An Agency Costs Theory of Trust Law

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Abstract

This paper develops an agency costs theory of the law of private trusts, focusing chiefly on donative trusts. The agency costs approach offers fresh insights into recurring problem areas in trust law including, among others, trust modification and termination, settlor standing, fiduciary litigation, trust-investment law and the duty of impartiality, trustee removal, the role of so-called trust "protectors," and spendthrift trusts. The normative claim is that the law of trusts should minimize the agency costs inherent to locating managerial authority with the trustee and the residual claim with the beneficiaries, but only to the extent that doing so is consistent with the ex ante instructions of the settlor. Accordingly, the use of the private trust triggers a temporal agency problem (whether the trustee will remain loyal to the settlor's original wishes) in addition to the usual agency problem when risk-bearing and management are separated (whether the trustee/manager will act in the best interests of the beneficiaries/residual claimants). The positive claim is that, at least with respect to traditional doctrines, the law of trusts conforms to the suggested normative approach. The paper draws on the economics of the principal-agent problem and the theory of the firm and it engages the ongoing debate about whether trust law is closer to property law or contract law. The analysis should be amenable to extension in future work to commercial and charitable trusts.

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TABLE OF CONTENTS

An Agency Costs Theory of Trust Law

INTRODUCTION

Agency cost theories of the firm dominate the modern literature of corporate law and economics.[1] Meanwhile the private express trust, an entity to which the corporation traces its roots,[2] has been left largely untouched by systematic agency costs analysis.[3] Yet in an echo of the famous Berle and Means critique of the corporation's "separation of ownership and control," the centerpiece feature of the private trust as an organizing device for the professional management of assets is that it "separates the benefits of ownership from the burdens of ownership."[4] This implies that many of the tools drawn from the agency cost theories of the firm that are routinely applied in the economic analysis of corporate law should be similarly applicable to the remarkably underdeveloped economic analysis of trust law.[5] Indeed, problems of shirking and difficulties in monitoring, which is the stuff that drives agency costs analysis, abounds in trust administration. Accordingly, this paper develops an agency costs theory of trust law as organizational law, for now focusing on the donative private trust. The analysis should be amenable to extension in future work to commercial and charitable trusts.[6]

Consider a stylized example. In the prototypical gratuitous trust, the settlor ("S") in effect contracts with the trustee ("T") to manage a portfolio of assets in the best interests of the beneficiaries ("B1" and "B2," collectively the

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[1] See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. Fin. Econ. 305 (1976), reprinted in Michael C. Jensen, *Foundations of Organizational Strategy* 51, 56-67 & 367 n. 12; Armen Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 Am. Econ. Rev. 777, 778 (1972). The classic exposition in the legal literature is Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* (1991). See also *Symposium: Contractual Freedom in Corporate Law*, 89 Colum. L. Rev. 1395-1774 (1989); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & Econ. 301 (1983); Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J. L. & Econ. 327 (1983); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288 (1980). See generally Stephen Bainbridge, *Corporate Law and Economics* 26-38 (2002).

[2] See Edward Rock & Michael Wachter, *Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 Nw. L. Rev. 651, 655-57 (2002); Joseph T. Walsh, *The Fiduciary Foundation of Corporate Law*, 27 J. Corp. L. 333, 333-35 (2002). See also Frederic Maitland, *Trust and Corporation*, in III H. A. L. Fisher, *The Collected Papers of Frederic William Maitland* 321, 395 (1911).

[3] Prior systemic applications of agency costs analysis to trust law are scarce. Notable exceptions include A.I. Ogus, *The Trust as Governance Structure*, 36 U. Toronto L. J. 186 (1986); Jonathan Macey, *Private Trusts for the Provision of Private Goods*, 37 Emory L. J. 295, 315-21 (1988). This is not to say, however, that agency costs analysis has not informed occasional specific analyses. See, e.g., Adam J. Hirsch & William K.S. Wang, *A Qualitative Theory of the Dead Hand*, 68 Ind. L. J. 1, 28-29 (1992); Adam J. Hirsch, *Trusts for Purposes: Policy, Ambiguity, and Anomaly in the Uniform Laws*, 26 Fla. St. U. L. Rev. 913, 928 (1999).

[4] Compare Adolph A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property* (1932), with Austin W. Scott, I *Scott on Trusts* § 1, p. 2 (4th ed. 1987) [hereafter "Scott on Trusts"].

[5] See Ogus, *supra* note __, at 186 (1986) (noting the "neglect" of the trust by the law-and-economics movement); Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 N.Y.U. L. Rev. 434, 435 (1998) (same).

[6] On extensions to charitable trusts, see *infra* notes 179, 233, 293 and text accompanying. On extensions to commercial trusts, see *infra* notes 12-13, 145, 289-292 and text accompanying.

"Bs"), subject to the ex ante restraints imposed by the settlor.[7] Hence, using the vocabulary of agency in economic rather than legal parlance, T can be viewed as the agent of S; but T can also be viewed as the agent of B1 and B2. To the extent that T might slight or ignore what S would have wanted in the ongoing management of the trust, we have a problem of agency costs in the S/T relationship. But to the extent that T might slight or ignore what B1 and B2 want in the ongoing management of the trust, we have the usual agency problem when risk-bearing (here by B1 and B2) is separated from management (here by T). So where the corporate form presents one dominant source of agency costs (the shareholder/manager relationship), the trust presents two. This difference is crucial, because it means that even if the vocabulary for the economic analysis of trust law will be similar to that of the economic analysis of corporate law, the underlying analyses will be different. Given the trust's independent donative transfer, commercial transaction, and capital markets significance,[8] this should not be surprising.

That S saddled his or her transfer to B1 and B2 with the friction of competing principal-agent relationships is the core insight that animates the agency costs analysis. The paper's normative claim is that the law of private trusts should minimize the agency costs inherent to locating managerial authority with the trustee (T) and the residual claim with the beneficiaries (B1 and B2), but only to the extent that doing so is consistent with the ex ante instructions of the settlor (S). This qualification gives priority to the settlor over the beneficiaries as the trustee's primary principal.[9] The positive claim is that, at least with respect to traditional doctrines,[10] the law conforms to the suggested normative approach.[11]

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[7] See John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 Yale L. J. 625 (1995). See also Edward C. Halbach, Jr., *Uniform Acts, Restatements, and Trends in American Trust Law at Century's End*, 88 Cal. L. Rev. 1881, 1881 (2000).

[8] See, e.g., Henry Hansmann & Ugo Mattei, *Trust Law in the United States. A Basic Study of Its Special Contribution*, 46 Am. J. Comp. L. 133, 133 (1998); sources cited in *infra* note 13.

[9] In a sense, this paper is a (long) answer to the question posed in William T. Allen & Reiner Kraakman, *Commentaries and Cases on the Law of Business Organizations* § 2.3.3, p. 38 (2003), "If the trustee relationship is analogized to the agency relationship, whom should we view as the principal?" See also id. at 36. Note, however, that under traditional doctrine the settlor, even if living, cannot enforce the terms of the trust (see *infra* Part IV.B.3)—hence the length of the answer.

[10] Analysis of modern reforms such as asset protection trusts, see Stewart Sterk, *Asset Protection Trusts: Trust Law's Race to the Bottom?*, 85 Cornell L. Rev. 1035 (2000) [hereafter Sterk, APT], and the abrogation of the rule against perpetuities, see Note, *Dynasty Trusts and the Rule Against Perpetuities*, 116 Harv. L. Rev 2588; Stewart E. Sterk, *Jurisdictional Competition to Abolish the Rule Against Perpetuities: R.I.P. for the R.A.P.*, 24 Cardozo L. Rev. 2097 (2003) [hereafter Sterk, RAP]; Joel C. Dobris *The Death of the Rule Against Perpetuities, or the RAP Has No Friends: An Essay*, 35 Real Prop. Prob. & Tr. J. 601 (2000); Angela M. Vallario, *Death By A Thousand Cuts: The Rule Against Perpetuities*, 25 J. Legis. 141 (1999), requires not only agency costs analysis but also reference to their political economies and the dynamics of the domestic and international regulatory competition in private trust law. See Robert H. Sitkoff & Jonathan Corsico, *Follow the Money: The Domestic and Offshore Jurisdictional Competition for Trust Business* (work-in-progress on file with the author).

[11] This paper is therefore in some tension with Macey, *supra* note __, though this tension is more apparent than real. For a variety of institutional reasons that are lucidly canvassed in Jeffrey N. Gordon,

Theoretical and practical payoffs to the agency costs approach abound. On the theoretical side, it points to a further research agenda for the economic analysis of trust law. Beneficiaries assume the role of risk-bearing "residual claimants" (or at least they do in the context of donative trusts),[12] and important questions for research include the following: When and why do individuals choose to organize their relationships—both commercial and donative—by reference to the law of trusts rather than some other branch of organizational law?[13] What is the private trust's default governance arrangement, and why? Does the law do a good job of supplying the terms that the relevant parties would have bargained for with full information and low negotiation costs and, for that matter, who are the relevant parties? What is the role of markets—including labor, product, and capital markets[14]—in all this? Because trust law is chiefly state law, is there a regulatory competition among them, and if so, to what end?[15]

On the practical side, agency costs analysis offers fresh insights into recurring problem areas in the law of private trusts including, among others, trust modification and termination, settlor standing, fiduciary litigation, trust-investment law and the duty of impartiality, trustee removal, the role of so-called trust "protectors," and spendthrift trusts. Moreover, on several of these and other issues American and English trust law diverge, so a further payoff of the agency costs approach is that it provides a framework for evaluating the competing Anglo-American views.

The paper is organized as follows. Part I situates the analysis within the current literature of trust law. More specifically, it advances the claim that classifying trust law as organizational law and subjecting it to agency costs analysis is the logical next step in the nascent economic analysis of the private express trust. Thus, this paper does not advance the inherently dubious claim that all prior approaches to the trust should be discarded. To the contrary, the insights developed within the debate about whether trust law is closer to con-

The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U. L. Rev 52 (1987), the evolution towards efficiency in trust law reflects a blend of common law and statutory reform. For further discussion, see Sitkoff & Corsico, *supra* note __.

[12] See *infra* Parts III.D., IV.A. The parenthetical qualification is necessary because in contrast to the typical settlor of a gratuitous trust, "the settlor in a commercial trust almost always retains a residual interest." Steven L. Schwarcz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, 58 Bus. Law. 559, 562 (2003).

[13] See generally Schwarcz, *supra* note __, at 560, 573-84; Hansmann & Mattei, *supra* note __, at 473-78; John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 Yale L. J. 165, 189 (1997). See also Michael Bryan, *Reflections on Some Commercial Applications of the Trust*, in Ian Ramsay, ed., *Key Developments in Corporate Law and Trusts Law* 205-26 (2002). See also Steven L. Schwarcz, *Commercial Trusts as Business Organizations*, __ Duke J. Comp. & Int. L. __ (forthcoming 2003). In particular the trust plays a critical role as a special purpose entity in structured finance transactions. See, e.g., Schwarcz, at 564-65; Edward M. Iacobucci & Ralph A. Winter, *Asset Securitization and Asymmetric Information* (manuscript).

[14] See Robert H. Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency*, 28 J. Corp. L. __ (forthcoming 2003).

[15] See Sterk, APT, *supra* note __; Sterk, RAP, *supra* note __; Sitkoff & Corsico, *supra* note __.

tract law or property law point to the viability of the agency costs approach.[16] In Part II, the paper briefly reviews the agency cost theories of the firm and the economics of the principal-agent problem. Both underpin the paper's agency costs approach to trust law. Part III identifies and then illuminates through agency costs analysis the key relationships between the parties who have an interest in the trust property and/or its management. Finally, Part IV develops the paper's positive and normative claims with reference to illustrative trust law doctrines including, but not limited to, the recurring issues mentioned in the prior paragraph. In so doing, Part IV helps to illuminate some of the endogenous governance considerations relevant to the initial choice to make use of trust law rather than some other branch of organizational law.[17]

I. TRUST LAW AS ORGANIZATIONAL LAW

This Part advances the claim that the law of trusts blends property law-like and contract law-like features. Hence trust law is properly classified and best understood as organizational law. This Part may therefore be situated within the discourse over whether trust law is more closely related to contract law or property law. Early participants in this debate, which has been ongoing for over 100 years, include Frederic Maitland (who took a contractarian perspective), Austin Scott (who took a proprietary perspective), and Harlan Fiske Stone (another contractarian).[18] More recently, the discussion has been reenergized and infused with greater economic sophistication by John Langbein and by Henry Hansmann and Ugo Mattei.[19]

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[16] The ensuing agency costs analysis owes some of its stimulation to a pair of recent articles, the first by John Langbein and the second by Henry Hansmann and Ugo Mattei. See Langbein, *supra* note __; Hansmann & Mattei, *supra* note __. See also Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 Yale L. J. 387, 416 (2000); Thomas W. Merrill & Henry E. Smith, *The Property/Contract Interface*, 101 Colum. L. Rev. 773, 843-49 (2001); Ogus, *supra* note __. Its more general inspiration is the nexus of contracts models of the firm. See sources cited in *supra* note 1; *infra* Part II.

[17] The paper puts the exogenous tax features of the private trust to the side (they are exogenous in that they stem from the tax code rather than trust law). For discussion, see Edward Halbach, *The Uses and Purposes of Trusts in the United States*, in David Hayton, ed., *Modern International Developments in Trust Law* 123-43, at 139-42 (1999). Thus, the ensuing analysis for the most part will not address exogenous variables that are admittedly relevant to the choice between organizational forms such as their differing tax and bankruptcy treatments. For discussion with respect to commercial trusts, see Langbein, *supra* note __, at 180-81; Schwarcz, *supra* note __, at 581.

[18] On the Maitland/Scott "dialogue," see Langbein, *supra* note __, at 644-46 (collecting and describing their publications). See also Harlan F. Stone, *The Nature of the Rights of the* Cestui Que Trust, 17 Colum. L. Rev. 467 (1917).

[19] For modern American manifestations, see Langbein, *supra* note __; Hansmann & Mattei, *supra* note __; Hansmann & Kraakman, *supra* note __; Merrill & Smith, *supra* note __, at 844 & n. 248; Joel C. Dobris, *Changes in the Role and the Form of the Trust at the New Millennium, or, We Don't Have to Think of England Anymore*, 62 Alb. L. Rev. 543, 546-48 (1998); Gregory S. Alexander, *The Dead Hand and the Law of Trusts in the Nineteenth Century*, 37 Stan. L. Rev. 1189, 1196-97 & n. 13 (1985). See also Philbrick, *supra* note __, at 151; Richard Powell, *Powell on Real Property* ¶ 513[3], at pp. 41-142 (1995). For modern English manifestations, see David Hayton, *Developing the Obligation Characteristic of the Trust*, 117 L. Q. Rev. 96, 107-08 (2001); Paul Matthews, *From Obligation to Property, and Back Again? The Future of the Non-Charitable Purpose Trust*, in Hayton, *supra* note __, at 203-41; George Gretton, *Trusts Without Equity*, 49 Int'l & Comp. L. Q. 599, 603-08 (2000); Joshua Getzler, *Leg-*

A. Trust Law as Property Law

In accord with the views of Scott,[20] the law of trusts is most frequently classified as a species of property law. The 1959 Restatement (Second) of Trusts, for example, characterizes the "creation of a trust . . . as a *conveyance* of the beneficial interest in the trust property rather than as a *contract*."[21] Likewise Gregory Alexander recently distinguished the trustee's fiduciary obligation from those of corporate and other fiduciaries on the ground that the fiduciary relationship in trust law is "property-based."[22] In England, moreover, a leading treatise suggests that the law of trusts "is at the heart of the common law of property,"[23] and the just-finalized (2003) first two volumes of the Restatement (Third) of Trusts retain the view of the Second Restatement that the stake of the beneficiaries is in the nature of a property interest.[24]

For developing a functional understanding of trust law, however, merely classifying it as property law, without a functional analysis of the trust's proprietary or *in rem* features, is unsatisfying.[25] To be sure, the existence of specifically identified property (the trust *res*) is necessary for trust formation.[26] But

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islative incursions into modern trusts doctrine in England: The Trustee Act 2000 and the Contracts (Rights of Third Parties) Act 1999, 2 Glob. Jur. Top. Art. 2 (2002); Joshua Getzler, *Patterns of Fusion* 164-65, in Peter Birks, ed., *The Classification of Obligations* 157-92 (1997); Neil Jones, *Trusts in England after the Statute of Uses* 192-96, in Richard Helmholz & Reinhard Zimmermann (eds.), *Intinera Fiduciae: Trust and Treuhand in Historical Perspective* 173 (1998); Michael Macnair, *The Conceptual Basis of Trusts in the Later 17th and Early 18th Centuries* 221-29, in id. at 207; Richard Edwards, *Trusts and Equity* 16-29 (5th ed. 2002); Graham Moffat, *Trusts Law—Texts and Materials* 190-95 (3d ed 1999); Richard Nolan, *Property in a Fund* (manuscript). See also Patrick Parkinson, *Reconceptualising the Express Trust*, 61 Camb. L. J. 657 (2002); Stefan Grundmann, *The Evolution of Trust and* Treuhand *in the 20th Century* 471-78, in Helmholz & Zimmermann, *supra*, at 470; C.E.F. Rickett, *The Classification of Trusts*, 18 N. Z. U. L. Rev. 305 (1999); Gregory S. Alexander, *The Transformation of Trusts as a Legal Category*, 5 L. & Hist. Rev. 303, 322-50 (1987); Joel C. Dobris, Stewart E. Sterk, & Melanie B. Leslie, *Estates and Trusts* 476-77 (2d ed. 2003); Elias Clark, et. al., *Gratuitous Transfers: Wills, Intestate Succession, Trusts, Gifts, Future Interests, and Estate and Gift Taxation* 454-56 (4th ed. 1999).

[20] See Langbein, *supra* note __, at 643-46. See also Eugene F. Scoles, Edward C. Halbach, Jr., Ronald C. Link, & Patricia Gilchrist Roberts, *Problems and Materials on Decedents' Estates and Trusts* 605-06 (6th ed. 2000); Parkinson, *supra* note __, at 657-58.

[21] Restatement (Second) of Trusts § 197 cmt. b (emphasis added). See Langbein, *supra* note __, at 648-49.

[22] Gregory S. Alexander, *A Cognitive Theory of Fiduciary Relationships*, 85 Cornell L. Rev. 767, 768 & n. 7 (2000). See also Getzler, *supra* note __, at 10-14 (similar analysis by an English trust scholar). But see Sitkoff, *supra* note __ (comparing the fiduciary obligation in corporate and trust law).

[23] Robert Pearce & John Stevens, *The Law of Trusts and Equitable Obligations* v (3d ed. 2002).

[24] See, e.g., Restatement (Third) of Trusts § 5(i) & cmt. i.

[25] See Hansmann & Mattei, *supra* note __, at 435-38 ("While there is an extensive legal literature on the institution of the trust, that literature—whether domestic or comparative in focus—tends to be doctrinal rather than broadly functional in perspective."). See also Langbein, *supra* note __, at 643-66; Sarah Worthington, *The Commercial Utility of the Trust Vehicle*, in David Hayton, ed., *Extending the Boundaries of Trusts and Similar Ring-Fenced Funds* 135 (2002).

[26] Restatement (Second) of Trusts § 74; II Scott on Trusts § 74, pp. 428-32. See also Jane B. Baron, *The Trust Res and Donative Intent*, 61 Tul. L. Rev. 45 (1986). This is an important difference between the trust and, say, a life insurance contract. The insurance company, unlike a trustee, is not required to segregate any assets. See, e.g., Jesse Dukeminier & Stanley M. Johanson, *Wills, Trusts, and Estates* 332 n. 2 (6th ed. 2000).

continuing to deem trust law to be a species of property law for that reason,[27] or to do so because of the private trust's origin in the conveyance of land, obscures not only the trust's proprietary functions, but also trust law's highly enabling, elastic, flexible, and default nature with respect to its *in personam* relations. As Scott's famous treatise observes, "The duties of the trustee are such as the creator of the trust may choose to impose; the interests of the beneficiaries are such as he may choose to confer upon them."[28]

Accordingly, the task for the functional study of trust law should be to identify its *in rem* proprietary elements and then to understand how they have been blended over time with the trust's *in personam* contractarian elements. For as Thomas Merrill and Henry Smith have recently observed, the modern law of trusts offers many of the *in rem* benefits of property law while at the same time offers much of the *in personam* flexibility of contract law.[29]

B. The Contractarian Challenge

In an important recent article, John Langbein offered a functional account of the law of trusts that challenged the received wisdom of trust law as property law by contending that trust law's contractarian elements predominate. To Langbein, "the deal between settlor and trustee is functionally indistinguishable from the modern third-party-beneficiary contract. Trusts are contracts."[30] In comparison to the meaning of "contractarian" as that term is used in the literature of corporate law and economics, however, Langbein's contractarian approach is more closely allied with the law of contracts than with the "nexus of contracts" metaphor that informs the agency cost theories of the firm.[31] On this view, the basis for the rights and remedies of the beneficiary as against the trustee, which is to say the law of trust governance, might be reckoned for expositional purposes as a third-party beneficiary contract between the settlor and trustee.[32]

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[27] See II Scott on Trusts § 74, pp. 429-30; Parkinson, *supra* note __, at 658-59, 663-67; Rickett, *supra* note __, at 308-09. See also Baron, *supra* note __, at 51-54. Cf. Langbein, *supra* note __, at 627.

[28] I Scott on Trusts § 1, p. 2. See also Halbach, *supra* note __, at 133.

[29] See Merrill & Smith, *supra* note __, at 843-49. See also Henry Hansmann & Reinier Kraakman, *Property, Contract, and Verification: The* Numerus Clausus *Problem and the Divisibility of Rights*, 31 J. Legal Stud. S373, S375 (2002). Cf. Hayton, *supra* note __, at 107-08; Francis S. Philbrick, *Property* 10, 150-60 (1939).

[30] Langbein, *supra* note __, at 627. See also Parkinson, *supra* note __, at 659, 676-82 (suggesting "that the law of trusts is better conceptualised as a species of obligation rather than being understood as a form of property ownership").

[31] Compare Langbein, *supra* note __, at 627, with Bainbridge, *supra* note __, at 27-28 ("As used by contractarians, however, the term is not limited to those relationships that constitute legal contracts."); Melvin A. Eisenberg, *The Conception That the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. Corp. L. 819, 822-23 (1999). See also *infra* Part II.C; sources cited in *supra* note 1.

[32] See Langbein, *supra* note __, at 650. One might think of the rights and duties imposed by the trust instrument as stemming not from the law of trusts but rather from the law of *the* trust. Cf. E. Allan Farnsworth, *Contracts* § 7.1, pp. 425-26 (3d ed. 1999).

Langbein's analysis implies that trust law's role is to offer a set of standardized terms that minimize transaction costs for the deal between the settlor and the trustee. By invoking the law of trusts, the settlor and the trustee need only record the extent to which their deal deviates from the default governance regime.[33] This view has two important normative implications. First, trust law's default governance regime, including most critically the fiduciary obligation of the trustee to the beneficiaries,[34] should reflect the terms for which the parties would likely have bargained with low negotiation costs and full information. Second, courts should employ an intention-seeking approach on questions of interpretation.[35] Thus, with respect to matters of internal trust governance, Langbein demonstrates both the positive and the normative power of the sort of hypothetical bargain analysis that is familiar from contract and corporate law and economics.[36]

For purposes of understanding the relevance of trust law to the dealings of the trusts' principal parties with outsiders, however, the model of the trust as functionally equivalent to a third-party beneficiary contract runs into trouble. The problem is that in the usual third-party beneficiary contract, the rights of the parties and third-party beneficiaries to the contract do not implicate the rights of other nonparties to the deal. But regulating the relationships with outsiders of the trust's insiders (the trustee, the beneficiaries, and the settlor) is a key feature of trust law, one that implicates something of an *in rem* dynamic.[37] This includes the law of trustee insolvency (an exceedingly rare phenomenon in donative trusts but an important consideration for commercial trusts);[38] spendthrift trusts (the more common problem of beneficiary insolvency);[39] equitable tracing principles;[40] and the continuity of the office of the trustee despite turn-

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[33] See Langbein, *supra* note __, at 660-63. See also Ogus, *supra* note __, at 206-07.

[34] See *infra* Part IV.D.

[35] See *infra* note 106 and text accompanying.

[36] Langbein, *supra* note __, at 630, 663-64. See, e.g., Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L. J. 87, 89-91 (1989) (collecting illustrative examples).

[37] This is the important contribution of Hansmann & Mattei, *supra* note __. See also Hansmann & Kraakman, *supra* note __; Hansmann & Mattei, *supra* note __. For discussion and references see *infra* Part I.C.

[38] Langbein himself called the law of trustee insolvency "the weak point of contractarian analysis." Langbein, *supra* note __, at 667-69. See also Hansmann & Mattei, *supra* note __, at 454-61, 469-72; Merrill & Smith, *supra* note __, at 846-47; Getzler, *supra* note __, at 12-13. On the relevance of insolvency to commercial trusts, see Schwarcz, *supra* note __, at 581.

[39] See generally Restatement (Second) of Trusts §§ 149-62; *infra* Part IV.B.2. Although the law of contracts sometimes allows the promisee (the role played by the settlor in Langbein's model) to disable the third-party beneficiary from *assigning* his or her chose in action to another, see Farnsworth, *supra* note __, at § 11.4, pp. 717-18, it does not allow for the promisee to disable the third-party beneficiary from *alienating* that chose in action to both voluntary *and* involuntary creditors. See Hansmann & Mattei, *supra* note __, at 452-53 & n. 58. Cf. David M. English, *Is There A Uniform Trust Act in Your Future*, Prob. & Prop. 25, 30 (January/February 2000).

[40] See *infra* Part IV.B.1.

over in its occupant.[41] Explanation of these features requires acknowledgement of trust law's proprietary features. Thus, as Langbein concluded, "Trust is a hybrid of contract and property, and acknowledging contractarian elements does not require disregarding property components whose convenience abides."[42]

C. Asset Partitioning and Organizational Law

In a subsequent article that revisited the functional relevance of trust law's proprietary features, Henry Hansmann and Ugo Mattei argued "that it is precisely the property-like aspects of the trust that are the principal contribution of trust law."[43] This is not to say that they have taken up the mantle of Austin Scott. To the contrary, they "agree with Langbein that, so far as the relationships between the settlor, the trustee, and the beneficiary are concerned, trust law adds very little to contract law."[44] Rather, they argued that the important contribution of trust law is its ability "to facilitate an accompanying organization of rights and responsibilities between the three principal parties [i.e., the settlor, the trustee, and the beneficiary] and third parties, such as creditors, with whom the principal parties deal."[45] By this Hansmann and Mattei refer in particular to "the use of trust law to shield trust assets from claims of the trustee's personal creditors."[46]

So Hansmann and Mattei's contribution—which might be understood as a specific application of a later, more general project by Hansmann and Reinier Kraakman[47]—was to stress the importance of trust law's extraordinary "asset partitioning" function. That is, the law of trusts allows the trustee to deal separately with creditors of the trust property from creditors of his or her own personal property. With respect to all creditors, the law of trusts in effect (though

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[41] See *infra* Part III.B. In fairness, however, many contracts provide for assumption or assignment to deal with the turnover problem. See, e.g., Farnsworth, *supra* note __, at ch. 11.

[42] Langbein, *supra* note __, at 669.

[43] Hansmann & Mattei, *supra* note __, at 469.

[44] Id. at 470.

[45] Id. at 472, 451-64. The text above should not be read, however, as an embrace of their overstatement that "organizational law is much more important as property law than as contract law," Hansmann & Kraakman, *supra* note __, at 390, or that "[p]rivately prepared standard form contracts" could match the drafting efficiencies of the present system of public provision of default rules for trust governance. Hansmann & Mattei, *supra* note __, at 448-49. True, in the absence of trust law the parties could incorporate the language of the Restatement's fiduciary provisions into their deal. See Hansmann & Mattei, *supra* note __, at 448. But the viability of that approach depends on the existence of ample judicial exegesis of the Restatement's text. Precedent is a public good, and the terms of a privately prepared contract can be duplicated by anyone. See Easterbrook & Fischel, *supra* note __, at 35. See also Marcel Kahan and Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 Va. L. Rev. 713 (1997); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 Va. L. Rev. 757 (1995).

[46] Id. at 438, 451-64.

[47] Hansmann & Kraakman, *supra* note __, at 414-17. See also Hansmann & Kraakman, *supra* note __, at S405-07.

not formally, at least not yet[48]) splits the trustee into "two distinct legal persons: a natural person contracting on behalf of himself, and an artificial person acting on behalf of the beneficiaries."[49] This creation of "two distinct legal persons" could not feasibly be reproduced with explicit contracting.[50] Thus asset partitioning represents an important difference between organizational forms and simple contractual arrangements.[51] The former have an external proprietary or *in rem* dimension that complements their internal contractarian or *in personam* features.

By giving a functional explanation for and a specific identification of the essential proprietary dimension of trust law, the Hansmann and Mattei project may be harmonized with Lanbein's contractarian approach. Taken together, they show that the law of trusts, like the law of other organizations, offers a nice blending of *in rem* and *in personam* features. And this implies that, going forward, the study of the law of private trusts should more closely resemble the study of other organizational forms,[52] an endeavor in which agency costs analysis abounds.

D. The Rise of the Managerial Trust

Further support for treating the law of trusts as organizational law stems from the empirical observation that the use of the private trust in modern practice has come increasingly to resemble the use of other organizational forms. As Langbein and others have shown, owing to the liberalization of testamentary freedom, the lifting of feudal restrictions on land transfer, and the shift in modern wealth away from land,[53] the private trust has evolved from a vehicle for conveying and preserving ancestral land into an organizing device that allows owners of property to ensure the ongoing and intergenerational professional management of their wealth.[54] In other words, in addition to classic but still relevant context-specific rationales such as minimizing taxes and asset

[48] See Halbach, *supra* note __, at 1882-83 ("Without abandoning the basic definition of a trust as a fiduciary relationship, there appear to be subtle but practically significant departures from the concept that a trust is not an entity."); Restatement (Third) of Trusts § 2 cmt. a & Reporter's Notes thereto. See also *Tatarian v. Commercial Union Insurance Co.*, 672 N.E.2d 997, 1000 (Mass. App. 1996) (analogizing the trust to a corporation and treating the trust as a separate entity). Cf. Schwarcz, *supra* note __, at 574-75.

[49] Hansmann & Kraakman, *supra* note __, at 416.

[50] See Hansmann & Mattei, *supra* note __, at 466.

[51] See Hansmann & Kraakman, *supra* note __.

[52] For a specific application of this general point, see Richard W. Painter, *Contracting Around Conflicts in a Family Representation: Louis Brandeis and the Warren Trust*, 8 U. Chi. L. Sch. Roundtable 353, 367-69 (2001).

[53] See Moffat, *supra* note __, at 37 ("The significance for trusts law of this shift in the nature of family wealth-holdings—that is, from land (predominantly) to investment assets as well as land—can scarcely be overstated."). See also John H. Langbein, *The Twentieth-Century Revolution in Family Wealth Transmission*, 86 Mich. L. Rev. 722 (1988).

[54] See, e.g., Langbein, *supra* note __, at 632-43; Moffat, *supra* note __, at 24-33. Cf. Halbach, *supra* note __, at 133-36.

protection, the donative trust today is also used more generally to bring together portfolio management skills with investment capital.

Thus, the use of professional fiduciaries is on the rise.[55] The default rules governing trust investment now require something of a total return investment strategy consistent with modern portfolio theory.[56] The fiduciary obligation has eclipsed limitations on the trustee's powers as the primary governance tool for aligning the interests of the trustee, who in the modern private trust is vested with vast discretion, with the interests of the beneficiaries.[57] All of this militates towards the view that, going forward, the study of the law of trusts should more closely resemble the study of other organizational forms. As we shall see, this is perhaps clearest with respect to the problem of agency costs in the modern managerial trust.

II. ECONOMIC FOUNDATIONS

For those unfamiliar with the economics of the principal-agent problem or the agency cost theories of the firm that the principal-agent problem underpins, this Part offers a brief overview. The goal is to provide context for the application of these ideas in Parts III and IV to the gratuitous private express trust.

A. The Theory of the Firm

In his 1937 essay, "The Nature of the Firm," Ronald Coase endeavored to understand why some economic activity took place within firms rather than in open market transactions.[58] Coase's insight was that such activity would be organized within firms when the expected costs of allocating resources by internal direction were less than the expected transaction costs of undertaking the same activity in an open market transaction.[59] Coase's contribution was therefore to demonstrate the salience of transaction costs. From this beginning at least three different though complementary modern approaches to the theory of the firm have evolved.

[55] "Private trustees still abound, but the prototypical modern trustee is the fee-paid professional, whose business is to enter into and carry out trust agreements." Langbein, *supra* note __, at 638. See also Alexander, *supra* note __, at 774-75 ("Today, the vast majority of trusts are administered by large financial institutions, such as trust companies and trust developments of commercial banks."); *Peering into Trust Industry Archives*, 115 Tr. & Est. 452 (1976). Several readers of earlier drafts questioned the empirical basis for this claim, which warrants further investigation. See Sitkoff, *supra* note __, at __. The specific point, however, is not critical to the ensuing agency costs analysis, and this empirical study is a project for another day.

[56] See *infra* Part IV.A.2.

[57] See Langbein, *supra* note __, at 638-43. See also John H. Langbein, *The Uniform Trust Code: Codification of the Law of Trusts in the United States*, 15 Tr. L. Int'l 66, 71 (2001).

[58] R.H. Coase, *The Nature of the Firm*, 4 Economica (n.s.) 386 (1937), reprinted in R.H. Coase, *The Firm, the Market, and the Law* 33-55 (1988). For a general introduction, see Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 Colum L. Rev. 1757 (1989).

[59] Coase, *supra* note __, at 38

The transaction costs approach, which is most closely associated with Oliver Williamson and is probably the most direct descendent of Coase's essay, focuses on the boundary between the firm and the market.[60] Property rights theories of the firm, in contrast, are "very much in the spirit of the transaction cost literature of Coase and Williamson, but differ by focusing attention on the role of physical, that is, nonhuman, assets in a contractual relationship."[61] The core relationships that aggregate into the trust as an organizational form, however, are for the most part open-market transactions rather than intra-firm transfers.[62] So neither the transaction costs nor the property rights approaches appear as immediately relevant to the present project as the agency cost theories.

Agency cost theories of the firm, which owe their origin to papers by Alchian and Demsetz and by Jensen and Meckling, model organizations as webs of express, implied, and metaphorical contracts among individuals with conflicting interests, all of which revolve around an organizing legal construct.[63] So the key insight of this so-called "nexus of contracts" approach was to demonstrate the importance of principal-agent economics for the study of organizations. As Jensen and Meckling put it, "Many problems associated with the inadequacy of the current theory of the firm can also be viewed as special cases of the theory of agency relationships, in which there is a growing literature."[64] Hence, the agency cost theories of the firm focus on the problems of shirking and monitoring that stem from information asymmetries within the organization's component relationships. A brief review of the economics of agency is therefore in order.[65]

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[60] See Oliver E. Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* (1985).

[61] Hart, *supra* note __, at 1765 & n. 32. See Stanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and lateral Integration*, 94 J. Pol. Econ. 691 (1986); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. Pol. Econ. 1119 (1990).

[62] See Rock & Wactler, *supra* note __, at 664-66.

[63] Alchian & Demsetz, *supra* note __, at 778; Jensen & Meckling, *supra* note __, at 56, 367 n. 12.

[64] Jensen & Meckling, *supra* note __, at 53-54. See also Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & Econ. 301 (1983); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288 (1980).

[65] For accessible and relatively nonmathematical introductions to principal-agent modeling, see Hal R. Varian, *Intermediate Microeconomics: A Modern Approach* 667-88 (6th ed. 2003); Kenneth J. Arrow, *The Economics of Agency*, in John W. Pratt & Richard J. Zeckhauser, eds., *Principles and Agents: The Structure of Business* 37-51 (1985). See also Kathleen M. Eisenhardt, *Agency Theory: An Assessment and Review*, 14 Acad. Mgmt. Rev. 57 (1989). For accessible formal introductions, see Mas-Colell, Whinston, & Green, *supra* note __, at 477-510 (1995); Hal R. Varian, *Microeconomic Analysis* 440-71 (3d ed. 1992); David M. Kreps, *A course in microeconomic theory* 577-719 (1990); Jean-Jacques Laffont & David Martimort, *The Theory of Inventives: The Principal-Agent Model* (2002). Important scholarly statements include Stephen A. Ross, *The Economic Theory of Agency: The Principal's Problem*, 63 Am. Econ. Rev. 134 (1973); Steven Shavell, *Risk sharing and incentives in the principal and agent relationship*, 10 Bell J. Econ. 55 (1979); Sanford J. Grossman & Oliver D. Hart, *An Analysis of the Principal-Agent Problem*, 51 Econometrica 7 (1983). For a basic discussion of the applicability of principal-agent modeling to legal problems, see Eric A. Posner, *Agency Models in Law and Economics*, in Eric A. Posner, ed., *Chicago Lectures in Law and Economics* 225 (2000).

B. The Economics of Agency

Using the vocabulary of agency in economic rather than legal parlance,[66] agency problems are caused by the impossibility of complete contracting when one party (the agent) has discretionary and unobservable decision-making authority that affects the wealth of another party (the principal). When the agent's effort is unobservable, ex post enforcement of the ex ante bargain, no matter how detailed it may be, is impractical. The problem is that the principal will be unable to ascertain whether a disappointing result was caused by the agent's breach or an exogenous factor. Thus, unless there is a perfect correlation between the agent's effort and the project's observable profits, in which case a good or bad return would conclusively show the level of the agent's effort,[67] it will be difficult for the principal to prevent shirking by the agent. This is the problem of "hidden action," sometimes called "moral hazard."[68] The problem is one of post-contractual asymmetric information.[69]

Consider, for example, "a real estate agent on a 5 percent commission."[70] Assuming the principal cannot feasibly monitor the agent's day-to-day activities, the agent has no incentive to "undertake even $10 worth of effort to improve the realized price by $100, because the agent reaps only $5 of this sum." But this $10 of additional effort would have been in the principal's best interests. If the parties' interests were perfectly aligned (as would be the case if the agent were selling his or her own property), then the agent would have undertaken the effort. The agent's failure to do so leads to a welfare loss. True, the divergence in this example is an artifact of the 5 percent commission, and a higher commission of say, 15 percent, would have solved the problem here. But no compensation scheme short of transferring complete ownership of the project to the agent will solve the incentive problem when the agent's efforts are unobservable.

The losses to the parties that stem from such a misalignment of interests are called agency costs. The Jensen and Meckling definition is ubiquitous in the legal literature: "Agency costs" refers to the sum of the costs of the principal's "monitoring efforts," the costs of the agent's "bonding efforts," and the "residual

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[66] The difference is that a principal-agent relationship in law requires a showing of control. See Restatement (Second) of Agency §§ 1; Restatement (Third) of Agency § 1.01 & cmt. c (T.D. No. 2, approved 2001). Cf. Allen & Kraakman, *supra* note __, at § 2.3.3, p. 36.

[67] See Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. Rev. 1045, 1049-51 (1991); Mas-Colell, Whinston, & Green, *supra* note __, at 478-79.

[68] See Mas-Colell, Whinston, & Green, *supra* note __, at 477 n. 1.

[69] A nice statement may be found at Laffont & Marimort, *supra* note __, at 3 (emphasis in original):

> The starting point of incentive theory corresponds to the problem of delegating a task to an agent with private information. This private information can be of two types: either the agent can take an action unobserved by the principal, the case of *moral hazard* or *hidden action*; or the agent has some private knowledge about his cost or valuation that is ignored by the principal, the case of *adverse selection* or *hidden knowledge*.

[70] This illustration is taken from Easterbrook & Fischel, *supra* note __, at 91. See also Posner, *supra* note __, at 225-29.

loss" as measured by the "dollar equivalent of the reduction in welfare experienced by the principal as a result of" the divergence in the principal's and the agent's interests.[71] In the foregoing example the lost $100 increase in the sale price would count as residual loss.

C. Agency Costs and Organizational Forms

Returning to the agency cost theories of the firm, the arresting insight of Jensen and Meckling's nexus of contracts model was to show that the study of organizational forms involves more concretely the study of clusters or webs of discrete principal-agent relationships.[72] Accordingly, subsequent research has explored the effectiveness of various devices, legal and otherwise, at minimizing agency costs within different organizational forms; and this literature has thrown light on the governance features that help distinguish different organizational forms from each other.[73] In particular, the literature of enterprise organizations has explored managerial labor markets,[74] incentive compensation,[75] alienable residual claims,[76] flexible sharing rules and mutual monitoring,[77] the market for corporate control (i.e., the takeover market),[78] disclosure rules,[79] and liability rules such as fiduciary duties,[80] as devices for minimizing agency costs.

The private express trust has not been similarly subjected to systematic agency costs analysis.[81]

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[71] Jensen & Meckling, *supra* note __, at 53-55.

[72] See *supra* notes 63-64 and text accompanying.

[73] See, e.g., Fama & Jensen, *supra* note __, at 311-21; Eugene F. Fama & Michael C. Jensen, *Organizational Forms and Investment Decisions*, 14 J. Fin. Econ. 103 (1985). Cf. Ogus, *supra* note __, at 195.

[74] See, e.g., Fama, *supra* note __, at 295.

[75] See Tod Perry and Marc Zenner, *CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?*, 35 Wake Forest L. Rev. 123 (2000); Kevin J. Murphy, *Executive Compensation*, in Orley Ashenfelter and David Card, eds., *Handbook of Labor Economics* 2485 (1999); Symposium on Management Compensation and the Managerial Labor Market, 7 J. Acct. & Econ. (1985). See also Lucian Arye Bebchuk, Jesse M. Fried, & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. Chi. L. Rev. 751 (2002).

[76] See, e.g., Fama & Jensen, *supra* note __, at 332-33.

[77] See id. at 335-37 (discussing professional partnerships).

[78] See, e.g., Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110 (1965); Symposium on the Market for Corporate Control, 11 J. Fin. Econ. (1983); Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. Chi. L. Rev. 973 (2002).

[79] See, e.g., Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. Chi. L. Rev. 1047 (1995); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669 (1984).

[80] See, e.g., Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 Cornell L. Rev. 261 (1986); sources cited in *infra* note __.

[81] See *supra* note __.

III. THE AGENCY COSTS MODEL

In comparison to the agency costs approach to corporate law,[82] the agency costs approach to trust law will be both simpler and more complex. It is in some respects simpler, because the trust is a less complicated organization. This makes the agency costs analysis and reckoning the hypothetical bargain of the principal parties easier. In other respects it is more complicated, however, because the actions of the individuals interested in the trust are not metered by price signals from efficient capital markets.[83] Moreover, the law regularly subordinates the interests of the beneficiaries as residual claimants to the dead hand interests of the settlor, an outgrowth of the frequently paternalistic function of the donative trust.[84]

A. The Contractarian Nexus

The trust is more than a simple contract between private parties. It is an organizational form with *in rem* as well as *in personam* dimensions. Thus, like the corporation and other organizational forms, the trust blends an external *in rem* asset partitioning dynamic with internal *in personam* contractarian flexibility. The trust's internal relationships are contractarian in that the law supplies default terms around which the parties may contract; and they are contractarian in that the underlying governance problems posed by the asymmetric information of the parties are amenable to principal-agent modeling.

True, there is tension between the contractarian metaphor and the position of the beneficiary. Beneficiaries are not normally thought to give ex ante consent and they are typically in no position to bargain. Moreover, as discussed in Part I, there remains much debate about whether the beneficiaries' stake in the trust is a species of obligation or property law. But even if the beneficiaries do not literally contract with the other principal parties, and even if the beneficiaries' stake is doctrinally more proprietary than contractarian, the problems of governance relevant to the beneficiaries' welfare are nonetheless illuminated by contractarian principal-agent modeling. From an economic perspective, hidden action (and possibly hidden information) abounds, so trust governance must confront both incentive and risk-sharing problems.[85] Accordingly, greater insight into the nature and function of trust law will come from a conception of the trust as a de facto legal entity that serves as the organizing construct for an aggregation of contractarian relationships. This vision of the trust is analogous to the

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[82] The model of the corporation as a nexus of contracts, which has most notably been advanced by Easterbrook & Fischel, *supra* note __, is the clearest example.

[83] See generally Sitkoff, *supra* note __. The trust has this in common with the close corporation. See Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 Stan. L. Rev. 271, 274-77 (1986).

[84] See, e.g., Mary Louise Fellows, *Spendthrift Trusts: Roots and Relevance for Twenty-First Century Planning*, 50 Rec. Assoc. Bar N.Y. 140 (1995).

[85] See generally Eisenhardt, *supra* note __, at 58.

Jensen and Meckling nexus of contracts model of the firm,[86] and as was the case for their analysis of the corporation, it implies the viability of agency costs analysis for trust law.

Thus, to return to the exemplary trust described in the introduction, which was settled by S for the benefit of B1 and B2 with T as trustee, the constituent relationships include those between S and T; T and the Bs; S and the Bs; T and T's creditors; the Bs and creditors of the Bs; S and S's creditors; S and a character known as the trust "protector" (who will be introduced later);[87] the Bs and the trust "protector"; T and the agents to whom T delegates authority; and T's delegates and the Bs.[88] The dominant (and sometimes conflicting) relationships are between S and T and between the Bs and T.

Denaturing the trust into its constituent relationships brings into view the applicability of hypothetical bargain analysis and the economics of the principal-agent problem. For if they are characterized by reference to their underlying economics, both the relationship between S and T and the relationship between the Bs and T might be modeled on the principal-agent scheme. The former is the temporal agency problem that helps distinguish the economic analysis of trust law from that of corporate law.[89] The latter is the traditional agency problem when risk-bearing is separated from management. This means that there is the potential for considerable tension between T's loyalty to S and T's loyalty to the Bs. As we shall see in the next Part, American trust law resolves this tension by requiring T to maximize the welfare of the Bs within the ex ante

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[86] "It is important to recognize that most organizations are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals. . . . By 'legal fiction' we mean the artificial construct under the law which allows certain organizations to be treated as individuals. . . . The private corporation or firm is simply one form of legal fiction that serves as a nexus for contracting relationships." Jensen & Meckling, *supra* note __, at 56 & 367 n. 12. Cf. Alchian & Demsetz, *supra* note __, at 778; Easterbrook & Fischel, *supra* note __, at 11-12.

[87] See *infra* Part IV.B.4.

[88] See, e.g., *In re Bond & Mortgage Guarantee Co.*, 303 N.Y. 423 (1952); *In re Kellogg,* N.Y.L.J. 25 (Dec. 30, 1999). The importance of the relations that fall into these last two categories has increased with the assimilation of portfolio theory into modern prudent investor standards. Current law now permits and might even require amateur trustees to delegate investment authority to professionals—what Langbein has called the "fractionation of trusteeship." John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 Iowa L. Rev. 641, 665-66 (1996). See Uniform Prudent Investor Act § 9 (1994); Restatement (Third) of Trusts: Prudent Investor Rule § 171 & cmt. f (1992); John H. Langbein, *Reversing the Nondelegation Rule of Trust-Investment Law*, 59 Mo. L. Rev. 105 (1994). See also Langbein, *supra* note __, at 72-73. Prudent investor rules in the U.K. are undergoing a similar shift. See, e.g., Penelope Reed & Richard Wilson, *The Trustee Act 2000: A Practical Guide* (2001). These scenarios might be amenable to modeling as a common agency. See B. Douglas Bernheim & Michael D. Whinston, *Common Agency*, 54 Econometrica 923 (1986). See also Bengt Holmstrom & Paul Milgrom, *Multitask Principal—Agency Analyses: Inventive Contracts, Asset Ownership, and Job Design*, 7 J. L. Econ. & Org. 24 (1991); Hideshi Itoh, *Incentive to Help in Multi-Agent Situations*, 59 Econometrica 611 (1991); Joel S. Demski, *Optimal Incentive Contracts with Multiple Agents*, 33 J. Econ. Theory 152 (1984); Bengt Holmstrom, *Moral hazard in teams*, 13 Bell J. Econ. 324 (1982).

[89] And agency law too. Legal agency requires the ongoing existence of a principal under whose control the agent acts. This enables the agent to seek clarification from the principal and the principal to maintain watch over the agent.

constraints imposed by S. This is to say that under the American (but not necessarily the English) approach the donor's intent controls.

B. The Office of the Trustee

The office of the trustee is in effect (though not formally) a separate entity from the trustee personally. This separate entity-like effect, which stems from the trust's partitioning of assets, implicates an *in rem* dynamic as it is effective against nonparties to the trust. The de facto office of trustee serves as the organizing hub for the various relations that aggregate into the private trust.[90]

With respect to creditors, turnover within the office of trustee and/or the personal insolvency of a particular trustee does not affect the continuity of the trust. Deals struck by a prior trustee as such bind successor trustees to the extent that they would have been enforceable against the prior trustee when in office.[91] The prior trustee, however, has no office-based liability to creditors of the trust once out of office unless he or she personally guaranteed the obligation. No trustee, whether in or out of office, has personal liability to outside creditors of the trust unless he or she personally guaranteed the obligation.[92] And the personal creditors of an insolvent trustee—a rather rare phenomenon in donative trusts but an important consideration for commercial trusts—have no recourse against the assets of the trust.[93]

Moreover, the rules that govern the trustee's liability towards creditors of the trust property tend to be mandatory with respect to the settlor but default with respect to the trustee and those with whom the trustee deals.[94] They are mandatory with respect to the settlor, because as to the settlor these rules have an *in rem* quality—they touch on the rights of outsiders.[95] And they are default

[90] Cf. Hayton, *supra* note __, at 155.

[91] See, e.g., *Wood v. Potter*, 289 N.W. 131, 133 (Mich. 1939); *Schroeder v. CMC Real Estate Corp.*, 510 N.E.2d 1045, 1048-49 (Ill. App. 1987). The qualification addresses the possibility of self-dealing or other grounds for voiding the transaction, and indeed the failure of a successor to pursue such remedies would be an independent breach of trust. See *infra* note 97 and text accompanying.

[92] See, e.g., UTC § 1010(a). The traditional rule of personal liability unless provided otherwise, see IIIA Scott on Trusts § 261, p. 417; Restatement (Second) of Trusts § 265 & cmt. a, can be understood as a penalty default that forces trustees to disclose that they are operating in a representative rather than individual capacity. See Hansman & Mattei, *supra* note __, at 459-61; Merrill & Smith, *supra* note __, at 846-47.

[93] See Hansmann & Mattei, *supra* note __, at 454 & n. 64 (collecting authority). See generally MacNair, *supra* note __, at 224-29.

[94] See, e.g., UTC 1010(a); UTC § 105(b)(11) ("The terms of a trust prevail over [common and statutory law] except . . . the rights under Sections 1010 through 1013 of a person other than a trustee or beneficiary."); UTC Art. 10 gen. cmt. ("The settlor may not limit the rights of persons other than beneficiaries as provided in Sections 1010 through 1013."). See generally John H. Langbein, *Mandatory Rules in the Law of Trusts* (manuscript on file with author); Langbein, *supra* note __, at 76-79 (analyzing the UTC's mandatory features); English, *supra* note __, at 27. Cf. Restatement (Second) of Trusts § 263; IIIA Scott on Trusts § 263, pp. 423-32.

[95] On similar reasoning agency law does not allow principals to opt out of liability to third parties on an apparent authority theory. See, e.g., Restatement (Second) of Agency §§ 160-61.

with respect to the trustee and outside creditors, because as to them these rules concern only *in personam* matters. Parties may fix their rights with respect to each other; but when outsiders are implicated, the law cabins the parties' flexibility.

The rules of trustee liability towards beneficiaries are quite different, but the distinctions follow naturally from the implication of the nexus of contracts model of organizational forms that it is the trustee *personally* who agrees to manage the assets held by the trustee *as trustee*. Thus, the beneficiaries may seek to surcharge a trustee personally for breach of trust not only while in office but also after the trustee has been sacked; removal does not extinguish the trustee's personal liability for breaches committed while in office.[96] The breaching trustee's successor, however, is not personally liable to the beneficiaries for the prior trustee's breach unless the successor unreasonably fails to discover and rectify the prior breach. But liability in this scenario stems from the successor trustee's own breach.[97]

What is more, the rules of internal trust governance, which is to say the *in personam* rights inter se of the beneficiaries, the settlor, and the trustee, are for the most part default as to the settlor.[98] That not all of these rules are default, however, suggests that there is an irreducible foundation of trust governance law that is mandatory. Indeed, as Langbein explains in a contemporaneous article on trust law's mandatory rules, even though a settlor may opt out of individual fiduciary duties, he cannot authorize a "bad faith" trusteeship or oust fiduciary law in its entirety.[99]

Part of the explanation for these limits are the obvious agency costs consequences of giving the trustee unfettered discretion. As the Delaware Supreme Court put it in a recent opinion, "A trust in which there is no legally binding obligation on a trustee is a trust in name only."[100] But there is more. Further explanation lies in the necessity of keeping clear for third-parties who would deal with the trustee the distinction between property transferred to the trustee in trust versus outright gifts or other forms of limited transfer such as equitable charges.[101] So there is a mandatory irreducible minimum of trust governance,

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[96] As a practical matter this liability will almost always be fixed in an accounting proceeding made incident to the removal action.

[97] See Restatement (Second) of Trusts § 223; III Scott on Trusts § 223, pp. 395-96. This explains why many professionally-drafted trustee succession provisions absolve the successor from this audit responsibility. Without that absolution, many potential successors would decline to serve. For further discussion and references, see Vollmar, Hess, & Whitman, *supra* note __, at 1072-73.

[98] See, e.g., UTC § 105; Langbein, *supra* note __.

[99] See Langbein, manuscript *supra* note __. The motivation for doing so is often to deny entitlement to beneficiaries who the settlor wants to benefit, but not too much—not any further than the settlor's delegate, the trustee, would otherwise allow.

[100] *McNeil v. McNeil*, 798 A.2d 503, 509 (Del. 2002).

[101] Cf. Merrill & Smith, *supra* note __. An equitable charge is created when one party transfers property to another, not subject to a fiduciary obligation (indeed the transferee is permitted to benefit personally from the transferred property), but nevertheless subject to the right of a third party to receive a pay-

not only to serve a protective and cautionary function for the settlor who would otherwise swamp his or her beneficiary in an agency costs morass (a goal that might have been achieved with a penalty default[102]), but also because on this issue the *in personam* (i.e., internal governance) converges with the *in rem* (i.e., external relations authority).[103]

C. The Relative Position of the Settlor

The settlor's intent to create a trust is a prerequisite to trust formation.[104] This means that Langbein's third-party beneficiary contract between the settlor and the trustee is the trigger, as it were, for the set of individual relationships that compose the trust. The settlor-trustee relationship is indeed contractual, as settlors and trustees are free to dicker over the terms of the trust such as compensation (even if in fact they do not).[105] This leads to three points.

First, as Langbein has shown, when interpreting the trustee's obligations under the trust instrument, an intention-seeking standard is normatively desirable.[106] This prescription follows from the insight that in the case of a voluntary transaction between adults, the joint intent of the parties carries a presumption of pareto optimality.[107] Not surprisingly, the new Restatement of Property for donative transfers points in this direction,[108] a positive trend that is also consistent with the idea of the settlor as the dominant principal. Moreover, for the usual transaction-costs-savings reasons, the underlying law of trust governance should supply those terms for which the majority of settlors and trustees would have dickered with full information and low negotiation costs.[109] "The proper

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ment from the transferee. See, e.g., Restatement (Third) of Trusts § 5(h) & cmt. h; I Scott on Trusts §§ 10, 10.3, 10.4; Restatement (Second) of Trusts § 10 & cmts. a-b; *Ogle v. Durley*, 77 So.2d 688, 691-92 (Miss. 1955).

[102] See, e.g., Ayres & Gertner, *supra* note __.

[103] For further discussion, see Langbein, manuscript *supra* note __; *infra* Part IV.C.

[104] See Restatement (Third) of Trusts § 13; Restatement (Second) of Trusts § 23; UTC § 402(a)(2).

[105] See, e.g., Langbein, *supra* note __, at 639, 651. See also Getzler, *supra* note __, at 4. Whether or not there is much dickering in practice doesn't alter the contractual nature of the underlying relationship. All that a lack of actual bargaining suggests is that either (i) the default rules (or, more clearly, the standardized forms and fee schedules typically used by corporate fiduciaries) closely approximate median preferences, or (ii) amateurs such as family members who are dragged into the role are motivated by altruism rather than fees, and indeed such amateurs often receive no fees at all. See also Langbein, *supra* note __, at 639 & n. 66 (comparing the marketing of trust services with the sales of vacuum cleaners).

[106] Langbein, *supra* note __, at 663-64. See also Halbach, *supra* note __ at 1881; Parkinson, *supra* note __, at 676-79; Cf. Hayton, *supra* note __, at 96.

[107] See, e.g., Richard A. Epstein, *Simple Rules for a Complex World* 80-82 (1995); Easterbrook & Fischel, *supra* note __, at 22-25.

[108] "The controlling consideration in determining the meaning of a donative document is the donor's intention. The donor's intent is given effect to the maximum extent allowed by law." Restatement (Third) of Property: Wills and Other Donative Transfers § 10.1 (2003).

[109] See, e.g., Richard A. Posner, *Economic Analysis of Law* § 15.6, p. 454 (6th ed. 2003); Ayres & Gertner, *supra* note __, at 89-91 (collecting scholarly statements); *Wal-Mart Stores, Inc. Associates' Health and Welfare Plan v. Wells*, 213 F.3d 398, 402 (7th Cir. 2000) (Posner, C.J.) (ERISA). See also Posner, at §

question becomes: What was the intention of the parties to the trust deal respecting this point, and if they did not articulate their intention on this matter, which default rule captures the likely bargain they would have struck had they thought about it."[110]

Second, in view of the potential ex ante informational asymmetries between repeat-player trust lawyers and institutional fiduciaries on the one hand, and settlors on the other, there is room in the law of trusts as a normative matter for the occasional welfare-enhancing, information-forcing penalty default rule.[111] And indeed as a positive matter such penalty defaults do exist. Perhaps the most salient example concerns clauses that exculpate the trustee from liability to the beneficiaries for breach of trust. Before enforcing these exoneration clauses, courts often require a showing that the settlor had affirmative knowledge of the clause and its meaning.[112] By forcing this term to be transparent, the rule helps to ensure that the exculpation clause was not mere boilerplate unwittingly embraced by the settlor.

Third, in contrast to the founder of a corporation or a commercial trust,[113] the settlor of a donative private trust receives no direct price signal about the quality of the governance arrangement to which he or she agrees with the trustee.[114] There is no public offering for beneficial interests in a donative private trust, and potential beneficiaries don't purchase their rights from the settlor. So the only price signal in donative trusts about potential governance structures is both weak and ambiguous—the level of commissions, if any, demanded by the trustee.[115] In conjunction with the potential for informational asymmetries noted just above, this bolsters the case for the occasional information-forcing de-

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4.1, p. 96, § 14.3, p. 413, § 14.7, pp. 427-28. This is an implication of R.H. Coase, *The Problem of Social Cost*, 3 J. L. & Econ. 1 (1960).

[110] Langbein, *supra* note __, at 664.

[111] See, e.g., Ayres & Gertner, *supra* note __. The informational asymmetry between trust lawyers and settlor/clients is a source of agency costs in the legal market.

[112] See III Scott on Trusts § 222.4, pp. 393-95; UTC § 1008(b) & cmt ("Subsection (b) responds to the danger that the insertion of such a clause by the fiduciary or its agent may have been undisclosed or inadequately understood by the settlor."); Restatement (Second) § 222(3) & cmt d. See also Langbein, manuscript *supra* note __, at 33-34; *Report on Exculpation Clauses in Trust Instruments: Committee on the Modernization of the Trustee Act*, 22 Est. Tr. Pen. J. 55 (2003) (Canadian law); David Hayton, *English Fiduciary Standards and Trust Law*, 32 Vand. J. Trans. L. 555, 580 (1999) (English law); Langbein, *supra* note __, at 74-75 (discussing the UTC).

[113] See Schwarcz, *supra* note __, at 562.

[114] Cf. Jensen & Meckling, *supra* note __, at 58:

> [T]he owner will bear the entire wealth effects of these expected costs so long as the equity market anticipates these effects. Prospective minority shareholders will realize that the owner-manager's interests will diverge somewhat from theirs; hence the price which they will pay for shares will reflect the monitoring costs and the effect of the divergence between the manger's interest and theirs.

[115] The signal is weak in both directions. Professionals often have company-wide fee schedules, and amateurs such as family members often serve without commission. See *supra* note 105.

fault rule and/or in some cases possibly even disregarding the intent of the settlor.[116]

None of this is to suggest that settlors are disinterested in the quality of the trust's governance regime. To the contrary, a common purpose in settling a trust in the first place, tax exigencies and controlling personalities to one side,[117] is to maximize the welfare of the beneficiaries. The point of the prior paragraph is that settlors do not receive the sort of price signals that would force them accurately to internalize the costs and benefits of the governance arrangement to which they agree with the trustee. Hence, to paraphrase the condition posited by Easterbrook and Fischel as necessary for skepticism about a term in the cognate context of the corporate contract, the consequences for beneficiary welfare of the terms of the trust might "not have been appreciated by" the settlor.[118]

D. Beneficiaries as Residual Claimants

The trustee, individuals hired by the trustee to assist in the trust's management, and those who do business with the trustee as trustee all have fixed claims on the trust corpus that generally have priority over the claims of the beneficiaries. Trustees are free to negotiate for their own fee schedules or other terms designed to protect their interests,[119] and those who do business with the trustee over trust assets can likewise protect themselves by contract. Beneficiaries of donative trusts, however, are limited to taking so much as the trust instrument allows out of whatever is left of the trust's assets when everyone else is done.[120] "The residual risk—the risk of the difference between stochastic [i.e., variable] inflows of resources and promised payments to agents—is borne by those who contract for the rights to net cash flows. We call these agents the residual claimants or residual risk bearers."[121]

To say that the beneficiaries are the residual claimants is to say that managerial decisions are infra-marginal for all the relevant players except for the beneficiaries. This may provide an agency costs explanation for why the default rule for irrevocable trusts is that only the beneficiaries may sue the trustee

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[116] For further discussion and references, see Langbein, manuscript *supra* note __.

[117] Anecdotes from practitioners suggest that some settlors are so control-oriented that their chief motivation is to maintain dominance over their family after death, seeking not just to minimize taxes but sometimes even sacrificing that goal in order to maintain control over the beneficiaries' behavior. See also *infra* note 196. For discussion of strategic intergenerational transfers, see B. Douglas Bernheim, Andrei Shleifer, & Lawrence H. Summers, *The Strategic Bequest Motive*, 93 J. Pol. Econ. 1045 (1985).

[118] Easterbrook & Fischel, *supra* note __, at 17, 23-25, 31. Cf. Langbein, manuscript *supra* note __, at Part II.

[119] See *supra* note __ and text accompanying.

[120] The limitation to donative trusts is necessary because in the commercial context the settlor is often the residual claimant. In these cases the beneficiaries are typically investors in trust certificates that, like debt, only entitle the investors to a return of their investment plus interest. Thereafter any surplus value goes back to the settlor. See Schwarcz, *supra* note __, at 562-53.

[121] Fama & Jensen, *supra* note __, at 328. Cf. Easterbrook & Fischel, *supra* note __, at 67-70.

for a breach of trust.[122] And on the same reasoning the default fiduciary obligations of the trustee are designed to create incentives for the trustee to manage the trust from the beneficiaries' (and hence the marginal) perspective. The trend towards the managerial trust, moreover, increases the significance of the beneficiaries' residual position. Now that the trust is used for more than intergenerational conveyances and the preservation of ancestral land, status as a trust beneficiary brings both greater potential risk and greater potential reward.[123]

Against the foregoing it might be argued that because private trust beneficiaries are nothing more than passive recipients of a donative transfer, the analogy to Jensen and Meckling's nexus of contracts metaphor does not hold. Indeed, even though acceptance (which can be implied) is a required element of every gift,[124] trust beneficiaries do not give consent to their status as such in the same way that parties give consent to a literal contractual relationship. But the nexus of contracts model is just that, a model; and the economics of agency does provide a helpful framework for understanding the law's default solutions to problems of governance.

Hence, an important further benefit of the agency costs approach to trust law is that it invites comparison of the trust to other organizational forms. This expands the potential for drawing on empirical insights, albeit if only by analogy. Thus far, the typical trust law empirical project has been comparative. Although the common law trust is uniquely Anglo-American,[125] there is nontrivial variation within the common law countries;[126] and naturally there is also utility to studying how the non common law countries have adapted to their nominal lack of an explicit law of trusts.[127] But this comparative approach tends to be qualitative rather than quantitative, no doubt because of the difficulty in obtaining good data on trusts in practice.[128] In contrast, thick capital markets provide ample data for quantitative analysis of theoretical predictions about the impact

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[122] See Restatement (Second) of Trusts § 200; III Scott on Trusts §§ 200, 200.1. But see *infra* Parts IV.B.3. and IV.B.4.

[123] See Langbein, *supra* note __, at 642.

[124] See Restatement (Third) of Property: Wills and Other Donative Transfers § 6.1 & cmt i.

[125] In fairness, however, it must be noted that many of the civil law countries have long had trust-like devices. See Richard Helmholz & Reinhard Zimmermann, *View of Trust and* Treuhand*: An Introduction* 27-31, in Helmholz & Zimmermann, *supra* note __. See also Maurizio Lupoi, *The Civil Law Trust*, 32 Vand. J. Trans. L. 967 (1999); Adair Dyer, *International Recognition and Adaption of Trusts: The Influence of the Hague Convention*, 32 Vand. J. Trans. L. 989 (1999); Jeffrey A. Schoenblum, *The Hague Convention on Trusts: Much Ado About Very Little*, 3 J. Int. Tr. Corp. Plan. 5 (1994).

[126] Several examples are discussed in *infra* Part IV.

[127] See Hansmann & Mattei, *supra* note __, at 435-36; Donovan Waters, *Private Foundations (Civil Law) versus Trusts (Common Law)*, 21 Ests., Tr. & Pens. J. 281 (2002); Helmholz & Zimmermann, *supra* note __. See also Langbein, *supra* note __, at 669-71.

[128] See Sitkoff, *supra* note __, at __; Langbein, *supra* note __, at 178.

of corporate law on shareholder welfare.[129] So analogical comparisons to the empirical literature on whether specific corporate governance mechanisms improve investor welfare might help inform the analysis of whether specific trust governance mechanisms improve beneficiary welfare.

IV. APPLICATIONS OF THE MODEL

By reference to illustrative applications, this Part demonstrates the positive and normative power of the agency costs approach. The normative claim is that the law of private trusts should minimize the agency costs inherent to locating managerial authority with the trustee and the residual claim with the beneficiaries, but only to the extent that doing so is consistent with the ex ante instructions of the settlor. The qualification gives priority to the settlor over the beneficiaries as the trustee's primary principal. Hence, to return once again to our exemplary trust settled by S for the benefit of B1 and B2 with T as trustee, this means that T should maximize the welfare of B1 and B2 subject to the ex ante limits imposed by S. Consequently, the optimal solution to the Bs/T principal-agent problem, which is for the Bs to sell the residual claim to T (doing so would solve both the incentive and risk-sharing problems),[130] is foreclosed by the settlor's choice of the trust over an outright transfer. So in view of the exigency of honoring the paternalistic motives of the donative settlor, the best that the law of trust governance can hope for is a second-best solution to the Bs/T agency problem.

The positive claim is that, at least with respect to traditional doctrines, the law of trusts conforms to the suggested normative approach. Indeed, as Edward Halbach, the Reporter for the new Third Restatement of Trusts recently observed, a "theme" in modern trust law "is flexibility and efficiency in the pursuit of the best interests of the beneficiaries within the settlor's legally permissible objectives."[131]

A. Donative Beneficiaries as Residual Claimants

As we have seen, agency costs analysis would have us classify the beneficiaries of donative trusts as "residual claimants." Claims on the assets of the trust by all the other relevant parties—most notably the trustee and those with whom the trustee transacts as trustee—are usually set by express contract and have a higher priority than the beneficiaries' claim. Thus, like the residual claimants in any other organizational form, donative trust beneficiaries bear the residual risk of good or bad performance. Put more formally, managerial decisions regarding the trust's assets are usually infra-marginal to all but the bene-

[129] See, e.g., Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part I: Technique and Corproate Litigation*, 4 Amer. L. & Econ. Rev. 141 (2002); Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part II – Empirical Studies of Corporate Law*, 4 Amer. L. & Econ. Rev. 380 (2002).

[130] See Mas-Colell, Whinston, & Green, *supra* note __, at 482-83. This assumes that T is either risk-neutral or at least less risk-averse than the Bs. See *infra* Part IV.A.3.

[131] Halbach, *supra* note 21, at 1881. See also Ogus, *supra* note __, at 205.

ficiaries. The emergence of the managerial trust, moreover, has enlarged the range of the beneficiaries' potential risk and reward.[132] In this respect modern trust beneficiaries are beginning more closely to resemble the residual claimants of other organizational forms than the trust beneficiaries of yore.

Yet today's typical donative trust beneficiaries have some interesting characteristics, relevant to reckoning the probable intent of the settlor, that distinguish them from the residual claimants of other organizational forms. In view of these characteristics and the relevant agency costs analysis, this section explains the operation of three rules of private trust governance as consistent with the likely preferences of the parties. In other words, these distinguishing characteristics reflect important empirical assumptions that underpin the hypothetical bargain that is encoded in traditional trust doctrine.[133] When choosing an organizational form, one looks for the form in which the default empirical assumptions about risk-preferences, the number of residual claimants, the thickness of the relevant markets, and so on most closely resemble one's own situation. Doing so minimizes the transaction costs of customizing the form to fit one's particular needs.[134]

1. The duty of impartiality. The law of trusts nicely facilitates the creation of residual claimants with interests adverse to each other. The still classic example, here described with reference to our exemplary private trust, is a trust for the lifetime income benefit of one party (say, B1) with the remainder principal benefit to another (say, B2). As residual claimants B1 and B2's overall interests are grossly aligned on matters such as self-dealing or embezzlement by T. But often their specific interests in the day-to-day management of the trust will not be congruent. The most obvious example is that B1 should prefer income-producing investments while B2 should prefer capital appreciation.[135] This creates "conflicts among the claim holders of different states because alternative decisions shift payoffs across states and benefit some claim holders at the expense of others."[136]

Trust law's amenability to having residual claimants with adverse interests thus poses a challenge for crafting an effective governance regime, because the preference set of the residual claimants, in whose interests the trust should be managed, may not be coherent. In corporate law, by comparison, the basic aim of profit-maximization is assumed to be shared by all shareholders (their

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132 See Langbein, *supra* note __, at 637-43.

133 Cf. Leo E. Strine, Jr., *The Inescapably Empirical Foundation of the Common Law of Corporations*, 27 Del. J. Corp. L. 499 (2002).

134 See, e.g., Ogus, *supra* note __, at 187.

135 See, e.g., Dennis *v. Rhode Island Hospital Trust Co.*, 744 F.2d 893 (1st Cir. 1984); Dobris, *supra* note __, at 569-71. See also Joel C. Dobris, *Why Trustee Investors Often Prefer Dividends to Capital Gain and Debt Investments to Equity—A Daunting Principal and Income Problem*, 32 Real Prop. Prob. & Tr. J. 255 (1997).

136 Fama & Jensen, *supra* note __, at 329.

preferences are said to be "single-peaked"), which helps corporate governance avoid the well-known pathologies of agenda manipulation and cycling.[137]

Trust law's evolutionary response for aggregating the otherwise conflicting interests of different classes of beneficiaries is the fiduciary duty of impartiality.[138] The duty of impartiality requires the trustee to "act impartially in investing, managing, and distributing the trust property, giving due regard to the beneficiaries' respective interests."[139] Thus, under the default trust governance arrangement, T cannot justify an action as benefiting B1 over B2. Instead, T must justify his or her actions in relation to the aggregate welfare of B1 and B2—i.e., of all the residual claimants—as a class. In effect, the trust's residual claimants' interests are made coherent by directing the trustee to act in view of their needs rather than their individual wants. The overarching directive of the duty of impartiality is that of balance.[140]

This seems consistent with the settlor's probable intent. True, in the foregoing example one might argue that because S intended B1 to receive an immediate benefit and intended B2 to receive only the residue on the death of B1, S rated B1's position as superior to B2's. But that seems a thin basis for concluding that S wanted T to prefer the interests of B1 over B2. If S had such a preference, it would have been simple enough to put something to that effect in the trust instrument; and in the absence of such language, given the gratuitous basis of the traditional private trust, we assume that S wanted T to exercise discretion in balancing the interests of the named beneficiaries over time in view of the specific context.[141] This stands in contrast to the law of corporations, which requires managers to favor the most residual of the residual claimants in the case of conflict between them,[142] though of course within the same class of

[137] See Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 U. Chi. L. Rev. 1103, 1110 n. 28 (2002); Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 Colum. L. Rev. 1599, 1611–12 (1989); Frank H. Easterbrook and Daniel R. Fischel, *Voting in Corporate Law*, 26 J. L. & Econ. 395, 405–06 (1983).

[138] "Unfortunately, over the years, the true nature and implications of the duty of impartiality have been little explained, and vaguely defined at best, in the cases and literature." Halbach, *supra* note __, at 1912.

[139] UTC § 803. See also Restatement (Second) of Trusts §§ 183, 232.

[140] See Restatement (Third) of Trusts: Prudent Investor Rule § 227 cmts. c & i; Halbach, *supra* note __, at 549; Halbach, *supra* note __, at 1913; Edward C. Halbach, Jr., *Trust Investment Law in the Third Restatement*, 27 Real Prop., Prob, & Tr. J. 407, 441-45 (1992).

[141] Thus, the trustee "has considerable discretion in preserving the balance between the beneficiaries." Scott on Trusts § 232, p. 232. This means that "balance" is not synonymous with equal treatment. Thus if B1 was S's widow and B2 was a distant cousin, then T could lawfully tip the balance in favor of B1. "There is . . . no absolute rule on this matter and under some circumstances [favoring the life or remainder beneficiaries] might be justified." Id.

[142] See *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947); Robert C. Clark, *Corporate Law* § 14.5, p. 636 (1986); Bainbridge, *supra* note __, at § 7.4, p. 342.

stock all shareholders must be treated equally.[143] Trust law's duty of impartiality applies both *within* and *across* beneficiary classes.

From this perspective the duty of impartiality is both a critical feature of trust governance and a salient distinguishing default characteristic of trust law as organizational law. It is a critical feature of private trust governance, because without it often there would be no coherent set of residual claimants in whose interests the trust's managers should operate. And it is a salient distinguishing default characteristic of the law of private trusts, relevant to choice of form for commercial transactions,[144] because the duty is not an explicit part of the default fiduciary obligation of the managers of most other organizational forms.

Thus the law of trusts has considerable experience with the problem of balancing the interests of claim holders of different states, and this might be a reason to choose the deal reflected within trust law's default governance regime over the deal reflected by the default governance arrangements of other organizations.[145] As Steven Schwarcz has explained, one "should consider using the trust form of business organization where residual claimants do not expect management to favor their class of claims over senior claimants."[146]

2. Total return investing. Complementing the duty of impartiality is the modern trend towards total return investing.[147] Motivated by the teachings of modern portfolio theory,[148] total return investing has been codified in the recent revisions to the prudent investor standards that underpin trust law's fiduciary duty of care.[149] The basic idea is that trustees are to craft a diversified portfolio in view of its balance of overall rather than investment-specific risk and potential return.[150] A contemporaneous reform revised the definitions of "principal"

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143 The clearest application of this principle is the rule against non-pro-rata distributions, which prevents controlling shareholders from favoring themselves. See, e.g., *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971); Bainbridge, *supra* note __, at § 7.4, pp. 338-40.

144 See Schwarcz, *supra* note __, at 575-80.

145 Reasoning along similar lines, Daniel Fischel and John Langbein have suggested "that the duty of impartiality should be imported into pension law" as a response to the frequency of adverse interests among pension fund beneficiaries. Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. Chi. L. Rev. 1105, 1119-21, 1159-60 (1988). And indeed courts have done just that. For discussion and references, see John H. Langbein & Bruce A. Wolk, *Pension and Employee Benefit Law* 680, 848 (3d ed. 2000).

146 Schwarcz, *supra* note __, at 579.

147 See, e.g., Lyman W. Welch, *Brave New World of Total Return Laws*, Tr. & Est. 24 (June 2002).

148 See, e.g., Macey, *An Introduction to Modern Financial Theory* (2d ed. 1998). Influential early applications to trust-investment law include John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law*, 1976 Am. B. F. Res. J. 1; John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law: II*, 1977 Am. B. F. Res. J. 1; Bevis Longstreth, *Modern Investment Management and the Prudent Man Rule* (1986). See also Harvey E. Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine*, 76 Colum. L. Rev. 721 (1976).

149 See generally Halbach, *supra* note __; Langbein, *supra* note 88.

150 See Uniform Prudent Investor Act §§ 2-3; Restatement (Third) of Trusts: Prudent Investor Rule § 227(a). See also John H. Langbein, *The New American trust-investment Act*, 8 Tr. L. Int'l 123, 123-24

and "income," making porous the boundary between the two.[151] Together, total return investing and more flexible definitions of principal and income have the potential to ease the tension between lifetime and remainder beneficiaries by refocusing the trustee's balancing of their interests on a more transparent margin—namely, the ex post allocation to one or the other of the trust's total return receipts.[152]

Specifically, the 1997 Uniform Principal and Income Act refocuses the tension between capital appreciation and present income production on the trustee's ex post power "equitably" to "adjust" the classification of specific investment returns within the total return portfolio as "income" or "principal."[153] The so-called unitrust,[154] which is an alternative to equitable adjustment that provides a fixed percentage of the trust corpus each year to the "income" beneficiaries with the remainder left for the "principal" beneficiaries,[155] likewise eases the tension.

With equitable adjustment or a unitrust, the higher the total return, the better all the beneficiaries do.[156] The latter does so with less discretion and so fewer agency costs. But it less perfectly aligns the interests of the income and principal beneficiaries, because much of the potential upside from higher risk investments will accrue to the principal beneficiaries. The former somewhat better aligns the beneficiaries' interests, but it does so with higher agency costs because it gives the trustee additional discretion. Still, the exercise of this discretion is more transparent than the former approach of hiding the problem behind the portfolio's initial allocation between income-producing and capital-appreciating investments.

Thus the trend towards total return investing, like the duty of impartiality, can be understood as the sort of agency-costs-minimizing rules to which the parties probably would have agreed had dickering been feasible. Indeed, in larger trusts that were to be managed by professional trustees, opting out of the

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(1994). Damages in surcharge actions for imprudence should likewise reflect the total return imperative. See Sitkoff, *supra* note __, at __.

[151] Uniform Principal and Income Act (1997).

[152] See Halbach, *supra* note __, at 1913-14. See also Langbein, *supra* note 88, at 666-69. For a further, economically-informed discussion of principal and income, see Gordon, *supra* note __, at 99-112.

[153] Uniform Principal and Income Act §§ 103-04. See generally Joel C. Dobris, *New Forms of Private Trusts for the Twenty-First Century—Principal and Income*, 31 Real Prop. Prob. & Tr. J. 1 (1996); Joel C. Dobris, *The Probate World at the End of the New Century: Is a New Principal and Income Act in Your Future?*, 28 Real Prop. Prob. & Tr. J. 393 (1993).

[154] See, e.g., 12 Del. C. § 3527; N.Y. Est. Powers & Trusts Law § 11-2.4; IL P.A. 92-0838.

[155] See, e.g., Langbein, *supra* note 88, at 669; Jerold I. Horn, *Prudent Investor Rule, Modern Portfolio Theory, and Private Trusts: Drafting and Administration Including the "Give-Me-Five" Unitrust*, 33 Real Prop. Prob. & Tr. J. 1 (1998); Robert B. Wolf, *Total Return Trusts—Can Your Clients Afford Anything Less?*, 33 Real Prop. Prob. & Tr. J. 131 (1998). Cf. Joel C. Dobris, *Real Return, Modern Portfolio Theory, and College University, and Foundation Decisions on Annual spending from Endowments: A Visit to the World of Spending Rules*, 28 Real Prop. Prob. & Tr. J. 49 (1993).

[156] See generally Macey, *supra* note __, at 77-80.

recently discarded prior prudent investor standards was not uncommon.[157] And many professionally-drafted trust instruments authorized the trustee to invade principal for the benefit of the income beneficiaries.

3. Risk tolerance and the duty of care. In the paradigmatic donative trust, the residual claimants are risk-averse (think widows and orphans) but the trend is towards trustees who are risk-neutral (this is the usual economic assumption for business organizations) or at least less risk-averse than the beneficiaries.[158] That is, owing to the trend towards professional trustees, the typical modern trustee—whether a sophisticated individual such as a trust lawyer or an institution such as a bank—is likely to be less risk-averse than the typical beneficiary. There is, after all, no well-developed market for beneficial interests in American trusts.[159] Hence the beneficiaries can't easily diversify, and when one can't diversify the standard economic assumption is that of risk-averseness.[160] Corporate trustees, by contrast, are by definition risk-neutral (to repeat, this is the textbook assumption for business organizations), and individual trustees can diversify and in some cases can even insure against loss.[161]

This is not to suggest that trustees are indifferent to risk or that beneficiaries will never prefer aggressive portfolios of high-risk investments. Rather the point concerns the relative discounts, if any, that the parties assign to expected values in the face of uncertainty.[162] The basic intuition is that the undiversified have a distaste for volatility, preferring instead lower expected returns with less risk of a substantial loss—and this even if the probability that the substantial loss will materialize is relatively small. Thus the more risk-averse one is, the more likely one is to prefer a smaller but certain sum (say, $100) over a chance of a larger sum (say, $200) even if the larger sum ($200), when discounted by its probability (say, 60%), is still larger than the smaller but certain sum (here $120 versus $100).

The disparity in the trustees' and the beneficiaries' attitudes towards risk that stems from this institutional design poses a challenge for trust govern-

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[157] See Getzler, *supra* note __, at 3-4; Gordon, *supra* note __, at 75-76 & n. 99; Posner, *supra* note __, at § 15.6, p. 455.

[158] The human agents of an institutional fiduciary who are assigned to manage a particular trust, however, are likely to be risk-averse. But this is an agency problem within the institution's organizational structure, and analysis of that problem is beyond the scope of this paper.

[159] See Dukeminier & Johanson, *supra* note __, at 641 (noting an English auction in reversions and remainders and remarking that no "such organized market exists in this country."). See also *infra* note 259 and text accompanying.

[160] See Eisenhardt, *supra* note __, at 60-61; Varian, *supra* note § 12.6, p. 228. Behavioral studies, however, are critical of this assumption. See, e.g., Nicholas Barberis & Ming Huang, *Mental Accounting, Loss Aversion, and Individual Stock Returns*, 56 J. Fin. 1247, 1254 (2001).

[161] Legal malpractice insurance, for example, often includes some coverage for liability in fiduciary administration.

[162] Clear introductory explanations can be found in Robert Cooter & Thomas Ulen, *Law and Economics* 50-53 (4th ed. 2003), and Varian, *supra* note __, at §§ 12.5-12.7, pp. 224-229.

ance.[163] In the absence of the fiduciary obligation or other corrective mechanisms trustees would often be less averse to volatility than the beneficiaries.[164] Trust law's particular flavor of the fiduciary duty of care can be understood as an answer to this challenge.[165] Care in trust law is the functional equivalent of the objective reasonable person standard in tort law.[166] The trustee must "exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property."[167] This duty counsels caution, and that is what undiversified, risk-averse beneficiaries would prefer. Accordingly, the commonplace that portfolio management by trustees in practice is overly cautious likely reflects some combination of too much deterrence from the duty of care and a selection effect in the initial choice of cautious trustees by the settlor.[168]

The contrast between the duty of care in trust law and corporate law is instructive.[169] In corporate law the business judgment rule requires deference to the ordinary business decisions of management unless they're tainted by a conflict of interest or are so unreasonable as to amount to gross negligence.[170] This is a rather looser constraint,[171] but the business judgment rule is justifiable

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[163] Agency relationships, in other words, present both *incentive* and *risk-sharing* problems. See, e.g., Eisenhardt, *supra* note __, at 58.

[164] Commissions are often set as a percentage of the trust corpus. See, e.g., SCPA § 2309; Langbein, *supra* note __, at 639, 651. There is, however, an emerging trend, supported by academics, towards a "reasonableness" standard. See Cal. Prob. Code § 15681; Restatement (Third) of Trusts § 38; UTC § 708; Halbach *supra* note __, at 1909. See generally Vollmar, Hess & Whitman, *supra* note __, at 1059; Gordon, *supra* note __, at 82-83.

[165] An idea adverted to in Easterbrook & Fischel, *supra* note __, at 437.

[166] See Uniform Prudent Investor Act § 1 cmt.; Langbein, *supra* note __ at 656. See generally Cooter & Freedman, *supra* note __, at 1057-59.

[167] Restatement (Second) of Trusts § 174. See also Restatement (Third) of Trusts: Prudent Investor Rule § 227 cmt. d. See generally Joshua Getzler, *Duty of Care*, in Peter Birks & Arianna Pretto, eds., *Breach of Trust* 41-74 (2002).

[168] Conservatism might also stem from the rule of unanimity in trustee decisionmaking. See Ogus, *supra* note __, at 209-10. This lends support to the rejection of the unanimity requirement by UTC § 703 and Restatement (Third) of Trusts § 39, as does the observation that many drafters in practice likewise reject the unanimity requirement. Indeed, there has been considerable statutory activity on this issue as well. See Reporter's Notes to cmt. a of Restatement (Third) of Trusts § 39. This is related to Steven Schwarcz's suggestion that the "essential distinction between [commercial trusts and corporations] turns on the degree to which assets need to be placed at risk in order to satisfy the expectations of residual claimants." Schwarcz, *supra* note __, at 561.

[169] See Gordon, *supra* note __, at 94-96.

[170] See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1971); Bainbridge, *supra* note __, at § 6.4. The UK has in practice, though admittedly not in name, something of a business judgment rule too. See Brian Cheffins, *Company Law: Theory, Structure, and Operation* 313 (1997); *Devlin v. Slough Estates Ltd.* ([1983] Butterworth's Company Law Cases 497, 504); Company Law Review Steering Group, Developing the Framework (2000), ¶¶ 3.69-3.70, available online at http://www.dti.gov.uk/cld/claw_2_3.pdf (visited May 11, 2003).

[171] Of course, one must be careful about accepting doctrinal labels as conclusive as to whether prudence in trust law and business judgment in corporate law beget different outcomes. Indeed, there is ample authority for deferential review of trustee decisionmaking, see, e.g., Restatement (Second) of Trusts § 187, and the business judgment rule is not an abdication of the judicial function by the courts. Cf. Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, available online at http://ssrn.com/abstract=429260. But the different emphases in the canonical statements is telling, and although in numerous cases courts have found a breach of the duty of care by a trustee, see, e.g., Scott

from an agency costs perspective in view of the different context in which it operates. Corporate law draws from portfolio theory a paradigmatic shareholder who is diversified.[172] And diversified shareholders like the business judgment rule, because insulating managers from liability in the absence of egregious conduct, it helps offset the managers' incentives—including their large investment of human capital and personal wealth in the firm—towards avoiding risk.[173]

Trust law, in contrast, assumes that the beneficiaries are not diversified, so the trustee's default duty of care is set at the more restrictive reasonable-person threshold. On this view the different manifestations of the duty of care in corporate and trust law reflect different expectations regarding internal and external diversification.[174] In donative trusts diversification for the residual claimants is usually obtained internally.

Of course, given their other holdings some beneficiaries might well be diversified. For this possibility modern prudent investor standards require the trustee to consider the "risk tolerance" of the trust's particular beneficiaries in crafting the trust portfolio.[175] Trust investment strategies, in other words, should be a function of the beneficiaries' attitudes towards risk. Young scions of great wealth can better absorb higher volatility than elderly widows of modest means. So a "trust whose main purpose is to support an elderly widow of modest means will have a lower risk tolerance than a trust to accumulate for a young scion of great wealth."[176] When the trust's beneficiaries are better diversified, in other words, the trustees can (and indeed should) design a more aggressive portfolio.

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on Trusts § 174, cases holding that a manager of a publicly traded corporation breached the duty of care are almost nonexistent. See Bainbridge, *supra* note __, at §§ 6.2, 6.4; Allen & Kraakman, *supra* note __, at § 8.4.2, p. 254, § 13.4, pp. 518-19.

172 See, e.g., William W. Bratton, *Corporate Finance* 120 (5th ed. 2003).

173 See Easterbrook & Fischel, *supra* note __, at 93-102; Peter V. Letsou, *Implications of Shareholder Diversification on Corporate Law and Organization: The Case of the Business Judgment Rule*, 77 Chi.-Kent L. Rev. 179 (2001); *Joy v. North*, 692 F.2d 880, 885-86 & n. 6 (2d Cir. 1982) (Winter, J.); Bainbridge, *supra* note __, at § 6.3, pp. 259-63.

174 For a complementary analysis, see Rock & Wachter, *supra* note __, at 652-68. Note also that managerial decisions regarding a portfolio of liquid assets is easier to monitor than decisions regarding net present value of a corporation's operating assets. See Macey, *supra* note __, at 317-19. Exogenous factors impact the results of the latter whereas the former can be compared to the performance of a hypothetical prudent portfolio, thereby netting out secular market trends. For further discussion and references, see Sitkoff, *supra* note __, at __.

175 See Uniform Prudent Investor Act § 2; Restatement (Third) of Trusts § 227 cmt. e; Edward C. Halbach, Jr., *Trust Investment Law in the Third Restatement*, 27 Real Prop., Prob, & Tr. J. 407, 436-37, 444-45 (1992).

176 See Uniform Prudent Investor Act § 2(b) & cmt. See also Restatement of Trusts 3d: Prudent Investor Rule § 227(a). See generally Ogus, *supra* note __, at 196.

B. The Settlor/Beneficiary Tension

In light of the agency costs considerations on both sides, this section explores four examples of how the law of private trusts balances the ex post preferences of the beneficiaries with the ex ante wishes of the settlor. To return once again to our exemplary trust, settled by S for the benefit of B1 and B2 (collectively the "Bs") with T as the trustee, the nub of the problem is that the Bs bear the marginal costs and benefits of T's managerial decisions, but the ex ante preferences of S trump the later wishes of the Bs in guiding T's management.[177] A variant of the well-known dead hand problem (which is perhaps a pejorative aphorism for the idea that the settlor's intent controls),[178] this tension has been exacerbated by the modern trend towards the use of the trust as a vehicle for asset management by professionals. The modern managerial trust vests greater discretion in the hands of the trustee, and increased discretion broadens the range of the trustee's hidden action. Moreover, the ongoing erosion of the rule against perpetuities is expanding the temporal scope of the trustee's discretionary authority and hence the likelihood of later circumstances unanticipated by the settlor.[179]

1. Modification and termination. A nice example of the potential for divergent interests between the settlor and the beneficiaries concerns the possibility of the beneficiaries' seeking the premature termination of the trust. This problem includes the issue of whether the beneficiaries can seek modification of the trust's terms, as the power to modify is generally held to be subsumed within the power to terminate.[180] The American rule, which originated with *Claflin v. Claflin*,[181] may be summed up as unfriendly. Under the *Claflin* doctrine, a trust may be terminated prematurely with the settlor's consent or, in the absence of the settlor's consent, only if the termination would not frustrate a

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[177] See Ogus, *supra* note __, at 214.

[178] See generally Alexander, *supra* note __, at 1254-64; Hirsch & William, *supra* note __; Ronald Chester, *Inheritance, Wealth and Society* passim (1982); Posner, *supra* note __, at § 18.3, pp. 518-20; Gareth H. Jones, *The Dead Hand and the Law of Trusts,* in Edward C. Halbach, Jr., ed., Death, Taxes and Family Property 119 (1977).

[179] See Lawrence W. Waggoner, et. al., *Family Property Law* 900 (3d ed. 2002). See also Sterk, RAP, *supra*, note __; Note, *Dynasty Trusts*, *supra* note __; Dobris, *supra* note __; Vallario, *supra* note __; Jesse Dukeminier, *Dynasty Trusts: Sheltering Descendants from Transfer Taxes*, 23 Est. Plan. 417 (1996). An interesting question is whether private trusts might soon face the sort of dead-hand problems that are familiar in charitable trusts as the latter have long been exempt from the rule against perpetuities. See generally Alex M. Johnson, Jr., *Limiting Dead Hand Control of Charitable Trusts: Expanding the Use of the* Cy Pres *Doctrine*, 21 U. Hawaii L. Rev. 353, 356 (1999); Posner, *supra* note __, at § 18.4, p. 520; Macey, *supra* note __.

[180] Cf. II Scott on Trusts § 107.3, p. 125. Note, however, that the relevant considerations for modification versus termination are not entirely the same. See Restatement (Third) of Trusts § 65 cmt. f. This follows from, among other things, the observation that in practice termination often pits the current against the remainder beneficiaries whereas modification more commonly touches only the settlor/beneficiary tension.

[181] 20 N.E. 454 (Mass. 1889). See Restatement (Third) of Trusts § 65 cmt. a.

"material purpose" of the trust.[182] Settlor's consent, however, is by definition unavailable for the modification of a testamentary trust, and anyway courts have had little difficulty in finding a "material purpose" that would be offended by a modification or termination.[183] So as a practical matter, unless the trustee consents,[184] American trusts are difficult to amend or terminate once established. Indeed, even if all the competent beneficiaries and the trustee were inclined to strike a deal, the frequency of unidentified or minor beneficiaries reduces the viability of this alternative.[185]

The upshot of the *Claflin* doctrine is that it helps align the interests of the settlor and the trustee. The rule allows the trustee to preserve the settlor's original design, regardless of wishes of the beneficiaries, which in the usual case is what the settlor would have wanted. The settlor, after all, chose a trust rather than another form of organization or an outright transfer,[186] so the *Claflin* doctrine is consistent with the model of the settlor as the primary principal. Moreover, even though a particular beneficiary might prefer the power to cause the termination of the trust if asked ex post, in the aggregate potential beneficiaries may do better ex ante with the *Claflin* doctrine. The assurance provided by the *Claflin* doctrine (i.e., the reduction in settlor/trustee agency costs that it facilitates) should increase the willingness of grantors to create a trust in the first place.[187] The justification appears to be that beneficiaries as a class do better with more trusts (and so more gifting[188]), albeit with potentially greater managerial agency costs, than with fewer trusts with a reduced potential for managerial agency costs.

On the other hand, the downside of the rule is that it entrenches the trustee and locks in a certain minimal level of beneficiary/trustee agency costs. Under the classic American approach, even if all of the beneficiaries are identifiable adults who would be better off if the trust were terminated (perhaps be-

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[182] See Restatement (Third) of Trusts § 65 & cmt. a; Restatement (Second) of Trusts § 337; IV Scott on Trusts §§ 337-340.2.

[183] See generally IV Scott on Trusts §§ 337.1-337.8. For a specific example, see *In re Estate of Brown*, 528 A.2d 752, 755 (Vt. 1987) ("We believe that the settlor's intention to assure a life-long income to Woolson and Rosemary Brown would be defeated if termination were allowed.").

[184] See Restatement (Second) of Trusts § 342; IV Scott on Trusts § 342, pp. 529-32; Roger W. Andersen, *Understanding Trusts and Estates* 110-111 (3d ed. 2003).

[185] Cf. IV Scott on Trusts § 342, p. 532.

[186] Cf. Langbein, *supra* note __, at 632 ("The donor who structures a gift in this way expects compensating advantages.").

[187] That the trust is less easily modified than a contract might help solve the so-called Samaritan's dilemma, see Eric Posner, *Law and Social Norms* __ (2000), by binding all to the ex ante deal. See Ogus, *supra* note __, at 189. The idea is that if S is willing to transfer resources to B but B anticipates that S will do so, then B will behave more recklessly because he know that S will be providing a safety net.

[188] The further assumption here is that the overall volume of gifting would fall because in the absence of these rules some grantors would prefer not to make a transfer at all. If the level of overall gifting remained constant, however, then beneficiaries might do better without the rule, provided that the alternative modes of transfer imposed fewer restrictions. But with fewer restrictions, these alternatives would be imperfect substitutes, so it is unlikely that the overall level of gifting would remain constant.

cause its consequent administrative expenses would be eliminated), the trustee need not assent to their wishes. Against the *Claflin* doctrine, therefore, it might be argued that the fundamental decision whether or not to continue the trust is not in the hands of those who bear the marginal costs and benefits of that decision.

True, at its most extreme this is just to say that the beneficiaries cannot override the settlor's choice of form; and the American rule appears to represent the judgment that all the relevant parties do better in the aggregate by allowing settlors to bind the residual claimants to the trust form of organization. But if one starts from the premise that ultimately settlors of today's managerial trusts would want to maximize the welfare of the beneficiaries, then it might well be that a different rule is preferable, especially in view of the ongoing erosion of the rule against perpetuities.[189] On this view, one-time settlors don't know to opt out of the default *Claflin* regime and their advisors are failing to call this to their attention (the latter being a manifestation of a different agency problem).

Thus, it should not be a surprise that there is a strong academic and slowly emerging decisional trend towards liberalizing these rules.[190] As in the classic (if then extraordinary) *Pulitzer* case, courts are beginning to show a willingness to authorize deviation from the settlor's administrative or other instructions that, over time, are shown to conflict with the settlor's assumed larger aim of benefiting the beneficiaries.[191] Certainly the new Uniform Trust Code and the new Third Restatement of Trusts embrace this view,[192] and in fact they extend it to the power of "equitable deviation." The idea behind equitable deviation is that courts should permit modification of even the dispositive instructions of the trust instrument in view of changed circumstances not anticipated by the settlor.[193] Related, there is burgeoning authority, perfectly sensible from an

[189] See *supra* note 179 and text accompanying.

[190] See, e.g., Halbach, *supra* note __, at 1899-1901; Edward C. Halbach, Jr., *Significant Trends in the Trust Law of the United States*, 32 Vand. J. Trans. L. 531, 538 (1999); Cal. Prob. Code § 15409. See also Ronald Chester, *Modification and Termination of Trusts in the 21st Century: The Uniform Trust Code Leads a Quiet Revolution*, 35 Real Prop. Prob. & Tr. J. 697 (2001); Gail Boreman Bird, *Trust Termination: Unborn, Living, and Dead Hands—Too Many Fingers in the Trust Pie*, 36 Hastings L. J. 564 (1985).

[191] *Matter of Pulitzer*, 249 N.Y.S. 87 (Surr. Ct. 1931), aff'd mem., 260 N.Y.S. 975 (App. Div. 1932). See e.g., *Carnahan v. Johnson*, 711 N.E.2d 1093 (Ohio App. 1998); *In re Mayo*, 105 N.W.2d 900 (Minn. 1960); Restatement (Third) of Trusts § 66 Reporter's Notes to cmt. b (collecting illustrative authority). For further discussion of *Pulitzer*, see Langbein, manuscript *supra* note __, at 22-24.

[192] See UTC §§ 410-12; Restatement (Third) of Trusts §§ 65-66; David M. English, *The Uniform Trust Code (2000): Significant Provisions and Policy Issues,* 67 Mo. L. Rev. 143, 169-176 (2002); Chester, *supra* note __, at 724-28; Julia C. Walker, Note, *Get Your Dead Hands Off Me: Beneficiaries' Right to Terminate or Modify a Trust Under the Uniform Trust Code*, 67 Mo. L. Rev. 443 (2002); English, *supra* note __, at 27-28.

[193] See Halbach, *supra* note __, at 1900-01; UTC § 412; Restatement (Third) of Trusts § 66. Cf. Peter J. Wiedenbeck, *Missouri's Repeal of the* Claflin *Doctrine—New View of the Policy Against Perpetuities?*, 50 Mo. L. Rev. 805 (1985); Paul G. Haskell, *Justifying the Principle of Distributive Deviation in the Law of Trusts*, 18 Hastings LJ. 267, 294 (1967); N.Y. Est. Pow. & Tr. L. § 7-1.6(b).

agency-costs contractarian perspective, for trust modifications made desirable by tax exigencies that arise after the trust has been settled.[194]

Note, however, that all of these liberalizations are designed to advance the settlors' probable intent.[195] If at the time of the trust's creation a particular tax savings was not possible, the reasonable assumption is that the settlor would want the trust later modified to minimize taxes in light of subsequent changes to the tax law.[196] Similarly, the average settlor would want the court to modify even the distributive provisions of the trust if, thanks to unanticipated circumstances, the settlor's prior regime is no longer sensible.[197] To return to our exemplary trust, settled by S for the benefit of B1 and B2, the supposition is that S would have preferred to favor B2 over B1 if subsequently the former was disabled in an accident while the business of the latter proved unusually successful.[198] So all of these liberalizations, if understood as designed to effect a substituted judgment for what the settlor would have wanted, are consistent with a model of the trust in which the settlor is the primary principal. These liberalizing trends give the beneficiaries what they want, but only when doing so would approximate what the settlor would have wanted. They add the nuance of standards, as it were, to the otherwise blunderbuss *Claflin* rule.

The more liberal English approach, in contrast, reflects a rather different dead-hand calculus. To begin with, the leading English case on the question of premature termination, *Saunders v. Vautier*,[199] reaches the opposite result from *Claflin*.[200] Thus the answer in England to the question of whether all the beneficiaries, if they are identifiable adults, can force the premature termination of a trust over the dissent of the trustee is yes.[201] Indeed, owing not only to *Saunders* but even more clearly to the Variation of Trusts Act of 1958,[202]

[194] See Restatement (Third) of Property: Wills and Other Donative Transfers § 12.2 & Reporter's Note (stating the rule and collecting authority); UTC § 416; IIA Scott on Trusts § 167, p. 281 n. 27 & 2001 Supplement at 306-11 (collecting authority); Halbach, *supra* note __, at 1887. Cf. Mary Louise Fellows, *In Search of Donative Intent*, 73 Iowa L. Rev. 611 (1988).

[195] See Langbein, *supra* note __, at 68-69.

[196] The qualification allows for the scenario in which the settlor opts for a less tax-efficient trust in order to maintain more control, for example the use of a nonexempt generation-skipping trust.

[197] These liberalizations are therefore importantly different from reformation (which the English call rectification of documents in equity). See generally Langbein, *supra* note __, at 69. Reformation conforms the document to what was actually intended at the time of execution. The innovation here is the extension of the concept to testamentary trusts. See Restatement (Third) of Property: Wills and Other Donative Transfers § 12.1; UTC § 415. See, e.g., *Pond v. Pond*, 678 N.E.2d 1321 (Mass. 1997).

[198] For an example of the traditional, contrary approach, see *In re Trust of Stuchell*, 801 P.2d 852 (Or. 1990) (refusing to modify a trust so as to preserve a disabled beneficiary's eligibility for public assistance on the ground that the modification's "only purpose . . . [was] to make the trust more advantageous to the beneficiaries"). But see Macey, *surpa* note __, at 300-02 (defending narrower interpretations of settlor's intent).

[199] 49 Eng. Rep. 282 (1841). See also *Goulding v. James*, [1997] 2 All ER 239, 247 ("The principle reconises the rights of beneficiaries, who are sui juris and together entitled to the trust property, to exercise their proprietary rights to over bear and defeat the intention of a testator or settlor to subject property to the continuing trusts, powers and limitations of a will or trust instrument.").

[200] For a historical discussion, see Alexander, *supra* note __, at 1200-04.

[201] See D.J. Hayton, *The Law of Trusts* 93-96 (3d ed. 1998); Moffat, *supra* note __, at 248-52.

ders but even more clearly to the Variation of Trusts Act of 1958,[202] English law resolves significantly more of the settlor/beneficiary tension on questions of trust modification in favor of the beneficiaries.[203] Unlike the recent liberalizations to American trust law, in England the question of what the settlor would have wanted has little bearing on the resolution of these questions.[204]

In the English trust, therefore, the settlor is not the primary principal and the settlor's interests are subordinated to the goal of minimizing managerial agency costs ex post. "[A]fter the settlor's death, the trust is regarded as the beneficiaries' property, not the settlor's property—and the dead hand continues to rule only by the sufferance of the beneficiaries."[205] A powerful criticism of this approach, at least since the 1958 Act, is that it is mandatory. English settlors cannot opt for the American or any other more restrictive approach. The *Claflin* doctrine, however, is default, so American settlors can choose instead the English or any other more permissive regime. Put differently, an American trust can be made to resemble an English one but English trusts cannot be made to resemble an American one.

2. Trustee removal. A second and more specific example of the potential tension between the interests of the settlor and the interests of the beneficiaries concerns the question of on what grounds the beneficiaries may obtain the removal of the trustee. Yet again to return to our exemplary trust, settled by S for the benefit of B1 and B2 with T as trustee, the question is when if ever can B1 and/or B2 replace T.

On the one hand, settlors select trustees among other reasons because of the trustees' expected fidelity to the wishes of the settlor in the future exercise of discretion. On the other hand, it is the beneficiaries who as residual claimants bear the marginal costs and benefits of the trustee's decisions. Hence the beneficiaries have an incentive to monitor the performance of the trustee, and anyway under standard doctrine only the beneficiaries have standing to bring an action against the trustee for breach of trust.[206] The difficulty, then, is setting the threshold for removal of the trustee high enough so that the trustee has room to carry out the settlors' wishes (including the protection of future beneficiaries) in the teeth of a contrary preference of the current beneficiaries without

[202] 6 & 7 Eliz. 2, ch. 53, § 1. Well-drafted instruments can easily circumvent *Saunders*, for example by ensuring the existence of contingent interests. The 1958 Act, however, is indeed mandatory and it allows for the variation ex post of even discretionary trusts. For general discussion and references, see Moffat, *supra* note __, at 253-72.

[203] See Ogus, *supra* note __, at 202-04; Hayton, *supra* note __, at 174; Moffat, *supra* note __, at 248-73; Pearce & Stevens, *supra* note __, at 423-38; Hayton, *supra* note __, at 598-600; Jones, *supra* note __, at 124-26. See generally Chester, *supra* note __, at 709-22. Canada is similarly more liberal. See Keith B. Farquhar, *Recent Themes in the Variation of Trusts*, 20 Est. Tr. & Pens. J. 181 (2001).

[204] See Farquhar, *supra* note __, at 186-91; Moffat, *supra* note __, at 248-86. See also Wiedenbeck, *supra* note __; Ogus, *supra* note __, at 202.

[205] Dukeminier & Johanson, *supra* note __, at 651. See also Jones, *supra* note __, at 119-20.

[206] See *infra* Part III.C.3.

setting it so high as in effect to sanction shirking or mismanagement. In other words, the goal is to minimize trustee/beneficiary agency costs subject to the ex ante constraints imposed by the settlor.

The law's default approach is to authorize courts to sack trustees who are shown generally to be dishonest or who are shown specifically to have engaged in a "serious breach of trust," but not necessarily to remove trustees for breaches that are not "serious" or to remove trustees for mere "friction."[207] Trustees who were chosen by the settlor as compared to those named by a third party or a court are even less readily removed—there is something of a thumb on the scale for them.[208] Thus, if the settlor was aware of an asserted ground for removal at the time of naming the trustee, that ground will not serve as a basis for the later removal of the trustee unless the trustee is "entirely" unfit to serve.[209]

These default rules appear to reflect the bargain to which the settlor and trustee would have agreed when trusts were used predominately for the preservation of family land and the typical trustee was an amateur rather than a fee-paid professional. When the trustee's mission was simply to hold onto ancestral land, there were fewer opportunities for beneficiary/trustee conflict (with less to do, shirking is less of a problem). And in the aggregate, beneficiaries do better when settlors are comfortable establishing trusts if the alternative is that settlors wouldn't make the transfer at all. So the traditionally high threshold for sacking a trustee serviced the interests of the settlor while imposing a tolerable level of agency costs on the beneficiaries.

Today, however, modern prudent investor standards allow for greater discretion in portfolio management and the default overarching aim is to maximize total return. This is related to the apparent trend towards professional trustees (which suggests a weakened personal link between the settlor and the trustee);[210] it is a component of the larger trend towards the use of the trust as an organizing device for the professional management of financial assets; and with these changes trust fiduciary law has replaced limited powers as the chief protection for beneficiaries.[211] All of this is to say that, in view of the rise of the modern managerial trust, the potential for agency costs in the trustee/beneficiary relationship has increased. Thus, the importance of removal as a check on these agency costs has likewise increased.

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[207] See, e.g., II Scott on Trusts at § 107, pp. 108-09; Restatement (Second) of Trusts § 107 cmts. b-c; Restatement (Third) of Trusts § 37 cmt. e(1).

[208] See, e.g., II Scott on Trusts at § 107.1, pp. 117-18; Restatement (Second) of Trusts § 107 cmt. f; Restatement (Third) of Trusts § 37 cmt. f. Cf. English, *supra* note __, at 197-199 (discussing situations "where the personal link between the settlor and trustee has been broken").

[209] See, e.g., II Scott on Trusts at § 107.1, p. 118; Restatement (Second) of Trusts § 107 cmt. g; Restatement (Third) of Trusts § 37 cmt. f.

[210] See note 55 and text accompanying.

[211] See generally Langbein, *supra* note __, at 638-43; Langbein, *supra* note __, at 71. See also Alexander, *supra* note __, at 775-76; Jones, *supra* note __, at 121-23.

Consistent with this analysis, anecdotal evidence suggests that settlors today regularly contract out of the default removal rules in favor of easier substitution of trustees,[212] sometimes even authorizing a third-party (so-called trust "protectors," who will be discussed later) to exercise the power to replace a trustee.[213] Consider also the analogy to the robust econometric evidence regarding the negative impact on shareholder welfare of corporate takeover defenses such as classified boards.[214] This, too, lends support to the view that reducing the threshold for the removal of trustees should improve beneficiary welfare (putting to the side the effect of deterring the settling of trusts in the first place).

The foregoing is therefore an argument in favor of the somewhat more liberal removal standards embraced by the new Uniform Trust Code and Restatement (Third) of Trusts.[215] The argument is particularly strong with respect to removal of large (as compared to boutique) institutional fiduciaries.[216] Unlike an individual with whom the settlor might have had a personal link, one institutional fiduciary is unlikely to have a comparative advantage over another in effecting the settlor's intent, especially after a corporate reorganization and/or turnover in the company's staff of account managers.[217] Of course, this is not to suggest that reputational concerns, especially for large banks and trust companies, won't militate towards fidelity. Rather the point is that making it easier (at least as a default matter) for the beneficiaries to substitute one institution for another might help create an ex post competition between institutional fiduciaries for trust control, as it were, to go along with the current ex ante competition for selection by the settlor.[218]

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[212] See, e.g., Restatement (Third) of Trusts § 34 cmt. c ("It is also common for the terms of trusts to provide for the appointment of new trustees."); John R. Price, *Price on Contemporary Estate Planning* § 10.41, p. 1152 (2d ed. 2000); American Jurisprudence, *Legal Forms—Trusts* §§ 251:370–251:373, 251:388 (2d ed. 2001); Society of Trust and Estate Practitioners, *Standard Provisions* § 13 (1997). This discussion puts to one side the doctrinal question of when this might cause the trustee to be deemed an agent, legally defined, of the beneficiaries, thereby triggering consequences that the settlor probably would not have intended. See Restatement (Second) of Agency §§ 14, cmt. c, 14B, cmt. c.

[213] See *infra* Part IV.B.4.

[214] See, e.g., Lucian Arye Bebchuk, John C. Coates IV, & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 Stan. L. Rev. 887 (2002); Robert Daines, *Do Classified Boards Affect Firm Value? Takeover Defenses After the Poison Pill* (manuscript on file with the author).

[215] See UTC § 706; English, *supra* note __, at 197-99; Restatement (Third) of Trusts § 37 & cmt. e; Langbein, *supra* note __, at 75-76 (noting that the UTC "responds to the concern that under traditional law beneficiaries have had little recourse when trustee performance has been indifferent, but not so egregious as to be in breach of trust"); English, *supra* note __, at 28.

[216] See Ronald Chester & Sarah Reid Ziomek, *Removal of Corporate Trustees Under the Uniform Trust Code and Other Current Law: Does a Contractual Lens Help Clarify the Rights of Beneficiaries?*, 67 Mo. L. Rev. 241, 253-56 (2002).

[217] See Restatement (Third) of Trusts § 37 cmt. f ("[D]eference . . . may no longer be justified if, after being designated, a corporate trustee undergoes a significant structural change, such as by merger."); Chester & Ziomek, *supra* note __. See also Price, *supra* note __, at § 10.43.1, p. 1161-62.

[218] Cf. Dukeminier & Johanson, *supra* note __, at 661. It should be noted, however, that a cost of this approach is further burdening the fiduciary apparatus that protects future beneficiaries from excessive favoring of the current beneficiaries. See *supra* Part IV.A.1.

3. Settlor standing. A further example of the settlor/beneficiary tension is the question of settlor standing to enforce the terms of the trust. The traditional rule is that in an irrevocable trust only the beneficiaries have standing to bring an action for breach of trust.[219] On first glance this follows naturally from the position of the beneficiaries as the residual claimants, and it mirrors the similar approach in other organizational forms, most obviously the corporation.[220] Once the trust has been established, the settlor, like anyone else who is not a beneficiary, has no tangible stake in enforcing its terms. The beneficiaries, in contrast, bear the marginal costs and benefits of the trustees' decision making. So it is the beneficiaries who have an incentive to bring litigation only when cost-justified, at least so far as they are identified and their stake is large enough to counter the collective action problem.[221]

But this analysis is too simple. Indeed, against this Langbein suggests that most settlors would prefer to retain the ability to bring enforcement actions against the trustee. Thus Langbein argues that the underlying default rule should be reversed so that it would imply settlor standing in the absence of a contrary instruction in the trust instrument.[222] There are, however, two additional relevant considerations, the second of which is more clearly brought into view by the agency-costs approach and its nexus of contracts analogy.

First, because of an exogenous tax consideration, this is a question on which evidence of the actual bargains struck by settlors is not necessarily indicative of their preferences. Under current doctrine, in order to have standing to sue, the settlor must retain some sort of beneficial interest in the trust.[223] But doing so would likely subject the trust to undesirable tax consequences.[224] This means that the general failure by settlors to retain standing rights is not good evidence of their preferences. More concretely, this failure is not good evi-

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[219] See Restatement (Second) of Trusts § 200; III Scott on Trusts §§ 200-200.1, pp. 207-12. See generally John T. Gaubatz, *Grantor Enforcement of Trusts: Standing in One Private Law Setting*, 62 N. C. L. Rev. 905 (1984); Note, *Right of a Settlor to Enforce a Private Trust*, 62 Harv. L. Rev. 1370 (1949).

[220] See Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 Stetson L. Rev. 23 (1991); Easterbrook & Fischel, *supra* note __, at 37-38; Bainbridge, *supra* note __, at § 9.2, pp. 410-17. In both corporate and trust litigation any recovery from the fiduciary will be owed either to the plaintiff or to the trust/corporation depending on the nature of the breach.

[221] See Gordon, *supra* note __, at 76-79.

[222] Langbein, *supra* note __, at 664-65. See also Hayton, *supra* note __, at 103. A similar analysis might apply to the question of whether the settlor of an inter vivos trust has the power to revoke or to amend the trust in the absence of express authority in the trust instrument to do so. See Halbach, *supra* note __, at 1898-99; UTC § 602; Restatement (Third) of Trusts § 63; Langbein, *supra* note __, at 70-71. There is also overlap with the question of standing under the Uniform Management of Institutional Funds Act ("UMIFA"), see, e.g., *Yale University v. Blumentahl*, 621 A.2d 1304 (1993), which is currently being revised.

[223] See Restatement (Second) of Trusts § 200 cmt. b; III Scott on Trusts § 200.1, p. 212.

[224] See generally George T. Bogert, *Trusts* § 145, p. 516 (6th ed. 1987). In correspondence with the author, Joel Dobris helpfully suggested that another way to look at the question is to ask whether a narrowly crafted power to enforce state law fiduciary duties would qualify as a string under IRC §§ 2036 and 2038.

dence that the increased trustee commissions that such standing would prompt has deterred settlors from retaining a beneficial interest. The proliferation of the trust "protector," which will be discussed below, is in fact evidence to the contrary.

Second, the agency cost implications of the recognition of settlor standing are not as obvious as suggested at the outset of this subsection. True, it is possible that settlor standing would increase agency costs by introducing a second master, as it were, over the trustee. "A manager told to serve two masters . . . has been freed of both and is answerable to neither."[225] This is the usual argument in the corporate law discourse against allowing managers to justify their decisions by reference to the welfare of any constituency other than shareholders.[226] And this objection might have particular salience in the trust context, because the fear of litigation on these alternate fronts might further inhibit already overly cautious trustees. After all, an important rationale for the recent changes to the standards of prudent investing was to encourage trustees to be less conservative.[227]

On the other hand, the donative settlor's motivation for interposing a trustee between the trust assets and the beneficiary, tax exigencies to one side, is often a lack of faith in the beneficiaries' judgment. Given the likelihood of feckless, unborn, minor, unidentifiable, or otherwise incompetent beneficiaries,[228] and further given the possibility of a free-rider problem among the beneficiaries,[229] settlor standing might minimize agency costs by making more viable the threat of litigation as a deterrent against actions by the trustee that are not in the best interests of the beneficiaries or are but breach a contrary instruction of the settlor. Many trust beneficiaries, as has been noted elsewhere, are not particularly effective monitors,[230] and even when they are, their preferences are not necessarily congruent with the settlor's.

The further contribution of the foregoing agency costs analysis to Langbein's discussion is to highlight the importance of the questions of whose claim the settlor would be permitted to advance and whether the settlor's approval of an action would insulate the trustee from a later action by the beneficiaries (or

[225] Easterbrook and Fischel, *supra* note __, at 38.

[226] See, e.g., Macey, *supra* note __, at 31-36; Bainbridge, *supra* note __, at § 9.2, pp. 414-18.

[227] See, e.g., Langbein, *supra* note __; Halbach, *supra* note __.

[228] The doctrine of virtual representation and the appointment of a guardian ad litem are at best partial solutions. Guardians ad litem are often highly inflexible, see, e.g., *Espinosa v. Sparber, Shevin, Shapo, Rosen & Heilbronner*, 612 So. 2d 1378, 1379 n. 1 (Fla. 1993); see also UPC § 1-403; UTC § 305; Martin D. Beglieter, *The Guardian Ad Litem in Estate Proceedings*, 20 Willamette L. Rev. 643 (1984), and the doctrine of virtual representation requires an alignment of interests across generations. See, e.g., UPC 1-403; N.Y. Surr. Ct. Proc. Act § 315; UTC § 304; *In re Wolcott*, 56 A.2d 641 (N.H. 1948); Lawrence B. Rodman & Leroy E. Rodman, *Virtual Representation: Some Possible Extensions*, 6 Real Prop. Prob. & Tr. J. 281 (1971). See generally Valerie J. Vollmar, Amy Morris Hess, & Robert Whitman, *An Introduction to Trusts and Estates* 345-46 (2003).

[229] See *infra* Part IV.D.1.

[230] See, e.g., Fischel & Langbein, *supra* note __, at 1114-15, 1118-19; Gordon, *supra* note __, at 82.

the beneficiaries' guardian ad litem).[231] This question is a specific manifestation of the larger issue of determining who is the trustee's dominant principal, the settlor or the beneficiaries. If the aim of trust law were to maximize the welfare of the beneficiaries, without more, then settlor standing should be qualified so as to require that any claim brought by the settlor be resolved from the perspective of the beneficiaries. But our model of the trust is one in which the trustee is to maximize the welfare of the beneficiaries subject to the initial constraints of the settlor. Thus, the recognition of settlor standing could reduce two very different types of agency costs.

First, again returning to our exemplary trust settled by S for the benefit of B1 and B2, T is more likely to act appropriately if not only B1 and B2 have standing to sue, but so did S. Here S's standing would provide a backstop check on managerial agency costs. Second, T is less likely to enter into a side bargain with the Bs to avoid the ex ante constraints imposed by S if S had standing to sue. For example, the Bs might otherwise offer to pay T to disburse the corpus of the trust, and there would be no duty of loyalty problem if all the Bs were competent adults who signed on to the deal.[232] In this scenario S's standing would help ensure that T respects S's limitations on the use of the trust's funds.

Given the lack of identifiable beneficiaries in charitable trusts, the foregoing analysis may be relevant to the ongoing debate over settlor standing in that context as well.[233]

4. Trust protectors. An emerging feature of modern managerial trusts is the appointment of a so-called trust "protector."[234] To return yet again to our exemplary trust, which was settled by S for the benefit of B1 and B2 with T as the trustee, S might also name his trusted friend P as the trust "protector," frequently an uncompensated position. Among other things P might be granted the authority to replace T, to approve modifications to the trust in view of developments in the tax law or changes in the Bs' welfare, and otherwise to make the sort of decisions with respect to the trust's management that S would have made

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231 For a complementary doctrinal analysis, see Hayton, *supra* note __, at 103-04.

232 See *supra* notes 184-185 and text accompanying.

233 See UTC § 405(c); Ronald Chester, *Grantor Standing to Enforce Charitable Transfers Under Section 405(C) of the Uniform Trust Code and Related Law: How Important is it and How Extensive Should it be?*, 37 Real Prop. Prob. & Tr. J. 611, 628-29 (2003); English, *supra* note __, at 180; Paula Kilcoyne, *Donor Standing Under the Uniform Management of Institutional Funds Act in Light of* Carl J. Herzog Foundation, Inc. v. University of Bridgeport, 21 West. N. Eng. L. Rev. 131 (1999). See also Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 Wisc. L. Rev. 227; *Symposium Issue on the Bishop Estate Controversy*, 21 U. Hawaii L. Rev. 353-714 (1999); Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. Pa. L. Rev. 497, 606-15 (1981); UTC § 405 & cmt.; Ilana H. Eisenstein, Note, *Keeping Charity in Charitable Trust Law: The Barnes Foundation and the Case for Consideration of Public Interest in Administration of Charitable Trusts*, 151 U. Pa. L. Rev. 1747 (2003).

234 See Reporter's Notes to Restatement (Third) of Trusts § 64 cmts. b-d ; Hayton, *supra* note __, at 579. See also SD ST § 55-1B-1(2); UTC § 808(c) & cmt.

had S been able to do so.[235] Originally conceived as a check on local trustees in offshore asset-protection trusts—not surprisingly, offshore jurisdictions typically require the appointment of a bcal trustee and anyway doing so is critical to avoiding *in rem* jurisdiction by mainland courts[236]—the trust protector has today migrated into ordinary trusts. This migration is unsurprising in light of the protector's usefulness in minimizing agency costs.

Putting to one side the doctrinal question of when, if ever, protectors should be held to be fiduciaries with respect to the beneficiaries,[237] the ability of the protector to check agency costs is relatively straightforward. An office of trust protector allows the settlor to appoint a trusted friend or confidant to monitor the trustee's management. Thus, for all the reasons noted in the prior subsection that settlor standing might reduce agency costs, the appointment of a trust protector might similarly reduce agency costs. But it has the further advantages of avoiding the tax consequences of settlor standing and it continues to function even after the settlor's death.

True, such an appointment opens the door to new sources of agency costs—the settlor/protector relationship as well as the beneficiaries/protector relationship. But these costs are likely to be swamped by the reduction in agency costs overall. By giving the protector authority, say, to replace the trustee, but not appointing the protector to be the trustee, the settlor is freed to appoint a trusted and loyal friend as the trust protector even if this friend otherwise lacks the administrative or portfolio management skills necessary himself to be a good trustee or co-trustee.[238] Moreover, by giving the protector the power to select his or her successor, the office of the protector will continue to be occupied despite the erosion of the rule against perpetuities and the emergence of so-called perpetual trusts.

The more general point is that the emergence of trust protectors is a response to the settlor's uncertainty about the future. Like powers of appointment,[239] a trust protector can be used to build flexibility into a trust.

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[235] See, e.g., SD ST § 55-1B-6 (2002) (listing potential powers); Hayton, *supra* note __, at 583-84 (same). See generally Donovan W. M. Waters, *The Protector: New Wine in Old Bottles?*, in A. J. Oakley, ed., *Trends in Contemporary Trust Law* 63 (1963); Antony Duckworth, *Protectors—Fish or Fowl, Part I*, 4 J. Int'l Tr. & Corp. Plan. 131 (1995); Antony Duckworth, *Protectors—Fish or Fowl, Part II*, 5 J. Int'l Tr. & Corp. Plan. 18 (1996); Paul Matthews, *Protectors: Two Cases, Twenty Questions*, 9 Tr. L. Int'l 108 (1995). See also Halbach, *supra* note __, at 1916-17.

[236] See Sitkoff & Corsico, *supra* note __.

[237] On this question, which is beyond the scope of this paper, see, e.g., Reporter's Notes to Restatement (Third) of Trusts § 64 cmts. b-d (T.D. No. 3, approved 2001); Waters, *supra* note __.

[238] The evolution of the protector might thus be understood as falling within the framework of Langbein's predicted "fractionation of trusteeship." Langbein, supra note __, at 665-66.

[239] See, e.g., George G. Bogert & George T. Bogert, *The Law of Trusts and Trustees* § 299 (rev. 2d ed. 1992).

C. Internal Governance and External Authority

By including creditors within its scope, the agency costs model of the trust as an organizational form helpfully highlights the interrelationship between internal governance and the scope of the authority of "insiders" to transact with "outsiders." The key point is that the agency cost considerations relevant to the substantive content of the rules of internal trust governance are a function of the scope of the external relations authority of the principal parties to deal with outsiders; and similarly the extent to which the insiders to the trust deal might safely be granted authority to transact over trust assets with outsiders is a function of the effectiveness of the internal governance structure.[240]

Hence, the agency costs approach to the trust advanced in this paper should not be taken as an embrace of the sort of contractarian nihilism that leads to the conclusion that organizations have no boundaries—in Jensen and Meckling's words, that "it makes little or no sense to try to distinguish those things that are 'inside' the firm (or any other organization) from those things that are 'outside' of it."[241] To the contrary, the point recognizes the existence of boundaries and the crucial asset partitioning role of organizational law (i.e., the de facto separate legal entity of the trust or its equivalent, the trustee as trustee). The claim is rather that the rules which govern the relations of the trust's "insiders" with "outsiders"—what Hansmann and Mattei refer to as trust law's "essential" asset partitioning function—are intertwined with the governance mechanisms available to the insiders for regulating the external relations of each other. So the claim of this section is that the rules of governance are intertwined with the rules of external relations. Any change in one will have a ripple effect on the terms to which the relevant parties would have agreed concerning the other. Accordingly, agency costs analysis of trust law speaks not only to matters of *both* internal governance *and* external relations, but it also brings into view the interrelationship between the two.

1. Equitable tracing. Perhaps the best example of this point is the principle of equitable tracing. Under standard doctrine, beneficiaries have the right to assert an equitable lien on property transferred by the trustee to a third-party in breach of trust, provided the transferee is not a bona fide purchaser for value without notice.[242] Fraudulent conveyance law to one side, one's recourse for a broken contract does not normally include a suit against the outsider who benefited by the breach.[243] So there is some tension here with notion of the trust

[240] Thus, just as one would not study the rules of an agent's (legally defined) authority to bind the principal without reference to the effectiveness of the governance devices provided by the law of agency (and vice versa), so too the rules of the external relations of the principal parties with respect to the trust property are related to the rules of internal trust governance (and vice versa).

[241] Jensen & Meckling, *supra* note __, at 56-57.

[242] See Restatement (Second) of Trusts §§ 283-295; IV Scott on Trusts §§ 283-95; *Kline v. Orebaugh*, 519 P.2d 691, 696 (Kan. 1974).

[243] This is an important premise for the notion of efficient breach. See, e.g., Posner, *supra* note __, at § 4.9, pp. 120-21. But see Hansmann & Kraakman, *supra* note __, at S412-13.

as a third-party beneficiary contract. Langbein's answer, in addition to concluding that the trust is in the end a hybrid of contract and property,[244] is to characterize the rule as embodying "a judgment about how far to impinge on outsiders to the trust deal between the settlor and trustee in order to vindicate that deal."[245]

There is, in contrast, no tension between this point and the agency costs model of the trust as an organizational form. By including those who deal with the trustee within the relevant set or nexus of relationships, the rule of equitable tracing can be understood as reflecting the parties' presumed intent in light of the comparative advantage of the outsider over the beneficiary to bear the agency costs associated with this particular potential breach by the trustee. Thus, even though Hansmann & Mattei regard the default rules of internal trust governance as "relatively unimportant" in comparison to the rules that control the relations of the principle parties with outsiders,[246] their explanation of equitable tracing likewise acknowledges the interrelationship between external relations and internal governance. When "the rule [of equitable tracing] operates, the third party transferor is almost by definition a lower-cost monitor of the [trustee's] breach of duty than is the [beneficiary]."[247] In other words, in the absence of a contrary agreement, efficiency militates towards allocating this risk to the outsider rather than increasing the burden on the trust's internal governance devices. The outsider is the cheaper bearer of this risk.[248]

This sort of analysis not only provides a functional explanation for equitable tracing as a positive matter, but it also helps bring into view pertinent normative considerations for modern trust law reform. Recognition of the interrelationship between internal governance and the scope of external relations authority shows that the "price" for relaxing one is increasing the problems associated with the other. Thus, recognition of the tradeoff provides a straightforward means for ascertaining the costs and benefits of law reform on the margins of this question.

A concrete example is the trend towards liberalizing the rules that govern the dealings of the trustee, as trustee, with third parties.[249] The foregoing analysis suggests that the price, as it were, for enlarging the trustee's transactional authority will be an increase in potential agency costs and so a greater burden on the internal governance devices. Hence, when David English, the Uniform Trust Code's Reporter, suggests that "beneficiaries are helped more by

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[244] See *supra* note 42 and text accompanying.

[245] Langbein, *supra* note __, at 647-48. See also Hansmann & Kraakman, *supra* note __, at S378-79.

[246] Hansmann & Mattei, *supra* note __, at 438. See *supra* note __ and text accompanying.

[247] Id. at 464.

[248] Cf. Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. Leg. Stud. 83 (1977).

[249] UTC §§ 1010-13. These UTC provisions, which are based on similar provisions in the 1969 Uniform Probate Code and Uniform Trustee Powers Act, are the culmination of a decades-long process of statutory reform. See *supra* note 11.

the free flow of commerce than they were by the largely ineffective protective features of former law,"[250] he might be interpreted as suggesting that increasing the value of property held in the trust's default form by expanding the trustees' transactional opportunities (the benefit of this reform) outweighs the minimal increase in the burden on the existing governance devices (the cost of this reform).[251]

2. The spendthrift trust. A second example of the importance of the interrelationship between internal governance considerations and the scope of the principal parties' external relations authority may be found in the spendthrift trust. Spendthrift trusts, in comparison to ordinary trusts without spendthrift protection, shield the trusts' assets from the beneficiaries' creditors.[252] This is true even if the trust instrument requires mandatory payouts, because those payments could be made directly to the beneficiaries' service providers.[253] Not surprisingly, there is a substantial literature on the policy soundness of the spendthrift trust.[254] There is also considerable divergence among the common law nations on their enforcement. Spendthrift provisions are valid in the United States (indeed, they are the default in New York[255]), but they are not enforced in the majority of the common law world (including most prominently England).[256]

The existing normative commentary on the spendthrift trust tends to treat the question as presenting a tradeoff between paternalistic protection of feckless beneficiaries and the protection of voluntary and, more clearly, involuntary creditors.[257] Thus, the usual focus is on the policy soundness of limiting the

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[250] English, *supra* note __, at 208-11.

[251] This is consistent with the move away from cabining trustees' authority through limited powers and towards the fiduciary principle as the trust's chief governance device. See Langbein, *supra* note __, at 641-42; text accompanying *supra* notes __.

[252] See generally Restatement (Second) of Trusts §§ 152-53; Restatement (Third) of Trusts § 58; UTC § 502. State law restrictions on transfer are applicable even in bankruptcy. 11 U.S.C. § 541(c)(2). A few privileged creditors, however, including children, spouses, and former spouses seeking support or maintenance, may sometimes reach the beneficiaries' interest despite a spendthrift clause. See Restatement (Third) of Trusts § 59; UTC § 503; Carolyn L. Dessin, *Feed a Trust and Starve a Child: The Effectiveness of Trust Protective Techniques Against Claims for Support and Alimony*, 10 Ga. St. U. L. Rev. 691, 699-723 (1994).

[253] Cf. Dukeminier & Johanson, *supra* note __, at 647.

[254] See, e.g., Alan Newman, *The Rights of Creditors of Beneficiaries Under the Uniform Trust Code: An Examination of the Compromise*, 69 Tenn. L. Rev. 771 (2002); Robert T. Danforth, *Rethinking the Law of Creditors' Rights in Trusts*, 53 Hastings L. J. 287 (2002); Adam J. Hirsch, *Spendthrift Trusts and Public Policy: Economic and Cognitive Perspectives,* 73 Wash. U. L.Q. 1 (1995); Anne S. Emanuel, *Spendthrift Trusts: It's Time to Codify the Compromise*, 72 Neb. L. Rev. 179 (1993); Erwin N. Griswold, *Spendthrift Trusts* (1936); John Chipman Gray, *Restraints on the Alienation of Property* (1883). See also Fellows, *supra* note __.

[255] N.Y. Est. Powers & Trusts Law § 7-1.5. Spendthrift clauses are standard in practitioner formbooks and they are customary estate planning boilerplate. See Hirsch, *supra* note __, at 3 & n. 7.

[256] The classic English case is *Brandon v. Robinson*, 34 Eng. Rep. 379 (Ch. 1811). For further discussion and references, see Moffat, *supra* note __, at 211-24.

[257] See, e.g., Posner, *supra* note __, at § 18.7, p. 523-24; Hirsch, *supra* note __; Emanuel, *supra* note __; Ogus, *supra* note __, at 217-18.

scope of the beneficiaries' external relations authority in view of how doing so impacts both the beneficiaries and the outsiders with whom the beneficiaries transact. This approach, however, overlooks the interrelationship between the external relations of the trust insiders with third parties on the one hand and the details of the internal governance regime on the other.[258]

One governance benefit of the enforcement of spendthrift provisions is that the payouts in a spendthrift trust may safely be made mandatory. This reduces the trustee's discretion and so diminishes the potential for managerial agency costs. But the cost is that an alternative potential check on agency costs, the theoretical possibility of the residual claimants' exit, is foreclosed as a matter of law. Exit is in theory a powerful governance device, but its potential has not been realized in the context of donative trusts.[259] The idea is that the consequent market for residual interests would provide price signals on the quality of the particular trust's management. Unlike the initial gratuitous transfer by the settlor, a subsequent sale by the beneficiary of his or her interest would indeed involve reckoning a price.[260]

Moreover, open as compared to closed residual claims offer the possibility of welfare-improving secondary transactions. For example, if in the hands of the beneficiary the discounted present value of the future income stream from the trust is worth $10, but in the hands of someone who is more adept at monitoring and at fiduciary litigation the present value of the beneficiary's interest would be $15, a spendthrift provision results in a $5 residual loss. This is the agency costs "price," as it were, of honoring the settlor's dead hand interest in protecting a hapless beneficiary.[261]

In the absence of spendthrift recognition, however, settlors who wish to guard the trust's assets against an insolvent beneficiary's creditors would be channeled, as they are in England,[262] towards discretionary trusts.[263] (Discre-

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[258] There is no reason to limit "third persons" in trust law parlance to those who deal with the trustee as trustee. See, e.g., English, *supra* note __, at 208. Third persons also deal with beneficiaries as beneficiaries. Cf. Hansmann & Mattei, *supra* note __, at 451-53.

[259] Exit is discussed here as a theoretical governance device, because as noted earlier, see text accompanying *supra* note 159, there is no well-developed market for American trust interests. Perhaps this is a consequence of the frequency of spendthrift clauses, discretionary trusts, and protective provisions. Indeed the availability of the latter two, on which see *supra* note 263 and text accompanying, also helps explain the narrowness of the corresponding English market. The author thanks Richard Nolan for discussion on this point.

[260] See Jensen & Fama, *supra* note __, at 312-15; Fama, *supra* note __, at 292; Easterbrook & Fischel, *supra* note __, at 274-77. Cf. Robert D. Hershey, Jr., *Birthrights Up for Auction as Investments in London*, N.Y. Times D1 (March 6, 1978). See also notes 113-116 and text accompanying.

[261] The settlor, in other words, must have figured that the beneficiary would alienate his or her interest for less than $10 if given the chance to do so. As Richard Posner has remarked, such "[t]rusts are based on mistrust." Posner, *supra* note __, at § 18.7, pp. 523-24.

[262] See Hansmann & Mattei, *supra* note __, at 452 n. 57; Halbach, *supra* note __, at 1893.

[263] See, e.g., UTC § 504; Restatement (Second) of Trusts § 155; Evelyn Ginsberg Abravanel, *Discretionary Support Trusts*, 68 Iowa L. Rev. 273 (1983); Newman, *supra* note __, at 803-16. Yet another alternative, also common in England, see, e.g., Hayton, *supra* note __, at 590-92, is a trust with a "protective

tionary trusts are common in American practice too, but American settlors who are concerned about a beneficiary's future insolvency have the spendthrift alternative.) By leaving the payment decision to the discretion of the trustee, the beneficiary has no right to a payout, which means that neither does his or her creditors.[264] But the cost of this alternative disabling restraint is that the fiduciary obligation is further burdened with the task of regulating the trustees' exercise of this discretion over disbursements.[265] Since the remedy for an underpayment is merely an order that the payments be increased,[266] but the remedy for an overpayment is to surcharge the trustee personally for the excess amounts disbursed,[267] this skews trustees towards caution.[268] What is more, interests in discretionary trusts are not easily saleable because there is no guarantee of future payments, so discretionary trusts, like spendthrifts, fail to allow for exit.

These differing routes to giving effect to the settlor's interest in cabining the right of a beneficiary to alienate his or her interest in the trust—a mandatory trust with a spendthrift limitation versus a discretionary trust—have different agency costs consequences. Thus it is not obvious that disapproval of the spendthrift trust either decreases agency costs or improves the lot of the beneficiaries' creditors (though of course creditors of discretionary trust beneficiaries have leverage that creditors of spendthrift trust beneficiaries lack). Perhaps the divergence of opinion among the common law jurisdictions reflects this difficulty in reckoning the magnitudes of the foregoing competing effects.

Even if it does not help resolve the policy question of which form of protective measure is preferable, agency costs analysis does help explain the continued existence of one or more of them in all the common law jurisdictions. Without the option of at least one enforceable protective measure, settlors who are concerned about a beneficiary's future insolvency would be channeled towards informal arrangements such as outright transfers to trusted kin or

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provision." This is a clause that conditions the beneficiaries' interest on his or her solvency or the nonoccurrence of any event that, but for the protective provision, the beneficiary's interest would be reachable by a third party. See id.; Emanuel, *supra* note __, at 185-86; Ogus, *supra* note __, at 205; Bogert, *supra* note __, at § 44; Restatement (Third) of Trusts § 57; Trustee Act 1925 § 33 (UK).

[264] See, e.g., UTC § 504(b); *Goforth v. Gee*, 975 S.W.2d 448, 450 (Ky. 1998); *United States v. O'Shaughnessy*, 517 N.W.2d 574 (Minn. 1994); *Hamilton v. Drogo*, 150 N.E. 496 (N.Y. 1926); Restatement (Second) of Trusts § 155 & cmt. b; IIA Scott on Trusts § 155.1, pp. 159-64. But see Halbach, *supra* note __, at 1895; Restatement (Third) of Trusts § 60 cmt. e.

[265] See, e.g., Edward C. Halbach, Jr., *Problems of Discretion in Discretionary Trusts*, 61 Colum. L. Rev. 1425 (1961); Restatement (Third) of Trusts § 50.

[266] See Halbach, *supra* note __, at 1427; William M. McGovern, Jr. & Sheldon F. Kurtz, *Wills, Trusts, and Estates* § 9.5, p. 339-40 (2001); *Estate of Lindgren*, 885 P.2d 1280, 1283 (Mont. 1994); *Kolodney v. Kolodney*, 503 A.2d 625 (Conn. App. 1986).

[267] See Halbach, *supra* note __, at 1427; McGovern & Kurtz, *supra* note __, at § 9.5, p. 339-40; *Austin v. U.S. Bank of Washington*, 869 P.2d 404 (Wash. App. 1994); *Feibelman v. Worthen Nat. Bank*, 20 F.3d 835 (8th Cir. 1994); *In re Murray*, 45 A.2d 636 (Me. 1946).

[268] A further though illegitimate reason for trustee conservatism is that their fees are often a percentage of the trust corpus, though this rules-based approach is now giving way to a "reasonableness" standard. See *supra* note __.

friends with a wink and nod that the transferee will take care of the would-be beneficiary.[269] The potential agency costs to the beneficiaries and to the settlor of this approach, which would hardly benefit the beneficiaries' creditors, are manifest.

D. Fiduciary Litigation

As we have seen, the possibility of market-based governance devices for the private trust is cabined by the impediments, central to the donative trust's often paternalistic function, to the beneficiaries' alienating their stake in the trust and the difficulty in sacking the trustee. So in today's managerial private trusts, in which the limits of yore on the trustee's authority have yielded to broad grants of discretion, this places much of the governance burden on the fiduciary obligation.[270] It is here, however, that the agency costs approach to the private trust most closely converges with Langbein's contractarianism: both point strongly towards a contractarian, hypothetical-bargain underpinning for the fiduciary obligation.[271] Indeed, drawing on earlier economic analyses of the fiduciary relationship more generally,[272] Langbein persuasively shows that "pulpit-thumping rhetoric about the sanctity of fiduciary obligations" notwithstanding,[273] the fiduciary duties imposed by the law of trusts are simply majoritarian default rules.[274]

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[269] For further discussion and references, see Hirsch, *supra* note __, at 70-71.

[270] See Langbein, *supra* note __, at 642 (discussing the decline of powers law and the rise of fiduciary law for protecting the interests of the beneficiaries).

[271] There is no shortage of commentary on fiduciary duties generally. See, e.g., Alexander, *supra* note __; William W. Bratton, *Game Theory and the Restoration of Honor to Corporate Law's Duty of Loyalty*, in Lawrence E. Mitchell, ed., *Progressive Corporate Law* (1995); Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 Wash. L. Rev 1 (1990); Robert C. Clark, *Agency Costs versus Fiduciary Duties* 55, in John W. Pratt & Richard J. Zeckhauser, eds., *Principles and Agents: The Structure of Business* 55 (1985); Brian R. Cheffins, *Law, Economics and Morality: Contracting Out of Corporate Law Fiduciary Duties*, 19 Canadian Bus. L. J. 28 (1991); Cooter & Freedman, *supra* note __; Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 Duke L. J. 879; Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J. L. & Econ. 425 (1993); Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 Oregon L. Rev. (1995); Tamar Frankel, *Fiduciary Law*, 71 Cal. L. Rev 795 (1983); Oliver Hart, *An Economist's View of Fiduciary Duty*, 43 U. Toronto L. J. 199 (1993); Larry E. Ribstein, *The Structure of the Fiduciary Relationship* (manuscript); L.S. Sealy, *Fiduciary Relationships*, 1962 Cambridge L. J. 69; J.C. Shepherd, *Towards a Unified Concept of Fiduciary Relationships*, 97 L. Q. Rev. 51 (1981); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 Vand. L. Rev. 1399 (2002); Ernest J. Weinrib, *The Fiduciary Obligation*, 28 U. Toronto L. J. 1 (1975).

[272] A point anticipated in Alexander, *supra* note __, at 1. See Langbein, *supra* note __, at 657-60, citing Easterbrook & Fischel, *supra* note __; Cooter & Freedman, *supra* note __. See also Fischel & Langbein, *supra* note __, at 1113-17.

[273] Which is not to say that moral condemnation does not have utility as an expressive sanction, especially for institutional fiduciaries for whom reputation is a valuable asset. See Cooter & Freedman, *supra* note __, at 1073-74; Langbein, *supra* note __, at 658.

[274] "Loyalty and prudence, the norms of trust fiduciary law, embody the default regime that the parties to the trust deal would choose as the criteria for regulating the trustee's behavior in these settings in which it is impractical to foresee precise circumstances and to specify more exact terms." Langbein, *supra* note __, at 629, 657-60.

Thus, this section will not engage the debate over the contractarian basis for trust fiduciary law. Nor will it explore the tightness of fit between the structure of the fiduciary obligation in trust law and the agency problems embedded in the private trust (though there was some discussion of this earlier).[275] Instead, this section will briefly explore two possible answers to the question of *why* the fiduciary obligation appears to have succeeded as the private trust's chief check on agency costs.[276] The question is brought into sharp relief by the widely-held view that the fiduciary obligation has proved to be a less successful governance device in the cognate field of corporate governance.[277]

1. Litigation incentives. When liability rules are the chief check on agency costs, there is a practical limit to the number of residual claimants that the organization can reasonably support. The greater the number, the more serious the collective action dynamic that will weaken any individual's inventive to monitor and then to bring litigation.[278] Consider, for example, that the paradigmatic shareholder in a publicly-traded corporation has only a trivial stake in the company. So he or she has little incentive to reckon the costs and benefits of litigation from the perspective of all the shareholders. Consequently in corporate fiduciary litigation the real party in interest is often the lawyer.[279]

Litigation incentives are likely to be different, however, in the world of private donative trusts thanks to the (typically) smaller number of residual claimants.[280] Donative trust beneficiaries are likely to have a nontrivial stake when stake is measured by either the fraction of his or her wealth held in the trust or the fractional share of the trust to which he or she is entitled. Accordingly, fiduciary litigation in trust law is more likely than in corporate law to be prompted by the merits. That is, the relatively smaller number of residual

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[275] See *supra* Parts IV.A.1 (duty of impartiality) and IV.A.3 (duty of care). See also Sitkoff, *supra* note __, at __ (duty of loyalty, duty of disclosure). For general discussion, see Cooter & Freedman, *supra* note __, at 1047; W. Bishop & D.D. Prentice, *Some Legal and Economic Aspects of Fiduciary Remuneration*, 46 Mod. L. Rev. 289 (1983); Fischel & Langbein, *supra* note __, at 1113-17.

[276] For a behavioral decision theory approach to this question, see Alexander, *supra* note __.

[277] See Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J. Law, Econ. & Org. 55 (1991); Reinier Kraakman, Hyun Park, & Steven Shavell, *When Are Shareholder Suits in Shareholder Interests?*, 82 Geo. L. J. 1733 (1994); Bradley & Fischel, *supra* note __; John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 L. & Contemp. Prob. 5 (1985); John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 Colum. L. Rev. 261 (1981); Bainbridge, *supra* note __, at § 8.3, pp. 365-68. See also Sitkoff, *supra* note __ (comparing the governance of public corporations with that of donative trusts).

[278] See Gordon, *supra* note __, at 76-79.

[279] See Bainbridge, *supra* note __, at § 8.3, p. 367; Easterbrook & Fischel, *supra* note __, at 100-02; Allen & Kraakman, *supra* note __, at § 10.2, pp. 351-52, 355-56. See generally John C. Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 Colum. L. Rev. 669 (1986); Jonathan Macey & Geoffrey Miller, *The Plaintiff's Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. Chi. L. Rev. 1 (1991).

[280] This point was noted in Macey, *supra* note __, at 319-20. See also Hirsch & Wang, *supra* note __, at 29 n. 110.

claimants and their relatively larger stakes lessens the impact of the collective action and free-rider dynamics.

This is not to say that the litigation incentives for trust beneficiaries are perfect. Some beneficiaries lack a sufficient stake to reckon the costs and benefits of bringing litigation.[281] What is more, awards of attorneys' fees to one or both sides in suits over trust administration are not uncommon.[282] Even though courts can use this as a tool to encourage meritorious litigation, the availability of attorneys fees can also encourage strike suits.[283] Still, the more modest claim holds—fiduciary litigation is a viable governance option in trust law because there are fewer residual claimants and the collective action pathology is thereby minimized.

A separate objection might be that beneficiaries are often unsuited to monitor the trustee, perhaps because they are unborn, incapacitated, or simply irresponsible. After all, tax exigencies to one side, the settlor didn't trust them enough to make an outright transfer, favoring instead a trust despite its inherent agency costs. But trust fiduciary law, especially the duty of loyalty, is stricter and more prophylactic than the fiduciary law of other organizational forms.[284] Hence, as Fischel and Langbein have suggested, many of trust law's fiduciary duties can be understood as "substitutes for monitoring by the directly interested parties."[285] Moreover, the modern trend is towards expanding further the duty of trustees to furnish beneficiaries with relevant information regarding the management of the trust.[286]

At any rate, this analysis throws light on the relevance of the number of residual claimants to the choice of organizational form.[287] The agency costs-checking mechanisms of the private trust depends on their being relatively fewer. The corporation, in contrast, is constructed so that it can—but need not, as shown by the success of the close corporation—handle many. Unlike the typical close corporation, the trust separates risk bearing and management; but

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[281] See Gordon, *supra* note __, at 76-79.

[282] See, e.g., UTC § 1004 (court may award fees); III Scott on Trusts § 188.4 (trustees' authority to pay fees out of the trust corpus); *Allard v. Pacific National Bank*, 663 P.2d 104, 111-12 (Wash. 1983); Gordon, *supra* note __, at 76-77 n. 103.

[283] See generally Allen & Kraakman, *supra* note __, at § 10.2, pp. 351-52; Posner, *supra* note __, at § 21.11.

[284] Consider, for example, the no-further-inquiry rule, on which see sources cited in *infra* note __. See also *supra* Part IV.A.3 (comparison of the duty of care in trust law and corporate law).

[285] Fischel & Langbein, *supra* note __, at 1114-15, 1118-19. Note the emergence of organizations such as Heirs, Inc., the purpose of which is to facilitate better monitoring by trust beneficiaries. See <http://www.heirs.net/>. See also Kathy Kristof, *An Heir of Confidence*, Chicago Trib. C7 (May 21, 1996).

[286] See Halbach, *supra* note __, at 1914-15; UTC § 813. See also *Allard v. Pacific National Bank*, 663 P.2d 104, 110-111 (Wash. 1983); Langbein, *supra* note __, at 74; Langbein, manuscript, *supra* note __, at Part II.C. For further discussion of disclosure in trust law, see Sitkoff, *supra* note __.

[287] See generally Fama & Jensen, *supra* note __.

unlike the public corporation, the trust's residual claim is typically split among a small number of claimants.[288]

The relevance of the number of residual claimants to the agency-costs-checking utility of the fiduciary obligation is further emphasized by a quick comparison of the private trust with the statutory business trust. The chief differences between the two are in the frequency with which business trusts provide voting rights, transferable or at least redeemable interests, and less rigorous processes for removing trustees.[289] Together, these characteristics make the business trust look more like a public corporation than a donative private trust. Likewise the governance of numerous commercial manifestations of the private trust, at least when the residual claims are sold to outsiders, also more closely resembles the governance of the public corporation than it does the donative private trust.[290] It will therefore be interesting to see whether the ongoing relaxation of the rule against perpetuities and its consequent increase in the number of beneficiaries in donative trusts will eventually push trust law towards more of a corporate governance model.

It seems likely, moreover, that this agency costs analysis could be applied to employee benefit and pension trusts, upon which ERISA imposes a mandatory trust law paradigm.[291] Indeed, on first glance it appears that, given the large number of participants in many of these plans, the incentive structure and agency costs analysis for pension and employee benefits trusts might be more like that of public corporations than the traditional gratuitous private trust. This may explain some of the tension between the trust law paradigm and the realities of pension and employee benefit trusts in practice.[292]

The relevance of the number of residual claimants to the agency costs calculus is still further supported by the widely-held view that the absence of

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[288] In a loose sense, then, the trust is closer to the Alchian and Demsetz conception of the firm, with the residual claimant as the chief monitor, Alchian & Demsetz, *supra* note __, at 782, than it is to the later agency cost models of the public corporation, see, e.g., Fama, *supra* note __, at 289. But the trust is not as close to Alchian and Demsetz's model as the close corporation, for which the managers tend also to be the chief residual claimants. See Easterbrook & Fischel, *supra* note __, at 273.

[289] See generally Schwarcz, *supra* note __; Tamar Frankel, *The Delaware Business Trust Act Failure as the New Corporate Law*, 23 Cardozo L. Rev. 325 (2001); Wendell Fenton & Eric A. Mazie, *Delaware Business Trusts*, in R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations & Business Organizations* (2003); Andrew B. Kopans, *The Business Trust in the Mutual Fund Industry: Old Arguments in a New Industry with Two New Players* (unpublished manuscript); Sheldon A. Jones, Laura M. Moret, & James M. Storey, *The Massachusetts Business Trust and Registered Investment Companies*, 13 Del. J. Corp. L. 421 (1988). See also *Hecht v. Malley*, 265 U.S. 144, 146-47 (1924); Note, *Trusteeship in Modern Business*, 42 Harv. L. Rev. 1048 (1929).

[290] See Schwarcz, *supra* note __, at 579. See also Wallace Wen Yeu Wang, *Corporate Versus Contractual Mutual Funds: An Evaluation of Structure and Governance*, 69 Wash. L. Rev. 927 (1994); Langbein, *supra* note __.

[291] ERISA § 403, 29 U.S.C. § 1103; Langbein & Polk, *supra* note __, at 646-48.

[292] See Fischel & Langbein, *supra* note __, at 1107 (arguing that "the central concept of ERISA fiduciary law, the exclusive benefit rule, misdescribes the reality of the modern pension and employee benefit trust"). See also John H. Langbein, *The Supreme Court Flunks Trusts*, 1990 S. Ct. Rev. 207.

identifiable beneficiaries in charitable trusts raises serious governance problems.[293]

2. Fiduciary sub-rules. In other contexts, perhaps the most apposite being the governance of closely-held corporations, it has been suggested that the "usefulness of fiduciary duties as a guide for conduct is limited" by their being so open ended.[294] But the private trust differs importantly from the close corporation in that there is less variance in the operating context from one trust to another. This relative homogeneity of context has allowed the law of trusts to evolve a detailed schedule of fiduciary sub-rules as specific agency costs-checking devices where law of close corporations depends instead on the parties' cutting their own circumstances-specific deal.[295] The fiduciary sub-rules of trust law include the duties to keep and control trust property, to enforce claims, to defend actions, to keep trust property separate, to minimize costs (including taxes), to furnish information to the beneficiaries, and so on.[296]

The function of these sub-rules is to provide the benefits of *rules* (as compared to *standards*) without inviting strategic loop-holing by trustees.[297] When aggrieved beneficiaries can squeeze their claim into a specific sub-rule—and for these purposes, the default ban on self-dealing known as the no-further-inquiry rule can be included within this analysis[298]—their case is simplified. As in the application of any rule, the costs of decision are lower than for a standard. But when the aggrieved beneficiaries cannot squeeze their claim into a specific sub-rule, then the broad standards of care and loyalty serve as a backstop to allow for contextual, facts-and-circumstances inquiry into the trustees' behavior as a part of the courts' gap filling role owing to "the impossibility of writing contracts completely specifying the parties' obligations."[299] Recall that in the modern managerial trust, the fiduciary obligation has eclipsed detailed schedules of limited powers as the chief device for controlling managerial agency costs.[300] The effectiveness of the trust law fiduciary obligation as a check on agency costs is thus enhanced by use of a mix of sub-rules and overarching standards,[301] the

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[293] See sources cited in *supra* notes 179, 233. See also Macey, *supra* note __, at 315.

[294] Easterbrook & Fischel, *supra* note __, at 291.

[295] See id. at 281-86.

[296] See, e.g., Restatement (Second) of Trusts §§ 172-185; UTC §§ 801-13.

[297] See, e.g., Louis Kaplow, *Rules Versus Standards: An Economic* Analysis, 42 Duke L. J. 557 (1992); Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. Legal Stud. 257 (1974). See also *Mindgames, Inc. v. W. Publ'g Co.*, 218 F.3d 652, 656-58 (7th Cir. 2000) (Posner, C.J.); Carol M. Rose, *Crystals and Mud in Property Law*, 40 Stan. L. Rev. 577 (1988).

[298] On the no-further-inquiry rule, see, e.g., *Hartman v. Hartle*, 122 A. 615 (N.J. 1923); IIA Scott on Trusts §170.2, p. 320. For commentary, see Sitkoff, *supra* note __, at __; Cooter & Ulen, *supra* note __, at 1054; Easterbrook & Fischel, *supra* note __, at 437.

[299] Easterbrook & Fischel, *supra* note __, at 426.

[300] See *supra* note __ and text accompanying. Note the parallel to the fall of the *ultra vires* doctrine in corporate law. See Sitkoff, *supra* note __, at __.

[301] A similar sub-rule phenomenon exists within the law of agency, see Restatement (Second) of Agency §§ 380-86, 388-98. The detailed rules of legal ethics, see, e.g., Model Rules of Professional Responsibility 1.1 – 1.16; Code of Professional Responsibility Disciplinary Rules 5-101 – 5-107, might also be under-

former made possible by the relative homogeneity of managerial context for donative trusts.[302]

CONCLUSION

This paper's agency costs approach to the donative private trust not only helps illuminate the ongoing debate over whether trust law is closer to property law or contract law, but more importantly it provides a rich positive and normative framework for further economic analysis of trust law. Principal-agent economics, in other words, has great potential to offer further insights about the nature and function of the law of trusts. In particular, the agency costs analysis of this paper demonstrates how and why the use of the private trust triggers a temporal agency problem (whether the trustee will remain loyal to the settlor's original wishes) in addition to the usual agency problem when risk-bearing and management are separated (whether the trustee/manager will act in the best interests of the beneficiaries/residual claimants).

The paper's normative claim was that the law of private trusts should minimize the agency costs inherent to locating managerial authority with the trustee and the residual claim with the beneficiaries, but only to the extent that doing so is consistent with the ex ante instructions of the settlor. This qualification gives priority to the settlor over the beneficiaries as the trustee's primary principal. The positive claim was that, at least with respect to traditional doctrines, the law of trusts conforms to the suggested normative approach. In particular, the paper demonstrated the power of the agency costs approach to offer fresh insights by looking at recurring problem areas in trust law including, among others, trust modification and termination, settlor standing, fiduciary litigation, trust-investment law and the duty of impartiality, trustee removal, the role of so-called trust "protectors," and spendthrift trusts.

stood as manifestation of this sub-rule phenomenon. Cf. James R. McCall, *Endangering Individual Autonomy in Choice of Lawyers and Trustees—Misconceived Conflict of Interest Claims in the Kamehameha Schools Bishop Estate Litigation*, 21 U. Hawaii L. Rev. 487, 488 n. 1 (1999).

[302] On the relevance of ex ante programmability to agency costs analysis, see Eisenhardt, *supra* note __, at 62.