit understanding of the risk management function carried out specifically by investment institutions in relation to the investment products which they sell to their clients. Rather, the law is operating on established forms of risk-through-contract or fiduciary obligations and

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[27] That is, aside from particular statutory rules considered on a case-by-case basis in the appropriate chapters.
[28] *Speight v. Gaunt* (1883) 9 App. Cas. 1; *Nestle v. National Westminster Bank* (June 29, 1988) [1993] 1 WLR 1260.
[29] Or, possibly, what such a person ought to have done.
[30] *Nestle v. National Westminster Bank* (June 29, 1988) [1993] 1 WLR 1260.
[31] *Polly Peck No.2.* op cit..
[32] *Royal Brunei Airlines v. Tan* [1995] 2 A.C. 378.
[33] *Ibid.*
[34] *Ibid.* See Hudson, *Principles of Equity and Trusts*, (London: Cavendish, 1999), … .

not through risk-as-experienced in the modern world. The ramifications of this understanding of risk is then pursued into the context of each of the investment entities considered in this book.[35]

Conclusion

This is a world of increased risk of many kinds: opportunity and choice, hazard and danger. The legal treatment of investment must recognise that. Investment is a means of speculating on the hazard and volatility inherent in the global economy. Investment is a modish form of public policy which reduces the burden on central taxation and places it instead on the enthusiasm of venture capitalists for infrastructural projects underwritten by government. Investment is also, however, a means of expressing a commitment to each other and to our communal welfare. It constitutes a profoundly humane understanding of the need to nurture our most precious resource: the talents and the aspirations of ordinary people.[36]

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[35] Hudson, *The Law on Investment Entities* (Sweet & Maxwell, 2000), chapter1.
[36] Sentiments associated with John Smith, Foreword to *Strategies for National Renewal* (Vintage, 1994).