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An Agency Costs Theory of Trust Law

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Abstract

This Article 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 problems in trust law including, among others, 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 should minimize the agency costs inherent in 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 that arises 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 conforms to the suggested normative approach. This Article 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. Although the analysis focuses on donative trusts, it should be amenable to extension in future work to commercial and charitable trusts.

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† Associate Professor of Law, Northwestern University. For helpful comments on earlier drafts, the author thanks Gregory Alexander, Jennifer Arlen, John Armour, Mark Ascher, Ronen Avraham, Lisa Bernstein, Richard Brooks, Brian Cheffins, Ronald Chester, Albert Choi, Barry Cushman, Kevin Davis, Simon Deakin, Deborah DeMott, Joel Dobris, Frank Easterbrook, David English, Lee Fennell, Mark Filip, Daniel Fischel, Tamar Frankel, Nicholas Georgakopoulos, Joshua Getzler, David Haddock, Philip Hamburger, Henry Hansmann, David Hayton, R.H. Helmholz, Adam Hirsch, Marcel Kahan, Louis Kaplow, Andrew Kopans, Reinier Kraakman, John Langbein, Melanie Leslie, James Lindgren, Paul Mahoney, Fred McChesney, John McGinnis, Thomas Merrill, Roger Myerson, Jeffrey Pennell, James Penner, Eric Posner, Richard Posner, Claire Priest, Eric Rasmusen, Larry Ribstein, Roberta Romano, Jeffrey Schoenblum, Steven Schwarcz, Steven Shavell, Helene Shapo, Samuel Sitkoff, Tamara Sitkoff, Stewart Sterk, George Triantis, Thomas Ulen, Lawrence Waggoner, Sarah Worthington, Albert Yoon, and workshop participants at Cambridge, Chicago, Harvard, Indiana, London (London School of Economics and King's College), Michigan, Northwestern, Oxford, Virginia, and the Annual Meetings of the American (2003), Midwest (2002), and Canadian (2002) Law and Economics Associations. Richard Nolan fielded numerous questions about English law. The author also thanks Litsa Georgantopoulos, Kathryn Hensiak, Jeremy Polk, and Jeremy Sitkoff for excellent research assistance and the Victor Family Research Fund and the Northwestern University School of Law Summer Faculty Research Program for financial support.

INTRODUCTION

Agency cost theories of the firm dominate the modern literature of corporate law and economics.[1] Meanwhile, the private express trust, an entity from which the corporation traces its roots,[2] has been left largely untouched by agency cost analysis.[3] Yet, in an echo of Adolph Berle and Gardiner Means's famous critique of the corporation's "separation of ownership and control,"[4] the central feature of the private trust is that it "separate[s] the benefits of ownership from the burdens of ownership."[5] This implies that many of the analytical tools supplied by the agency cost theories of the firm, which are routinely applied in the economic analysis of corporate law, should be similarly applicable to the underdeveloped economic analysis of trust law.[6] Indeed, problems of shirking and monitoring, the driving concerns of agency cost analysis, abound in trust administration. Accordingly, this Article develops an agency costs theory of trust law as organizational law, here focusing on donative private trusts. The anal-

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); *see also* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327 (1983) [hereinafter Fama & Jensen, *Residual Claims*]; Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983) [hereinafter Fama & Jensen, *Separation*]; Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395–1774 (1989). *See generally* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS § 1.5, at 26–38 (2002) (discussing various economic models of business organizations). For the classic exposition in the legal literature, see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991).

2 *See* Edward Rock & Michael Wachter, *Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 NW. U. 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* 3 FREDERIC W. MAITLAND, *Trust and Corporation*, *in* THE COLLECTED PAPERS OF FREDERIC WILLIAM MAITLAND 321, 395 (H.A.L. Fisher ed., 1911) (stating "that the connection between Trust and Corporation is very ancient").

3 Prior systematic applications of agency cost analysis to trust law are scarce. The principal exception is A.I. Ogus, *The Trust as Governance Structure*, 36 U. TORONTO L.J. 186 (1986). This is not to say, however, that agency cost analysis has not occasionally informed specific analyses. *See, e.g.*, Adam J. Hirsch, *Trusts for Purposes: Policy, Ambiguity, and Anomaly in the Uniform Laws*, 26 FLA. ST. U. L. REV. 913, 928 (1999); Adam J. Hirsch & William K.S. Wang, *A Qualitative Theory of the Dead Hand*, 68 IND. L.J. 1, 28–30 (1992); Jonathan R. Macey, *Private Trusts for the Provision of Private Goods*, 37 EMORY L.J. 295, 315–21 (1988); Stewart E. Sterk, *Jurisdictional Competition To Abolish the Rule Against Perpetuities: R.I.P. for the R.A.P.*, 24 CARDOZO L. REV. 2097, 2111–14 (2003).

4 ADOLPH A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 5 (1932).

5 1 AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS § 1, at 2 (4th ed. 1987) [hereinafter SCOTT ON TRUSTS].

6 *See* Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 N.Y.U. L. REV. 434, 435 (1998) (noting that the "literature . . . tends to be doctrinal rather than . . . functional in perspective"); Ogus, *supra* note 3, at 186 R
(noting the "neglect" of the trust by the law-and-economics movement).

ysis should be amenable to extension in future work to commercial and charitable trusts.[7] The present Article's contribution is the systematic application of agency theory to the law of donative trusts.

Consider a stylized example. In the prototypical donative 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 "Bs"), subject to the ex ante restraints imposed by the settlor.[8] 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 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 analysis will be different. Given the trust's independent significance in donative transfers, commercial transactions, and capital markets,[9] this should not be surprising.

That S saddled her transfer to B1 and B2 with the friction of competing principal-agent relationships is the core insight that animates the agency costs analysis. This Article's normative claim is that the law should minimize the agency costs inherent in 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.[10] The positive claim is that, at least with respect to tradi-

7 On extensions to charitable trusts, see *infra* notes 188, 248, 314 and accompanying text. On extensions to commercial trusts, see *infra* notes 13–14, 153, 309–10 and accompanying text. R R

8 *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. 1877, 1881 (2000) (noting that developments in modern trust law have emphasized flexible management "in the pursuit of the best interests of trust beneficiaries within the settlor's legally permissible objectives").

9 *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 14. R

10 For a brief derivation of the basic goal, see *infra* note 136. In a sense, this Article is a (long) answer to the question posed by Allen and Kraakman: "If the trustee relationship is analogized to the agency relationship, whom should we view as the principal?" WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION § 2.3.3, at 38 (2003); *see also id.* at 36 (comparing trust law and agency law). Note, R

tional doctrines,[11] the law conforms to the suggested normative approach.[12]

Theoretical and practical payoffs to the agency costs approach abound. On the theoretical side, this approach points to a further research agenda for the economic analysis of trust law. Beneficiaries assume the role of risk-bearing residual claimants (at least in the context of donative trusts[13]), 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?[14] What is the private trust's default governance arrangement, and why is that arrangement the default? Does the law do a good job of supplying the terms for which the relevant parties would have bargained with full information and low negotiation costs? And, for that matter,

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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.

[11] Analysis of modern reforms, such as asset protection trusts, *see, e.g.*, Stewart E. Sterk, *Asset Protection Trusts: Trust Law's Race to the Bottom?*, 85 CORNELL L. REV. 1035 (2000), and the abrogation of the Rule Against Perpetuities, *see, e.g.*, 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); Jesse Dukeminier & James E. Krier, *The Rise of the Perpetual Trust*, 50 UCLA L. REV. 1303 (2003); Sterk, *supra* note 3; Angela M. Vallario, *Death by a Thousand Cuts: The Rule Against Perpetuities*, 25 J. LEGIS. 141 (1999); Note, *Dynasty Trusts and the Rule Against Perpetuities*, 116 HARV. L. REV. 2588 (2003), requires consideration not only of agency costs analysis, but also reference to the political economy of modern trust law reform and the dynamics of the domestic and international regulatory competition for trust business. *See* Robert H. Sitkoff & Jonathan L. Corsico, Jurisdictional Competition for Trust Business: Follow the Money (unpublished manuscript, on file with author).

[12] This Article is therefore in superficial tension with Jonathan Macey's argument that common law trust doctrines do not promote efficiency. *See* Macey, *supra* note 3, at 296. **R**
For a variety of institutional reasons that Jeffrey Gordon has lucidly described, trends toward efficiency in trust law reflect a blend of common law and statutory reform. *See* Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. REV. 52 (1987). For further discussion, see Sitkoff & Corsico, *supra* note 11. **R**

[13] *See* discussion *infra* Parts III.D & IV.A. The parenthetical qualification is necessary because in contrast to the settlor of a typical donative 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).

[14] *See* Schwarcz, *supra* note 13, at 560, 573–84 (comparing commercial trusts with **R**
other forms of business organization); *see also* Michael Bryan, *Reflections on Some Commercial Applications of the Trust, in* KEY DEVELOPMENTS IN CORPORATE LAW AND TRUSTS LAW 205–26 (Ian Ramsay ed., 2002) (discussing the increased commercial utility of the trust form); Hansmann & Mattei, *supra* note 6, at 472–78 (comparing the trust form and the corporate **R**
form); John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165, 189 (1997) (discussing the many commercial uses of the trust form); Steven L. Schwarcz, *Commercial Trusts as Business Organizations: An Invitation to Comparatists,* 13 DUKE J. COMP. & INT'L L. 321, 321 (2003) (stating that "trusts are increasingly employed as business organizations in a wide range of commercial and financial transactions in the United States"). In particular, the trust plays a critical role as a special purpose entity in structured finance transactions. *See, e.g.*, Edward M. Iacobucci & Ralph A. Winter, Asset Securitization and Asymmetric Information (Apr. 15, 2003) (unpublished manuscript, on file with the Cornell Law Review); Schwarcz, *supra* note 13, at 564–65. **R**

who are the relevant parties? What is the role of markets—including labor, product, and capital[15]—in all of this? Because trusts are chiefly governed by state law, is there a regulatory competition among the states, and if so, to what end?[16]

On the practical side, agency cost analysis offers fresh insights into recurring problems in trust law including, among others, 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. On several of these and other issues, there is divergence between American and English law. Thus, a further benefit of the agency costs approach is that it provides a framework for evaluating the competing Anglo-American views.

This Article is organized as follows. Part I situates the analysis within the current trust law literature. More specifically, Part I advances the claim that classifying trust law as organizational law, and subjecting it to agency cost analysis, is the logical next step in the nascent economic analysis of the donative private trust. Thus, this Article does not advance the inherently dubious claim that all prior approaches to the trust should be discarded. On the contrary, the insights arising out of the debate whether trust law is closer to contract law or property law point to the viability of the agency costs approach.[17] In Part II, the Article briefly reviews the agency cost theories of the firm and the economics of the principal-agent problem. Both underpin this Article's agency costs approach to trust law. Part III identifies and then illuminates, through agency cost analysis, the key relationships between the parties who have an interest in the trust property or its management. Finally, Part IV develops the Article's positive and normative claims with reference to illustrative doctrines including, but not limited to, the recurring issues mentioned above. In so doing, Part IV helps to illuminate some of the endogenous gov-

15 *See* Robert H. Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency*, 28 J. Corp. L. 565 (2003).

16 *See* Dukeminier & Krier, *supra* note 11; Sterk, *supra* note 11, at 1037–38; Sterk, *supra* note 3, at 2098; Sitkoff & Corsico, *supra* note 11. R

17 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 8; Hansmann & Mattei, *supra* note 6; *cf.* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 Yale L.J. 387, 416 (2000) (describing trust law as a form of organizational law); Thomas W. Merrill & Henry E. Smith, *The Property/Contract Interface*, 101 Colum. L. Rev. 773, 843–49 (2001) (same); Ogus, *supra* note 3, at 188 (discussing agency costs in private trusts). Its more general inspiration R is the nexus of contracts models of the firm. *See* sources cited *supra* note 1; *see also* discussion *infra* Part II. R

ernance considerations relevant to the initial choice to make use of trust law rather than some other branch of organizational law.[18]

I
TRUST LAW AS ORGANIZATIONAL LAW

This Part advances the claim that trust law blends features familiar from both property and contract law. Hence trust law is properly classified, and best understood, as organizational law. This Part therefore builds on the debate 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 (who took a contractarian perspective).[19] More recently, in both the United States and abroad, commentators have shown renewed interest in the debate,[20] and in

18 Although admittedly relevant to the choice between organizational forms, this Article puts the exogenous tax and bankruptcy features of the private trust to the side (they are exogenous in that they stem from the tax and bankruptcy codes rather than trust law). For discussion, see Langbein, *supra* note 14, at 180–81; Schwarcz, *supra* note 13, at 581–83. **R**

19 On the "dialogue" between Maitland and Scott, see Langbein, *supra* note 8, 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). **R**

20 For modern American manifestations, see 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); Ronald Chester & Sarah Reid Ziomek, *Removal of Corporate Trustees Under the Uniform Trust Code and Other Current Law: Does a Contractual Lense Help Clarify the Rights of Beneficiaries?*, 67 MO. L. REV. 241, 244–46 (2002); 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 n.22 (1998); Michael A. Heller, *The Boundaries of Private Property*, 108 YALE L.J. 1163, 1178 & n.73 (1999); Merrill & Smith, *supra* note 17, at 844 n.248; *see also* ELIAS CLARK ET AL., GRATUITOUS TRANSFERS: WILLS, INTESTATE SUCCESSION, TRUSTS, GIFTS, FUTURE INTERESTS, AND ESTATE AND GIFT TAXATION 454–56 (4th ed. 1999); JOEL C. DOBRIS ET AL., ESTATES AND TRUSTS 476–77 (2d ed. 2003); RICHARD POWELL, POWELL ON REAL PROPERTY ¶ 513[3], at 41-141–50 (Michael Allan Wolf ed., rev. 2003); Gregory S. Alexander, *The Transformation of Trusts as a Legal Category, 1800–1914*, 5 L. & HIST. REV. 303, 336–50 (1987). For modern English manifestations, see RICHARD EDWARDS & NIGEL STOCKWELL, TRUSTS AND EQUITY 16–29 (5th ed. 2002); GRAHAM MOFFAT ET AL., TRUSTS LAW: TEXTS AND MATERIALS 190–95 (3d ed. 1999); PAUL TODD & SARAH WILSON, TEXTBOOK ON TRUSTS §§ 2.2, 2.3, at 50–69 (6th ed. 2003); Joshua Getzler, *Legislative Incursions into Modern Trusts Doctrine in England: The Trustee Act 2000 and the Contracts (Rights of Third Parties) Act 1999*, 2 GLOBAL JURIST TOPICS Art. 2, at 6–14 (2002) [hereinafter Getzler, *Legislative Incursions*]; Joshua Getzler, *Patterns of Fusion*, *in* THE CLASSIFICATION OF OBLIGATIONS 157, 164–67 (Peter Birks ed., 1997) [hereinafter Getzler, *Patterns*]; George L. Gretton, *Trusts Without Equity*, 49 INT'L & COMP. L.Q. 599, 603–08 (2000); David Hayton, *Developing the Obligation Characteristic of the Trust*, 117 L.Q. REV. 96, 1008 (2001); Neil Jones, *Trusts in England After the Statute of Uses: A View from the 16th Century*, *in* ITINERA FIDUCIAE: TRUST AND TREUHAND IN HISTORICAL PERSPECTIVE 173, 192–96 (Richard Helmholz & Reinhard Zimmerman eds., 1998); Paul Matthews, *From Obligation to Property, and Back Again? The Future of the Non-Charitable Purpose Trust*, *in* EXTENDING THE BOUNDARIES OF TRUSTS AND SIMILAR RING-FENCED FUNDS 203, 203–41 (David Hayton ed., 2002) [hereinafter EXTENDING THE BOUNDARIES]; Jonathan Hilliard, *On the Irreducible Core Content of Trusteeship—A Reply to Professors Matthews and Parkinson*, 17 TOLLEY'S TR. L. INT'L 144 (2003); Michael Macnair, *The Conceptual Basis of Trusts in*

particular John Langbein, Henry Hansmann, Ugo Mattei, and Reinier Kraakman have infused it with greater economic sophistication.[21]

A. Trust Law as Property Law

Trust law is most frequently classified as a species of property law.[22] For example, the 1959 *Restatement (Second) of Trusts* characterizes the "creation of a trust . . . as a conveyance of the beneficial interest in the trust property rather than as a contract."[23] Gregory Alexander recently distinguished the trustee's fiduciary obligations from those of corporate and other fiduciaries on the ground that the fiduciary relationship in trust law is "property-based."[24] A leading English treatise contends that the law of trusts "is at the heart of the common law of property."[25] The first two volumes of the *Restatement (Third) of Trusts*, published in final form in 2003, retain the view that the beneficiaries' stake in a trust is in the nature of a property interest.[26]

However, merely classifying trust law as property law, without coupling that classification with a functional analysis of the trust's proprietary or in rem features, does little to advance our substantive understanding of why trust law takes the form that it does.[27] To be sure,

the Later 17th and Early 18th Centuries, *in* ITINERA FIDUCIAE, *supra*, at 207, 221–29; R.C. Nolan, *Property in a Fund*, 120 L. Q. REV. 108, 111–17 (2004). The debate manifests elsewhere as well, both within the common law countries, *see* Patrick Parkinson, *Reconceptualising the Express Trust*, 61 CAMBRIDGE L.J. 657 (2002) (Australia); C.E.F. Rickett, *The Classification of Trusts*, 18 N.Z. U. L. REV. 305 (1999) (New Zealand), and without, *see* Stefan Grundmann, *The Evolution of Trust and* Treuhand *in the 20th Century*, *in* ITINERA FIDUCIAE, *supra*, at 469, 471–78 (Germany).

21 *See* Langbein, *supra* note 8; Hansmann & Kraakman, *supra* note 17; Hansmann & Mattei, *supra* note 6. R

22 *See* Langbein, *supra* note 8, at 643–46; *see also* EUGENE F. SCOLES ET AL., PROBLEMS AND MATERIALS ON DECEDENTS' ESTATES AND TRUSTS 605–06 (6th ed. 2000); Parkinson, *supra* note 20, at 657–58. R R

23 RESTATEMENT (SECOND) OF TRUSTS § 197 cmt. b (1959); *see* Langbein, *supra* note 8, at 648–49. R

24 Gregory S. Alexander, *A Cognitive Theory of Fiduciary Relationships*, 85 CORNELL L. REV. 767, 768 & n.7 (2000); *see also* Getzler, *Legislative Incursions*, *supra* note 20, Art. 2, at 10–14 (similar analysis by an English trust scholar); *cf.* Sitkoff, *supra* note 15, at 570–82 (comparing the fiduciary obligation in corporate law and trust law). R R

25 ROBERT A. PEARCE & JOHN STEVENS, THE LAW OF TRUSTS AND EQUITABLE OBLIGATIONS v (3d ed. 2002).

26 *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS § 5(i) & cmt. i (2003) (stating that contracts to convey or for the benefit of third parties are not trusts).

27 *See* Hansmann & Mattei, *supra* note 6, at 435 ("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."); *id.* at 435–38 (discussing the benefits of a functional analysis of trust law); *see also* Langbein, *supra* note 8, at 643–69 (discussing suppression of the contractarian perspective and noting the functional correspondence between trust and contract); Sarah Worthington, *The Commercial Utility of the Trust Vehicle*, *in* EXTENDING THE BOUNDARIES, *supra* note 20, at 135 (noting the general lack of functional analysis of trusts). R R

the existence of specifically identified property (the trust res) is necessary for trust formation.[28] But continuing to deem trust law a species of property law on that basis,[29] 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 its highly enabling, elastic, flexible, and default nature with respect to in personam relations. As Scott's famous treatise observes, "[t]he 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."[30]

Accordingly, the task for the functional study of trust law should be to identify the trust's in rem, proprietary elements and then to illuminate how they have been blended with its in personam, contractarian elements. As Thomas Merrill and Henry Smith recently observed, the modern law of trusts offers many of the in rem benefits of property law while simultaneously offering much of the in personam flexibility of contract law.[31]

B. The Contractarian Challenge

In an important recent article, John Langbein offered a functional account of trust law that challenged the traditional view 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."[32] In comparison to the meaning of contractarian as the term is used in the literature of corporate law and economics, Langbein's contractarian approach is more closely allied with the law of contracts than with the "nexus of contracts" metaphor that informs

28 RESTATEMENT (SECOND) OF TRUSTS § 74 (1959); 1A SCOTT ON TRUSTS, *supra* note 5, § 74, at 428–32; *see also* Jane B. Baron, *The Trust Res and Donative Intent*, 61 TUL. L. REV. 45, 47–50 (1986) (describing the "*res* requirement"). This is an important difference between the trust and a life insurance contract. The insurance company, unlike a trustee, is not required to segregate assets. *See, e.g.*, JESSE DUKEMINIER & STANLEY M. JOHANSON, WILLS, TRUSTS, AND ESTATES 332 n.2 (6th ed. 2000). R

29 *See* 1A SCOTT ON TRUSTS, *supra* note 5, § 74, at 428–32; Parkinson, *supra* note 20, at 658–59, 663–67; Rickett, *supra* note 20, at 308–09; *see also* Baron, *supra* note 28, at 50–70 (criticizing traditional justifications for the res requirement without analyzing whether the requirement is functional); *cf.* Langbein, *supra* note 8, at 627 ("In truth, the trust is a deal, a bargain about how the trust assets are to be managed and distributed."). R R R

30 1 SCOTT ON TRUSTS, *supra* note 5, § 1, at 2. R

31 *See* Merrill & Smith, *supra* note 17, 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. 373, 375 (2002); *cf.* FRANCIS S. PHILBRICK, PROPERTY 150–60 (1939); Hayton, *supra* note 20, at 107–08. A further useful feature of trust law is its amenability to the creation of exotic beneficial interests without dividing legal title. *See, e.g.*, Merrill & Smith, *supra* note 17, at 848–49; Heller, *supra* note 20, at 1178. R R

32 Langbein, *supra* note 8, at 627; *see also* Parkinson, *supra* note 20, at 659 (arguing "that the law of trusts is better conceptualised as a species of obligation rather than being understood as a form of property ownership"). R

the agency cost theories of the firm.[33] On this view, the basis for the rights and remedies of the beneficiary against the trustee—which is to say the law of trust governance—might be understood, for expositional purposes, as a third-party beneficiary contract between the settlor and trustee.[34]

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.[35] 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,[36] 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.[37] Thus, with respect to matters of internal trust governance, Langbein demonstrates the positive and normative power of the sort of hypothetical bargain analysis that is familiar from both contract and corporate law and economics.[38]

For purposes of understanding the relevance of trust law to the dealings of the trust's principal parties with outsiders, however, the model of the trust as functionally equivalent to a third-party beneficiary contract encounters difficulty. In the usual third-party beneficiary contract, the rights of the parties and third-party beneficiaries do not touch the rights of other nonparties. 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[39]—one that implicates some-

33 *Compare* Langbein, *supra* note 8, at 627 ("Trusts are Contracts."), *with* BAINBRIDGE, *supra* note 1, at 28 ("As used by contractarians, however, the term [nexus of contracts] is not limited to those relationships that constitute legal contracts."). *See* 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* discussion *infra* Part II.C; sources cited *supra* note 1. R R

34 *See* Langbein, *supra* note 8, at 627. One might think of the rights and duties imposed by the trust instrument as stemming not from trust law but rather from the law of *the* trust. *Cf.* E. ALLAN FARNSWORTH, CONTRACTS § 7.1, at 425–26 (3d ed. 1999) (distinguishing between "contract law" and the "law of the contract"). R

35 *See* Langbein, *supra* note 8, at 660; *see also* Ogus, *supra* note 3, at 206–07 (noting the "transaction costs savings" provided by trust law's default rules). R

36 *See* discussion *infra* Part IV.D.

37 *See infra* note 110 and accompanying text. R

38 *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 of such analysis); *see* Langbein, *supra* note 8, at 630, 663–64. R

39 This is the crucial contribution of Hansmann and Mattei. *See* Hansmann & Mattei, *supra* note 6, at 466; *see also* Hansmann & Kraakman, *supra* note 17, at 390 ("[T]he essential role of all forms of organizational law is to provide for the creation of a pattern of creditors' rights—a form of 'asset partitioning'—that could not practicably be established other- R

thing of an in rem dynamic. This includes the law of trustee insolvency (an exceedingly rare phenomenon in donative trusts but an important consideration for commercial trusts);[40] spendthrift trusts (the more common problem of beneficiary insolvency);[41] equitable tracing principles;[42] and the continuity of the office of the trustee despite turnover in its occupant.[43] Explanation of these features requires acknowledgement of trust law's proprietary features. Thus, as Langbein concluded, "[t]rust is a hybrid of contract and property, and acknowledging contractarian elements does not require disregarding property components whose convenience abides."[44]

C. Asset Partitioning and Organizational Law

In an article subsequent to Langbein's that explored 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."[45] This is not to say that they took 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."[46] Rather, they argued that the important

wise." (footnote omitted)); Hansmann & Mattei, *supra* note 9, at 147 ("[T]he important contribution of trust law lies not in its ordering, via default rules of contract, of the relationships among the three principal parties to a trust-like relationship . . . but rather in its ordering of the relationships between those persons and third parties with whom they deal."). For further discussion of this function of trust law, see *infra* Part I.C. **R**

40 Langbein called the law of trustee insolvency "the weak point of contractarian analysis." Langbein, *supra* note 8, at 667; *see also* Hansmann & Mattei, *supra* note 6, at 454–61, 469–72 (noting that the transaction costs of using contract to protect the trust assets from an insolvent trustee's creditors "would often be prohibitively high"); Merrill & Smith, *supra* note 17, at 846–47 (discussing third party information processing costs and trustee insolvency). On the relevance of insolvency to commercial trusts, see Schwarcz, *supra* note 13, at 581–83. **R** **R** **R**

41 *See generally* RESTATEMENT (SECOND) OF TRUSTS §§ 149–62 (1959) (discussing spendthrift trusts); *infra* Part IV.C.2 (same). 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 her chose in action to another, *see* FARNSWORTH, *supra* note 34, § 11.4, at 717–18, it does not allow the promisee to disable the third-party beneficiary from alienating that interest to both voluntary and involuntary creditors. *See* Hansmann & Mattei, *supra* note 6, at 452–53 & n.58. **R** **R**

42 *See infra* Part IV.C.1.

43 *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 34, §§ 11.1–11.11. **R**

44 Langbein, *supra* note 8, at 669. Maitland's conclusion is similar. A beneficial interest in a trust "is something far better than the mere benefit of a promise." MAITLAND, *supra* note 2, at 353. Note also the exclusion of the declaration of trust from Langbein's analysis. *See* Langbein, *supra* note 8, at 672–75; *see also* Farkas v. Williams, 125 N.E.2d 600 (Ill. 1955) (holding a trust declaration to be a valid inter vivos trust). **R**

45 Hansmann & Mattei, *supra* note 6, at 469. **R**

46 *Id.* at 470.

contribution of trust law is its ability "to facilitate an accompanying reorganization of rights and responsibilities between the three principal parties [settlor, trustee, and beneficiary] and third parties, such as creditors, with whom the principal parties deal."[47] Hansmann and Mattei refer in particular to "the use of trust law to shield trust assets from claims of the trustee's personal creditors."[48]

Thus Hansmann and Mattei stressed the importance of trust law's "asset partitioning" function.[49] The partitioning of assets provided for by trust law allows the trustee to deal separately with creditors of the trust property and those of his or her own personal property. With respect to all creditors, the law of trusts in effect (though not formally, at least not yet[50]) 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."[51] This creation of two distinct legal persons could not feasibly be reproduced with explicit contracting.[52] Asset partitioning therefore represents an important difference between organizational forms and simple contractual ar-

47 *Id.* at 472; *see also id.* at 451–64 (outlining the manner by which trust law organizes the relationships between various parties). Although this analysis identifies an important proprietary aspect of trust law, it remains insufficient to support the broader claims that "organizational law is much more important as property law than as contract law," Hansmann & Kraakman, *supra* note 17, 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 6, at 449. True, in the absence of trust law the parties could incorporate the language of the *Restatement*'s fiduciary provisions into their deal. *See id.* 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 1, at 35; *see also* Marcel Kahan & 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); Larry E. Ribstein, Why Corporations?, 5–6 (Ill. Pub. Law & Legal Theory Research Paper Series, Working Paper No. 03–11, 2003), *available at* http://ssrn.com/abstract=451060.

48 Hansmann & Mattei, *supra* note 6, at 438; *see id.* at 454–61.

49 This contribution may be understood as a specific application of a broader project on organizational law by Hansmann and Reinier Kraakman. *See* Hansmann & Kraakman, *supra* note 17, at 414–17; Hansmann & Kraakman, *supra* note 31, at 405–07.

50 *See* RESTATEMENT (THIRD) OF TRUSTS § 2 cmt. a & rep. notes § 2 cmt. a; Halbach, *supra* note 8, at 1882 ("Without abandoning the basic definition of a trust as a fiduciary relationship, there appear to be subtle but practically significant departures from the traditional concept that a trust is not an 'entity.'"); *see also* Tatarian v. Commercial Union Ins. Co., 672 N.E.2d 997, 1000 (Mass. App. Ct. 1996) (analogizing the trust at issue to a corporation and treating the trust as a separate entity); *cf.* Schwarcz, *supra* note 13, at 574–75 (discussing recognition of trusts as legal entities).

51 Hansmann & Kraakman, *supra* note 17, at 416.

52 *See* Hansmann & Mattei, *supra* note 6, at 466 (noting that significant transaction costs would prevent creation of such agreements by contract).

rangements.[53] The former have an external proprietary or in rem dimension that complements their internal contractarian or in personam features.

By providing 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 Langbein's contractarian approach. Taken together, they show that the law of trusts, like the law of other organizations, offers a careful blending of in rem and in personam features. This implies that, going forward, the study of the law of private trusts should more closely resemble the study of other organizational forms,[54] an endeavor in which agency costs analysis abounds.

D. The Rise of the Managerial Trust

The empirical observation that the modern use of the private trust increasingly resembles the use of other organizational forms provides further support for treating trust law as organization law. As Langbein and others have demonstrated, 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.[55] This evolution in the use of the trust stems from the liberalization of testamentary freedom, the lifting of feudal restrictions on land transfer, and the shift in modern wealth away from land.[56]

Accordingly, in addition to classic but still relevant context-specific rationales such as minimizing taxes and asset protection, the modern donative trust is also used more generally to bring together portfolio management skills with investment capital. The use of professional fiduciaries is reported to be on the rise.[57] The default rules

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53 *See* Hansmann & Kraakman, *supra* note 17, at 391–98; *see also* George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. (forthcoming 2004). R

54 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).

55 *See* Langbein, *supra* note 8, at 632–43; *see, e.g.*, MOFFAT ET AL., *supra* note 20, at 24–36; Edward C. Halbach, Jr., *The Uses and Purposes of Trusts in the United States*, *in* MODERN INTERNATIONAL DEVELOPMENTS IN TRUST LAW 123, 133–38 (David Hayton ed., 1999). R

56 *See* John H. Langbein, *The Twentieth-Century Revolution in Family Wealth Transmission*, 86 MICH. L. REV. 722 (1988) (discussing historical changes in family wealth); MOFFAT ET AL., *supra* note 20, at 33 ("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."). R

57 *See* Alexander, *supra* note 24, at 775 ("Today, the vast majority of trusts are administered by large financial institutions, such as trust companies and trust developments of commercial banks."); Langbein, *supra* note 8, at 638 ("Private trustees still abound, but the prototypical modern trustee is the fee-paid professional, whose business is to enter into R R

governing trust investment now require something of a total return investment strategy consistent with modern portfolio theory.[58] The fiduciary obligation has eclipsed limitations on the trustee's powers as the primary 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.[59] All of this supports the view that, going forward, the study of trust law should more closely resemble the study of other organizational forms. 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 agency cost theories of the firm or the economics of the principal-agent problem, this Part offers a brief overview. The goal is to provide context for the subsequent application of these ideas to the 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.[60] 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 costs of undertaking the same activity in an open-market transaction.[61] Coase therefore demonstrated the salience of transaction costs. From this beginning have evolved at least three different though complementary approaches to the theory of the firm.

The transaction costs approach, which is most closely associated with Oliver Williamson and is probably the most direct descendant of Coase's essay, focuses on the boundary between the firm and the mar-

and carry out trust agreements."); *see also Peering into Trust Industry Archives*, 115 Tr. & Est. 452, 504 (1976) (describing such changes within the trust profession). Several readers of earlier drafts of this Article questioned the empirical basis for this claim. Although the claim warrants further investigation, the specific point is not critical to the ensuing agency costs analysis. Thus this empirical study will remain a project for another article. *See generally* Sitkoff, *supra* note 15, at 587–88 (discussing the feasibility of empirical study in trust law).

58 *See* discussion *infra* Part IV.A.2.

59 *See* Langbein, *supra* note 8, at 637–43; *see also* John H. Langbein, *The Uniform Trust Code: Codification of the Law of Trusts in the United States*, 15 Tolly's Tr. L. Int'l 66, 71 (2001) (noting the statutory trend toward "maximum trustee empowerment"). R

60 R.H. Coase, *The Nature of the Firm*, 4 Economica 386 (1937). For a general introduction to Coase's theory and to other theoretical approaches to the firm, see Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 Colum. L. Rev. 1757 (1989).

61 Coase, *supra* note 60, at 390–93. R

ket.[62] Property rights theories of the firm 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."[63] The core relationships that aggregate into the trust as an organizational form, however, are generally open-market transactions rather than intra-firm transfers.[64] This suggests that neither the transaction costs nor the property rights approaches are as immediately relevant to the present project as the agency cost theories.

Agency cost theories of the firm model organizations as webs of express, implied, and metaphorical contracts among individuals with conflicting interests. At the center of this web is an organizing legal construct.[65] The critical 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, "[m]any 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."[66] 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.[67]

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62 *See* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 15–42 (1985).

63 Hart, *supra* note 60, at 1765; *see, e.g.*, Sanford 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). R

64 *See* Rock & Wachter, *supra* note 2, at 664–66. R

65 *See* Jensen & Meckling, *supra* note 1, at 310 & n.12; sources cited *supra* note 1. R

66 Jensen & Meckling, *supra* note 1, at 308; *see also* Fama, *supra* note 1, at 291; Fama & Jensen, *Separation*, *supra* note 1, at 307–11. R R

67 For accessible and relatively nonmathematical introductions to principal-agent modeling, see HAL R. VARIAN, INTERMEDIATE MICROECONOMICS: A MODERN APPROACH 667–88 (6th ed. 2003) [hereinafter VARIAN, INTERMEDIATE MICROECONOMICS]; PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION AND MANAGEMENT 166–247 (1992); Kenneth J. Arrow, *The Economics of Agency*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 37–51 (John W. Pratt & Richard J. Zeckhauser eds., 1985); Kathleen M. Eisenhardt, *Agency Theory: An Assessment and Review,* 14 ACAD. MGMT. REV. 57 (1989). Several formal introductions are also generally accessible. *See* DAVID M. KREPS, A COURSE IN MICROECONOMIC THEORY 577–719 (1990); JEAN-JACQUES LAFFONT & DAVID MARTIMORT, THE THEORY OF INCENTIVES: THE PRINCIPAL-AGENT MODEL (2002); ANDREU MAS-COLELL ET AL., MICROECONOMIC THEORY 477–510 (1995); HAL R. VARIAN, MICROECONOMIC ANALYSIS 440–71 (3d ed. 1992) [hereinafter VARIAN, MICROECONOMIC ANALYSIS]. Important scholarly statements include Sanford J. Grossman & Oliver D. Hart, *An Analysis of the Principal-Agent Problem*, 51 ECONOMETRICA 7 (1983); Bengt Holmström, *Moral Hazard and Observability*, 10 BELL J. ECON. 74 (1979); 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). Finally, for discussion by legal scholars of the applicability of principal-agent modeling to legal problems, see HOWELL E. JACKSON ET AL., ANALYTICAL METHODS FOR LAWYERS 88–100 (2003); Eric A. Pos-

B. The Economics of Agency

Using the vocabulary of agency in economic rather than legal parlance,[68] 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 the agent's breach or an exogenous factor caused a disappointing result. 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,[69] it will be difficult for the principal to prevent shirking by the agent. This is the problem of "hidden action," sometimes called "moral hazard."[70] The problem is one of post-contractual asymmetric information.[71]

Real estate agents are a common illustration in the literature. Consider an agent working on a five percent commission.[72] Assuming that the property owner cannot feasibly monitor the agent's daily activities, then the agent will have no incentive to put in even $10 of additional effort to increase the sale price by $100, as the payoff to the agent of the extra effort is only $5. However, the $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 also the property owner), then the agent would have undertaken the

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ner, *Agency Models in Law and Economics, in* CHICAGO LECTURES IN LAW AND ECONOMICS 225 (Eric A. Posner ed., 2000).

68 The difference is that a principal-agent relationship in law requires a showing of control. *See* RESTATEMENT (SECOND) OF AGENCY § 1 (1958); RESTATEMENT (THIRD) OF AGENCY § 1.01 & cmt. c (Tentative Draft No. 2, 2001); *cf.* ALLEN & KRAAKMAN, *supra* note 10, § 2.3.3, at 36 (stating that "the trustee is ordinarily not subject to the control of the beneficiary"). **R**

69 *See* MAS-COLELL ET AL., *supra* note 67, at 478–79; Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1048–51 (1991). **R**

70 *See* MAS-COLELL ET AL., *supra* note 67, at 477 n.1 (defining "moral hazard"). **R**

71 A nice statement may be found at LAFFONT & MARTIMORT, *supra* note 67, at 3: **R**

> 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*.

See also JACKSON ET AL., *supra* note 67, at 50–58. **R**

72 This illustration is borrowed from Frank Easterbrook and Daniel Fischel. *See* EASTERBROOK & FISCHEL, *supra* note 1, at 91; Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 701 (1982); *see also* Posner, *supra* note 67, at 225–29 (discussing real estate brokerage contracts from an agency theory perspective). **R** **R**

$10 effort. The agent's failure to do so leads to a welfare loss. True, the divergence in this example is an artifact of the five percent commission; a higher commission—say, fifteen 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 in all possible scenarios 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 expenditures," the costs of the agent's "bonding expenditures," and the "residual loss" as measured by the "dollar equivalent of the reduction in welfare experienced by the principal" as result of the divergence in the principal's and the agent's interests.[73] 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 the Jensen and Meckling nexus of contracts model was that the study of organizational forms involves, more concretely, the study of clusters or webs of discrete principal-agent relationships.[74] Accordingly, subsequent research has explored the effectiveness of various devices, legal and otherwise, at minimizing agency costs within different organizational forms. This literature has also thrown light on the governance features that distinguish different organizational forms from each other.[75] In particular, the literature of enterprise organizations has explored managerial labor markets,[76] incentive compensation,[77] alienable residual claims,[78] flexible sharing rules and mutual monitoring,[79] the market for corporate control (i.e., the takeover

[73] Jensen & Meckling, *supra* note 1, at 308. R

[74] *See supra* notes 65–66 and accompanying text. R

[75] *See, e.g.*, Eugene F. Fama & Michael C. Jensen, *Organizational Forms and Investment Decisions*, 14 J. FIN. ECON. 101, 117–19 (1985); Fama & Jensen, *Separation*, *supra* note 1, at 311–21. R

[76] *See, e.g.*, Fama, *supra* note 1, at 294–95. R

[77] *See, e.g.*, Kevin J. Murphy, *Executive Compensation*, *in* 3B HANDBOOK OF LABOR ECONOMICS 2485 (Orley Ashenfelter & David Card eds., 1999); Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002); Symposium, *Management Compensation and the Managerial Labor Market*, 7 J. ACCT. & ECON. 3 (1985); Tod Perry & Marc Zenner, *CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?*, 35 WAKE FOREST L. REV. 123 (2000).

[78] *See, e.g.*, Fama & Jensen, *Residual Claims*, *supra* note 1, at 332–33. R

[79] *See id.* at 335–36 (discussing professional partnerships).

market),[80] disclosure rules,[81] and liability rules such as fiduciary duties,[82] as devices for minimizing agency costs.

The trust, although amenable to such analysis, has not similarly been subjected to systematic agency cost analysis.[83]

III
The Agency Costs Model

In comparison to the agency costs approach to corporate law,[84] the agency costs approach to trust law is both simpler and more complex. It is simpler because the trust is a less complicated organization. This makes the agency cost analysis and reckoning the hypothetical bargain of the principal parties easier. The analysis is more complicated, however, because the actions of those individuals interested in the trust are not metered by price signals from efficient capital markets.[85] 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.[86]

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 external in rem asset partitioning with internal in personam contractarian flexibility. The trust's internal relationships are contractarian not only because the law supplies default terms around which the parties may contract, but also because the underlying gov-

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80 *See, e.g.*, Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110 (1965); *see also, e.g.*, Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. Chi. L. Rev. 973 (2002); Symposium, *The Market for Corporate Control: The Scientific Evidence*, 11 J. Fin. Econ. 5 (1983).

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

82 *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); *infra* notes 290–97 and accompanying text. **R**

83 *See supra* note 3 and accompanying text. **R**

84 The clearest example is the model of the corporation as a nexus of contracts, which was most notably advanced in the legal literature by Easterbook and Fischel. *See* Easterbrook & Fischel, *supra* note 1, 1–39; Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract,* 89 Colum. L. Rev. 1416 (1989). **R**

85 *See generally* Sitkoff, *supra* note 15, at 568–72. 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). **R**

86 *See, e.g.*, Mary Louise Fellows, *Spendthrift Trusts: Roots and Relevance for Twenty-First Century Planning,* 50 Rec. Ass'n B. City N.Y. 140, 149–64 (1995); *infra* note 136 and accompanying text.

ernance problems that stem from 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 typically they are 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 contract or property right.[87] 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, contractarian principal-agent modeling nonetheless illuminates the problems of governance relevant to the beneficiaries' welfare. From an economic perspective, hidden action (and possibly hidden information) abounds, so trust governance must confront both incentive and risk-sharing problems.[88]

Accordingly, greater insight into the nature and function of trust law will come from a conception of the trust as a de facto entity that serves as the organizing construct for an aggregation of contractarian relationships. This vision of the trust is analogous to the Jensen and Meckling nexus of contracts model of the firm.[89] As was the case with their analysis of the corporation, this conception of the trust implies the viability of agency cost analysis for trust law.

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, but are not limited to, those between:

1. S and T;
2. T and the Bs;
3. S and the Bs;
4. T and T's creditors;
5. the Bs and the Bs' creditors;
6. S and S's creditors;
7. S and the trust protector (who will be introduced later);[90]

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87 *See* discussion *supra* Part I.A–B.

88 *See generally* Eisenhardt, *supra* note 67, at 58–59 (discussing situations amenable to agency cost analysis). R

89 Jensen and Meckling argued that most organizations, including the corporation, could be characterized as a "legal fiction[,] . . . [an] artificial construct under the law which allows certain organizations to be treated as individuals." Jensen & Meckling, *supra* note 1, at 310 n.12. These entities "serve as a nexus for a set of contracting relationships among individuals." *Id.* at 310 (emphasis omitted); *cf.* EASTERBROOK & FISCHEL, *supra* note 1, at 11–12 (discussing the various contractual relationships that form corporations); Alchian & Demsetz, *supra* note 1, at 777–78 (describing the firm as a "centralized contractual agent in a team productive process" (emphasis omitted)). R R R

90 *See infra* Part IV.B.4.

8. the Bs and the trust protector;
9. T and T's agents (to whom T delegates authority); and
10. T's delegates and the Bs.[91]

The dominant (and sometimes conflicting) relationships exist between S and T and between the Bs and T.

Distilling the trust into its constituent relationships brings into view the applicability of hypothetical bargain analysis and the economics of the principal-agent problem. 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 presents the temporal agency problem that helps distinguish the economic analysis of trust law from that of corporate law.[92] The latter presents the traditional agency problem when risk-bearing is separated from management. This means that there is 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 law resolves this tension by requiring T to maximize the welfare of the Bs within the ex ante constraints imposed by S. This is to say that, under the American approach (but not necessarily under the English approach) the donor's intent controls.

91 *See, e.g.*, *In re* Bond & Mortgage Guar. Co., 103 N.E.2d 721 (N.Y. 1952) (discussing the relationship between the trustee's agent, in this case the trustee's lawyers, and the beneficiaries); *Surrogates Court Decision of Interest: In re* Kellogg, N.Y.L.J. Dec. 30, 1999, at 25 (same). The importance of the relations that fall into these last two categories, numbers 9 and 10 above, 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. Langbein calls this phenomenon 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) [hereinafter Langbein, *The Uniform Prudent Investor Act*]; *see* RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 171 & cmt. f (1992); UNIF. PRUDENT INVESTOR ACT § 9, 7B U.L.A. 280 (2000); John H. Langbein, *Reversing the Nondelegation Rule of Trust-Investment Law*, 59 MO. L. REV. 105, 115–16 (1994); *see also* Langbein, *supra* note 59, at 72–73; *accord* P. J. REED & R. C. WILSON, THE TRUSTEE ACT 2000: A PRACTICAL GUIDE 11 (2001) (highlighting the similar shift in prudent investor rules in the United Kingdom). These scenarios might be amenable to modeling as a common agency. For examples of such modeling and discussions of common agency, see B. Douglas Bernheim & Michael D. Whinston, *Common Agency*, 54 ECONOMETRICA 923 (1986); Joel S. Demski & David Sappington, *Optimal Incentive Contracts with Multiple Agents*, 33 J. ECON. THEORY 152 (1984); Bengt Holmström, *Moral Hazard in Teams*, 13 BELL J. ECON. 324 (1982); Bengt Holmström & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J. L. ECON. & ORG. 24 (1991); Hideshi Itoh, *Incentives To Help in Multi-Agent Situations*, 59 ECONOMETRICA 611 (1991). R

92 The temporal agency problem also distinguishes the economic analysis of trust law from that of agency law. 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 facilitates the principal's monitoring of the agent. *See* sources cited *supra* note 68. Not surprisingly, the lack of monitoring by disabled principals of agents acting under a durable power of attorney is a cause for concern. *See* Carolyn L. Dessin, *Acting as Agent Under a Financial Durable Power of Attorney: An Unscripted Role*, 75 NEB. L. REV. 574, 584–88 (1996). R

B. The Office of the Trustee

The office of the trustee is in effect (though not formally) a separate entity from the trustee personally.[93] 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 the trustee serves as the organizing hub for the various relations that aggregate into the trust.[94]

With respect to creditors, turnover within the office of the trustee or the personal insolvency of a particular trustee does not affect the continuity of the trust. Deals struck by a prior trustee, while acting as trustee, bind successor trustees to the extent that they would have been enforceable against the prior trustee.[95] The prior trustee, however, has no office-based liability to the trust's creditors once out of office. No trustee, whether in or out of office, has personal liability to the trust's outside creditors unless he or she personally guaranteed the obligation.[96] 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.[97]

The rules that govern the trustee's liability toward 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.[98] They are mandatory with respect to the settlor, because as to

93 More precisely, the office of trustee is in effect a separate legal person. *See supra* notes 49–53 and accompanying text. In contrast to corporate law, in trust law there are few **R** if any prescriptions regarding the required structure for the (albeit de facto) fictitious separate entity.

94 *Cf.* David Hayton, *The Uses of Trusts in the Commercial Context*, *in* MODERN INTERNATIONAL DEVELOPMENTS IN TRUST LAW, *supra* note 55, 145, 155–57 (discussing the office of the trustee and noting that continuity of the trust is unaffected by "the death or dissolution of a trustee"); Worthington, *supra* note 27, at 155–57 (discussing the separate rights of the **R** trustee's creditors and the trust's creditors).

95 *See, e.g.*, Schroeder v. CMC Real Estate Corp., 510 N.E.2d 1045, 1048–49 (Ill. App. Ct. 1987); Wood v. Potter, 289 N.W. 131, 133–34 (Mich. 1939). The qualification addresses the possibility of self-dealing or other grounds for voiding the transaction. The failure of a successor trustee to pursue such remedies would be an independent breach of trust. *See infra* note 101 and accompanying text. **R**

96 *See, e.g.*, UNIF. TRUST CODE § 1010(a), 7C U.L.A. 227 (Supp. 2003). The traditional rule of personal liability unless otherwise provided, *see* 3A SCOTT ON TRUSTS, *supra* note 5, **R** § 261, at 417; RESTATEMENT (SECOND) OF TRUSTS § 265 & cmt. a (1959), can be understood as a penalty default that forces trustees to disclose that they are operating in a representative rather than an individual capacity. *See* Hansman & Mattei, *supra* note 6, at 459–61; **R** Merrill & Smith, *supra* note 17, at 846–47. **R**

97 *See* Hansmann & Mattei, *supra* note 6, at 454. *See generally* Macnair, *supra* note 20, at **R** 224–29 (discussing the evolution of trustee liability); Worthington, *supra* note 27, at **R** 155–58 (reviewing the rights of the beneficiaries and of the creditors of the beneficiaries, trustee, settlor, and the trust property).

98 *See, e.g.*, UNIF. TRUST CODE § 1010(a), 7C U.L.A. 227 (Supp. 2003); *id.* § 105(b)(11) ("The terms of a trust prevail over [common and statutory law] except . . . the rights under

the settlor these rules have an in rem quality—they touch on the rights of outsiders.[99] They are, in contrast, default with respect to the trustee and outside creditors, because as to these parties the rules concern only in personam matters—they touch only the rights of insiders. Parties may fix their rights with respect to each other, but when the rights of outsiders become involved, the law limits the parties' flexibility.

The rules of trustee liability toward beneficiaries are quite different. But these differences follow naturally from the nexus of contracts model of organizational forms, which implies 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 the trustee is 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.[100] 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. Liability in this scenario, however, stems from the successor trustee's own breach in unreasonably failing to address her predecessor's blunder.[101]

The rules of internal trust governance, which determine the rights inter se of the beneficiaries, the settlor, and the trustee, are for the most part default as to the settlor.[102] That not all of these rules are default, however, suggests that there is a mandatory foundation of trust governance law. Indeed, as Langbein explains, even though a

Sections 1010 through 1013 of a person other than a trustee or beneficiary."); *id.* 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*, 98 NW. U. L. REV. (forthcoming 2004) (comparing mandatory and default rules in trust law); Langbein, *supra* note 59, at 76–79 (analyzing the UTC's mandatory features); David M. English, *Is There a Uniform Trust Act in Your Future?*, PROB. & PROP. 25, 27 (Jan./Feb. 2000); *cf.* RESTATEMENT (SECOND) OF TRUSTS § 263 (1959) (discussing trustee liability to third parties); 3A SCOTT ON TRUSTS, *supra* note 5, § 263, at 423–32 (same). R

99 On similar reasoning agency law does not allow principals to opt out of liability to third parties for the acts of agents for which the agents have apparent authority. *See, e.g.*, RESTATEMENT (SECOND) OF AGENCY §§ 159–61 (1958).

100 As a practical matter, this liability is often fixed in an accounting proceeding made incident to the removal action.

101 *See* RESTATEMENT (SECOND) OF TRUSTS § 223 (1959); 3 SCOTT ON TRUSTS, *supra* note 5, § 223, at 395–96. This explains why many professionally drafted trustee succession provisions absolve the successor from this audit responsibility. Without such absolution, many potential successors would decline to serve. *See* VALERIE J. VOLLMAR ET AL., AN INTRODUCTION TO TRUSTS AND ESTATES 1072–73 (2003); Charles F. Gibbs & Collen F. Carew, *Liability of Successor Fiduciary for its Predecessor*, N.Y.L.J. 1 (Mar. 18, 2003). R

102 *See, e.g.*, UNIF. TRUST CODE § 105, 7C U.L.A. 139 (Supp. 2003); Langbein, *supra* note 8, at 651, 660–63. R

settlor may opt out of individual fiduciary duties, she cannot authorize a bad faith trusteeship or oust fiduciary law in its entirety.[103]

Part of the explanation for these limits is the obvious agency cost consequences of giving the trustee unfettered discretion. Hence these limits serve a protective and cautionary function for the settlor who might otherwise unwittingly swamp her beneficiary in an agency costs morass. However, this explanation is incomplete, because the protective and cautionary function could probably have been achieved with a penalty default.[104]

Further justification for these mandatory elements lies in the need to ensure that third parties who transact with the trustee can easily ascertain whether property in the possession of the trustee belongs to the trustee personally, is held in trust, or is held in some other limited form such as an equitable charge.[105] There is a mandatory irreducible minimum of trust governance, in other words, not only to serve a protective and cautionary function, but also because on this issue the in personam (i.e., internal governance) converges with the in rem (i.e., external relations).[106] 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 and more in the nature of an absolute estate or fee simple grant of property."[107]

C. The Relative Position of the Settlor

The settlor's intent to create a trust is a prerequisite to trust formation.[108] This means that Langbein's third-party beneficiary contract between the settlor and the trustee is the trigger for the cascade of individual relationships that compose the trust. The settlor-trustee relationship is indeed contractual, as settlors and trustees are free to

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103 *See* Langbein, *supra* note 98.

104 *See, e.g.*, Ayres & Gertner, *supra* note 38, at 95–107; *see also infra* note 116 and accompanying text (discussing exoneration clauses). R

105 *Cf.* Merrill & Smith, *supra* note 17 (discussing the third party information costs associated with various forms of property and contract rights). 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 payment from the transferee. *See* RESTATEMENT (THIRD) OF TRUSTS § 5(h) & cmt. h (2003); RESTATEMENT (SECOND) OF TRUSTS § 10 & cmts. a–b (1959); 1 SCOTT ON TRUSTS, *supra* note 5, §§ 10, 10.3, 10.4; *see, e.g.*, Ogle v. Durley, 77 So.2d 688, 691–92 (Miss. 1955). R R

106 *See* Langbein, *supra* note 98; *supra* Part I.B–C; *infra* Part IV.C.

107 McNeil v. McNeil, 798 A.2d 503, 509 (Del. 2002).

108 *See* RESTATEMENT (THIRD) OF TRUSTS § 13 (2003); RESTATEMENT (SECOND) OF TRUSTS § 23 (1959); UNIF. TRUST CODE § 402(a)(2), 7C U.L.A. 158 (Supp. 2003).

dicker over the terms of the trust, such as compensation, even if in fact they do not.[109] This leads to three points.

First, when interpreting the trustee's obligations under the trust instrument, an intention-seeking standard is normatively desirable.[110] This prescription follows from the principle that in the case of a voluntary transaction between competent adults, the joint intent of the parties carries a presumption of Pareto optimality.[111] Not surprisingly, the new *Restatement (Third) of Property* for donative transfers points in this direction,[112] a positive trend that is 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 bargained if they had full information and low negotiation costs.[113] As Langbein has noted, "[t]he proper 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."[114]

Second, given the potential informational asymmetries between repeat-player trust lawyers and institutional fiduciaries on the one

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109 *See, e.g.*, Langbein, *supra* note 8, at 639, 651; *see also* Getzler, *Legislative Incursions*, *supra* note 20, Art. 2, at 4 (discussing terms that professional trustees often insert into trust instruments). Several readers of earlier drafts objected to the foregoing analysis on the ground that, in practice, settlors simply do not dicker with trustees. But a lack of actual bargaining between settlors and trustees does not negate the contractual nature of their underlying relationship any more than the lack of actual bargaining between insurance companies and insureds negates the contractual nature of that relationship. All that a lack of bargaining suggests is that either (i) the terms of the forms used by corporate fiduciaries approximate median preferences or (ii) the process suffers from the more common problems of standard form contracts and disparities in party sophistication. *See infra* note 117 and accompanying text. Likewise, a lack of actual bargaining with amateur trustees, such as family members, implies only that amateurs are motivated by altruism or a sense of familial loyalty rather than fees or the other terms of the deal. **R** **R**

110 Langbein, *supra* note 8, at 663–64; *see also* Halbach, *supra* note 8, at 1881 (noting that giving effect to the transferor's intentions is a "pervasive theme" in recent trust law development); *cf.* Hayton, *supra* note 20, at 96 (predicting that trust law will continue to evolve toward further respect for the settlor's wishes); Parkinson, *supra* note 20, at 676–82 (discussing the implications of an obligation-based conception of the trust). **R** **R** **R**

111 *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 1, at 22–25, 145; RICHARD A. EPSTEIN, SIMPLE RULES FOR A COMPLEX WORLD 80–82 (1995). **R**

112 "The controlling consideration in determining the meaning of a donative document is the donor's intention. The donor's intention is given effect to the maximum extent allowed by law." RESTATEMENT (THIRD) OF PROPERTY: WILLS AND OTHER DONATIVE TRANSFERS § 10.1 (2003).

113 *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 15.6, at 454 (6th ed. 2003); Ayres & Gertner, *supra* note 38, at 89–91 (collecting scholarly statements); *see also* POSNER, *supra*, § 4.1, at 96, § 14.3, at 413, § 14.7, at 427–28 (discussing transaction costs, interpretation, and majoritarian default rules). This is an implication of R.H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960). **R**

114 Langbein, *supra* note 8, at 664. **R**

hand, and settlors on the other, there is room as a normative matter for the occasional information-forcing default rule.[115] As a positive matter, such penalty defaults do exist. Perhaps the most salient example concerns clauses that exonerate the trustee from liability to the beneficiaries for breach of trust. Before enforcing these clauses, especially in cases where the trustee was also the settlor's lawyer, courts often require a showing that the settlor had affirmative knowledge of the clause and its meaning.[116] By ensuring transparency, the rule helps to ensure that the clause was not unwittingly embraced by the settlor.[117]

Third, in contrast to the founder of a corporation or a commercial trust,[118] the settlor of a donative trust receives no direct price signal about the quality of the governance arrangement to which he or she agrees with the trustee.[119] There is no public offering for beneficial interests in a donative trust, and potential beneficiaries do not purchase their rights from the settlor. The only price signal in dona-

115 *See, e.g.*, Ayres & Gertner, *supra* note 38, at 94. The informational asymmetry between trust lawyers and settlor-clients is a separate source of agency costs, discussion of which is beyond the scope of this Article. *See generally* John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301 (2001) (discussing agency costs between corporate clients and lawyers). R

116 *See* RESTATEMENT (SECOND) OF TRUSTS § 222(3) & cmt. d (1959); UNIF. TRUST CODE § 1008(b) & cmt., 7C U.L.A. 226–27 (Supp. 2003) ("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."); 3 SCOTT ON TRUSTS, *supra* note 5, § 222.4, at 393–95; *see also* Comm. on the Modernization of the Tr. Act, *Report on Exculpation Clauses in Trust Instruments*, 22 EST. TR. PENSIONS J. 55 (2003) (discussing Canadian trust law's approach to exculpation clauses); David Hayton, *English Fiduciary Standards and Trust Law*, 32 VAND. J. TRANSNAT'L L. 555, 580 (1999) (describing the requirements for validity of exemption clauses under English law); Langbein, *supra* note 98 (describing exemption clause disclosure rules as antifraud and intent-serving measures); Langbein, *supra* note 59, at 74–75 (discussing the UTC's exculpation clause provisions). R R

117 In other words, unsophisticated settlors who do not read or understand the fine print present the standard form contract problem. *See, e.g.*, Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1174, 1179 (1983); *see also* Lewis A. Kornhauser, *Unconscionability in Standard Forms*, 64 CAL. L. REV. 1151 (1976) (suggesting that even where exchanges are "untainted by failures in the bargaining process," they can still "suffer from . . . unfair clauses"). More generally, regulation of exculpatory clauses relates back to the need to ensure clear lines of property ownership for outsiders with whom the trustee might deal. *See supra* notes 102–07 and accompanying text.

118 *See* Schwarcz, *supra* note 13, at 562–63 (comparing commercial and donative trusts). R

119 *Cf.* Jensen & Meckling, *supra* note 1, at 313. R

> [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.

Id.; *see also* Sitkoff, *supra* note 15, at 570–72 (discussing the relevance of capital markets to the governance of trusts and corporations).

tive trusts regarding potential governance structures—the level of compensation, if any, demanded by the trustee—is both weak and ambiguous.[120] In conjunction with the potential for informational asymmetries, the lack of a direct price signal bolsters the case for the occasional information-forcing default rule and, in some cases, possibly even justifies disregarding the expressed intent of the settlor.[121]

None of this is to suggest that settlors are uninterested in the quality of the trust's governance regime. On the contrary, a common purpose in settling a trust in the first place, tax exigencies and controlling personalities aside,[122] is to maximize the beneficiaries' welfare. The point of the prior paragraph is merely that settlors do not receive the sort of price signals from thick markets that would force them to internalize the costs and benefits of the governance arrangement to which they have agreed with the trustee. To paraphrase the condition posited by Frank Easterbrook and Daniel Fischel as necessary for skepticism about a term in the related context of the corporate contract, the consequences for beneficiary welfare of the trust terms might "not have been appreciated by" the settlor.[123]

D. Beneficiaries as Residual Claimants

The trustee and those who conduct business with the trustee as trustee 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,[124] 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 all

120 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 109. **R**

121 *See* Langbein, *supra* note 98.

122 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, e.g.*, B. Douglas Bernheim et al., *The Strategic Bequest Motive*, 93 J. POL. ECON. 1045 (1985) (discussing strategic intergenerational transfers); *see also infra* note 208 and accompanying text. **R**

123 EASTERBROOK & FISCHEL, *supra* note 1, at 31; *see also id.* at 17, 23–25; *cf.* Langbein, *supra* note 98. **R**

124 *See supra* note 109 and accompanying text. **R**

other claims are settled.[125] That is, as residual claimants, they bear the residual risk.[126]

To say that the beneficiaries are the residual claimants is to say that managerial decisions are inframarginal for all the relevant players except for the beneficiaries. This may provide an agency costs explanation for the rule in irrevocable trusts that only the beneficiaries may sue the trustee for a breach of trust.[127] The same reasoning may also explain why 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. Moreover, now that the trust form 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.[128]

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 is inappropriate. Indeed, even though acceptance (which can be implied) is a required element of every gift,[129] 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. The economics of agency provides a helpful framework for understanding the law's default solutions to problems of governance presented by the trust form of organization.

An important further benefit of the agency costs approach is that it invites comparison of the trust to other organizational forms. This expands the potential for drawing on empirical insights, albeit by analogy. Thus far the typical trust law empirical project has been comparative. Although the common law trust is uniquely Anglo-Ameri-

125 The limitation to donative trusts is necessary because in the commercial context, the beneficiaries are typically investors in trust certificates that, like debt, only entitle them to a return of their investment plus interest. Any surplus value goes back to the settlor, who is the residual claimant in such an arrangement. *See* Schwarcz, *supra* note 13, at 562–63. **R**

126 *See* Fama & Jensen, *Residual Claims*, *supra* note 1, at 328 ("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."); *cf.* EASTERBROOK & FISCHEL, *supra* note 1, at 67–70 (discussing the nature of residual claims in the context of voting rights in corporations). **R** **R**

127 *See* RESTATEMENT (SECOND) OF TRUSTS § 200 (1959); 3 SCOTT ON TRUSTS, *supra* note 5, §§ 200, 200.1. *But see infra* Part IV.B.3. **R**

128 *See* Langbein, *supra* note 8, at 642. **R**

129 *See* RESTATEMENT (THIRD) OF PROPERTY: WILLS AND OTHER DONATIVE TRANSFERS § 6.1 & cmt. i (2003).

can,[130] there is nontrivial variation across the common law nations.[131] Furthermore, there are clear payoffs to studying how the non-common law countries have adapted to their nominal lack of an explicit trust law.[132] Because of the difficulty in obtaining good data on trusts in practice, however, this comparative approach tends to be qualitative rather than quantitative.[133] In contrast, thick capital markets provide ample data for quantitative analysis of theoretical predictions about the impact of corporate law on shareholder welfare.[134] Accordingly, 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 might likewise improve beneficiary welfare.

IV
Applications of the Model

By reference to illustrative applications, this Part demonstrates the positive and normative analytical power of the agency costs approach. The normative claim is that the law should minimize the agency costs inherent in 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. To return to the exemplary trust settled by S for the benefit of B1 and B2 with T as trustee, the claim is that T should maximize the welfare of B1 and B2, subject to

130 Note, however, that many civil law countries have long had trust-like devices. *See* Richard Helmholz & Reinhard Zimmermann, *Views of Trust and* Treuhand*: An Introduction*, *in* ITINERA FIDUCIAE, *supra* note 20, at 27, 27–31; *see also* Adair Dyer, *International Recognition and Adaption of Trusts: The Influence of the Hague Convention*, 32 VAND. J. TRANSNAT'L L. 989, 1013–16 (1999) (discussing the adoption of trust-like forms in civil law countries); Maurizio Lupoi, *The Civil Law Trust*, 32 VAND. J. TRANSNAT'L L. 967, 971–76 (1999) (describing various "civil trust" forms); Donovan Waters, *Private Foundations (Civil Law) Versus Trusts (Common Law)*, 21 EST. TR. & PENSIONS J. 281, 295–308 (2002) (same); *cf.* Jeffrey A. Schoenblum, *The Hague Convention on Trusts: Much Ado About Very Little*, 3 J. INT'L TR. & CORP. PLAN. 5 (1994). R

131 Examples are discussed *infra* Part IV.B.1, IV.C.2.

132 *See* Helmholz & Zimmermann, *supra* note 130, at 30–31; *see also* Hansmann & Mattei, *supra* note 6, at 435–36 (discussing increased recognition of trust-like institutions in civil law countries and stating that "the trust is likely to become the most important contribution of the common law tradition to the European system of private law" (footnote omitted)); Langbein, *supra* note 8, at 669–71 (discussing "nontrust" legal systems); MAURIZIO LUPOI, TRUSTS: A COMPARATIVE STUDY 267–86 (Simon Dix trans., 2000) (same); DAVID JOHNSTON, THE ROMAN LAW OF TRUSTS (1988) (same); *cf.* Waters, *supra* note 130, at 292–83 (discussing civil law trust-like forms). R R R R

133 *See* Langbein, *supra* note 14, at 178; Sitkoff, *supra* note 15, at 587–88. R

134 *See, e.g.*, Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part I: Technique and Corporate Litigation*, 4 AM. L. & ECON. REV. 141 (2002); Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part II: Empirical Studies of Corporate Law*, 4 AM. L. & ECON. REV. 380 (2002).

the ex ante limits imposed by S. Consequently, the optimal solution to the Bs-T principal-agent problem, which would be for the Bs to sell the residual claim to T (doing so would solve both the incentive and risk-sharing problems),[135] is foreclosed by the settlor's choice of the trust over an outright transfer. Given the primacy of honoring the settlor's intentions, the best that the law of trust governance can hope for is a second-best solution to the Bs-T agency problem.[136]

The positive claim is that, at least with respect to traditional doctrines, the law conforms to the suggested normative approach. As Edward Halbach, the Reporter for the new *Restatement (Third) of Trusts* recently observed, a "theme" in modern trust law "is flexibility and efficiency in the pursuit of the best interests of trust beneficiaries within the settlor's legally permissible objectives."[137]

A. Donative Beneficiaries as Residual Claimants

Agency cost analysis prompts the classification of donative trust beneficiaries as residual claimants.[138] 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' claims. Like the residual claimants in any other organizational form, donative trust beneficiaries therefore bear the residual risk of good or bad performance. Managerial decisions regarding the trust's assets are inframarginal to all but the beneficiaries. The emergence of the managerial trust, moreover, has enlarged the range of the beneficiaries' potential risk and reward.[139] In this respect, modern trust beneficiaries are beginning more closely to resemble the residual

135 *See* MAS-COLELL ET AL., *supra* note 67, 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. R

136 This solution is second best from the perspective of the beneficiaries ex post. American law, however, is more concerned with the ex ante perspective of the settlor. The normative analysis therefore assumes that the goal is to maximize the expected utility of the settlor. The settlor's expected utility, in turn, is assumed to depend on the settlor's (paternalistic) view of the beneficiaries' expected utility. Further exposition of this point, including development of a formal model, is beyond the scope of this Article. Note, however, that there are numerous complexities that surround this issue, including the relevance of the beneficiaries' own view of their utilities—something to which, as we shall see, English law gives greater attention. *See infra* notes 211–17 and accompanying text. For further discussion of the economics of altruism and deferred gifts, see, for example, ERIC A. POSNER, LAW AND SOCIAL NORMS 55–62 (2000); Louis Kaplow, *A Note on Subsidizing Gifts*, 58 J. PUB. ECON. 469 (1995); Richard A. Posner, *Gratuitous Promises in Economics and Law*, 6 J. LEG. STUD. 411 (1977); Steven Shavell, *An Economic Analysis of Altruism and Deferred Gifts*, 20 J. LEG. STUD. 401 (1991); sources cited in *infra* note 196.

137 Halbach, *supra* note 8, at 1881. R

138 *See supra* Part III.D.

139 *See supra* note 128 and accompanying text. R

claimants of other organizational forms than the trust beneficiaries of yore.

Yet today's prototypical 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 cost analysis, this section explains the operation of three rules of private trust governance as consistent with the likely preferences of the parties. These distinguishing characteristics therefore reflect important empirical assumptions that underpin the hypothetical bargain encoded in traditional trust doctrine.[140] When choosing an organizational form, one looks for the form in which the default empirical assumptions about risk-preferences, the number of residual claimants, and other relevant factors most closely resemble one's own situation. Doing so minimizes the transaction costs of customizing the form to fit one's particular needs.[141]

1. *The Duty of Impartiality*

Trust law facilitates the creation of residual claimants with interests adverse to each other. The still classic example, here described with reference to the exemplary trust first discussed in the Introduction, is a trust for the lifetime income benefit of one party (B1) with the remainder principal benefit to another (B2). As residual claimants, the overall interests of B1 and B2 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.[142] 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."[143]

Trust law's amenability to residual claimants with adverse interests poses a challenge for crafting an effective governance regime, because the preference set of the residual claimants, in whose interests

140 *Cf.* Leo E. Strine, Jr., *The Inescapably Empirical Foundation of the Common Law of Corporations,* 27 DEL. J. CORP. L. 499 (2002) (noting some of the empirical assumptions that underpin various corporate law doctrines).

141 *See, e.g.*, Ogus, *supra* note 3, at 187. R

142 *See, e.g.*, Dennis v. R.I. Hosp. Trust Nat'l Bank, 744 F.2d 893, 895–96 (1st Cir. 1984) (holding that a trustee acted improperly in favoring the income beneficiaries over the remainder beneficiaries); Dobris, *supra* note 20, at 569–71 (noting that the Uniform Principal and Income Act "created a meaningful principal and income problem for a number of trustees"); *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) (discussing the tension between income and remainder beneficiaries). R

143 Fama & Jensen, *Residual Claims, supra* note 1, at 329. R

the trust should be managed, may not be coherent. Corporate law, by comparison, assumes that all shareholders share the basic aim of profit maximization (their preferences are said to be "single-peaked"). This assumption elides the problems of agenda manipulation and cycling.[144]

Trust law's evolutionary response for aggregating the otherwise conflicting interests of different classes of beneficiaries is the fiduciary duty of impartiality.[145] This duty requires the trustee to "act impartially in investing, managing, and distributing the trust property, giving due regard to the beneficiaries' respective interests."[146] Thus, under the default arrangement, T cannot justify an action as benefiting B1 or B2 exclusively. Instead, T must justify her decisions in relation to the aggregate welfare of B1 and B2 as a class. The trust's residual claimants' interests are made coherent in effect by directing the trustee to act with a view to their needs rather than their individual wants; balance is the overarching directive of the duty of impartiality.[147]

This appears consistent with the settlor's probable intent. True, in the foregoing example one might argue that S rated B1's position as superior to B2's because S gave B1 an immediate benefit but gave B2 only the remainder on the death of B1. But that seems a thin basis for concluding that S wanted T to prefer the interests of B1 over the interests of B2. If S had such a preference, it would have been simple enough to put something to that effect in the trust instrument. 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, favoring B1 or B2 only if the later context justified doing so.[148] This stands in contrast to the law of corporations, which requires managers to favor the

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

145 *See* Halbach, *supra* note 8, at 1912–13. R

146 UNIF. TRUST CODE § 803, 7C U.L.A. 204 (Supp. 2003); *see also* RESTATEMENT (SECOND) OF TRUSTS §§ 183, 232 (1959).

147 *See* RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 cmts. c & i (1992); Edward C. Halbach, Jr., *Significant Trends in the Trust Law of the United States*, 32 VAND. J. TRANSNAT'L L. 531, 549 (1999) [hereinafter Halbach, *Significant Trends*]; Edward C. Halbach, Jr., *Trust Investment Law in the Third Restatement*, 27 REAL PROP. PROB. & TR. J. 407, 441–44 (1992) [hereinafter Halbach, *Trust Investment*]; Halbach, *supra* note 8, at 1913. R

148 Thus, balance does not require equal treatment. In fact, the trustee "has considerable discretion in preserving the balance between the beneficiaries." 3A SCOTT ON TRUSTS, *supra* note 5, § 232, at 7. For example, T could lawfully tip the balance in favor of B1 if B1 R was S's widow and B2 was a distant cousin. "There is . . . no absolute rule on this matter and under some circumstances [favoring the life or remainder beneficiaries] might be justified." *Id.*

claimant with the most residual claim in the case of conflict,[149] though of course within the same class of stock all shareholders must be treated equally.[150] 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 characteristic of trust law as organizational law. It is critical, 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 characteristic, relevant to choice of form for commercial transactions,[151] because the duty is not an explicit part of the default fiduciary obligation in most other organizational forms.

Courts therefore have considerable experience in applying trust law to the problem of balancing the interests of residual claimants of different classes. Especially for commercial transactions, this might be a reason to choose the deal reflected within trust law's default governance regime over those offered by the default governance arrangements of other organizations.[152] 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."[153]

2. *Total Return Investing*

The modern trend toward total return investing complements the duty of impartiality.[154] Motivated by the teachings of modern portfolio theory,[155] total return investing has been codified in the re-

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149 *See, e.g.*, Zahn v. Transamerica Corp., 162 F.2d 36, 46 (3d Cir. 1947); BAINBRIDGE, *supra* note 1, § 7.4, at 342; ROBERT CHARLES CLARK, CORPORATE LAW § 14.5, at 636 (1986). **R**

150 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, 721–22 (Del. 1971); BAINBRIDGE, *supra* note 1, § 7.4, at 338–42. **R**

151 *See* Schwarcz, *supra* note 13, at 575–80. **R**

152 Reasoning along similar lines, Fischel and 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, 1121 (1988). Courts have followed this suggestion. *See* JOHN H. LANGBEIN & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 680, 848 (3d ed. 2000).

153 Schwarcz, *supra* note 13, at 579. **R**

154 *See, e.g.*, Lyman W. Welch, *Brave New World of Total Return Laws*, TR. & EST., June 2002, at 24.

155 *See, e.g.*, JONATHAN R. MACEY, AN INTRODUCTION TO MODERN FINANCIAL THEORY 17–31(2d ed. 1998). For early applications to trust-investment law, see Gordon, *supra* note 12; BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE (1986); John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law*, 1976 AM. B. FOUND. RES. J. 1; John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law: II*, 1977 AM. B. FOUND. RES. J. 1; *see also* Harvey E. Bines, *Modern Portfo-*

cent revisions to the prudent investor standards that underpin trust law's fiduciary duty of care.[156] The basic idea is that trustees should craft a diversified portfolio in light of its balance of overall (rather than investment-specific) risk and potential return.[157] A contemporaneous reform, which revised the definitions of "principal" and "income," made the boundary between the two porous.[158] 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 allocation to "principal" or "income" of the trust's total return receipts.[159]

The 1997 Uniform Principal and Income Act refocuses the tension between capital appreciation and present income production on the trustee's ex post power to adjust the classification of specific investment returns within the total return portfolio as income or principal.[160] The so-called unitrust,[161] which is an alternative to equitable adjustment that provides a specified percentage of the trust corpus each year to the income beneficiaries with the remainder left for the "principal" beneficiaries,[162] likewise eases the tension between capital appreciation and income production.

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lio Theory and Investment Management Law: Refinement of Legal Doctrine, 76 COLUM. L. REV. 721 (1976) (discussing portfolio theory in the context of investment management).

156 *See* Halbach, *Significant Trends*, *supra* note 147, at 546; Langbein, *supra* note 91; *see also* Joel C. Dobris, *Speculations on the Idea of "Speculation" in Trust Investing: An Essay*, 39 REAL PROP. PROB. & TR. J. (forthcoming 2004) (discussing the role of "speculation" modern trust-investment law).

157 *See* UNIF. PRUDENT INVESTOR ACT §§ 2–3, 7B U.L.A. 289–98 (2000); RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227(a) (1992); *see also* John H. Langbein, *The New American Trust-Investment Act*, 8 TOLLY'S TR. L. INT'L 123, 123–24 (1994). Damages in surcharge actions for imprudence should likewise reflect the total return imperative. *See* Sitkoff, *supra* note 15, at 583–87. **R**

158 UNIF. PRINCIPAL & INCOME ACT (1997 Act), 7B U.L.A. 131 (2000).

159 *See* Halbach, *supra* note 8, at 1913–14; *see also* Langbein, *The Uniform Prudent Investor Act*, *supra* note 91, at 666–69 (discussing the tension between modern investment theories and traditional distinctions between principal and income). For further economically-informed discussion of principal and income, see Gordon, *supra* note 12, at 99–112. **R** **R** **R**

160 UNIF. PRINCIPAL & INCOME ACT (1997 Act) §§ 103–04, 7B U.L.A. 139–43 (2000). *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) (proposing means to alleviate tension between conflicting beneficiary interests); 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) (discussing proposed reforms to principal and income allocation rules).

161 *See, e.g.*, DEL. CODE ANN. tit. 12, § 3527 (2001); N.Y. ESTATE POWERS & TRUSTS LAW § 11–2.4 (McKinney Supp. 2004).

162 *See, e.g.*, 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, 30–33, 36–46 (1998); Langbein, *The Uniform Prudent Investor Act, supra* note 91, at 669; 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* **R**

With equitable adjustment or a unitrust, the higher the total return, the better all the beneficiaries do.[163] The unitrust does so with less discretion and so a reduced potential for agency costs. But it less perfectly aligns the interests of the income and principal beneficiaries, because a disproportionate share of the potential upside from higher risk investments will accrue to the principal beneficiaries. Equitable adjustment somewhat better aligns the beneficiaries' interests, but it increases the potential for agency costs ex post because it gives the trustee additional discretion ex ante. Still, the exercise of this discretion is more transparent than the traditional approach of hiding the problem behind the portfolio's initial allocation between income-producing and capital-appreciating investments.

In any of its forms, the trend toward 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 bargaining been feasible. Indeed, before these reforms, opting out of the prior prudent investor standards was not uncommon in professionally drafted instruments.[164] Authorization for the trustee to invade principal for the benefit of the income beneficiaries was also not uncommon.[165]

3. *Risk Tolerance and the Duty of Care*

In the paradigmatic donative trust, the residual claimants are risk averse (imagine widows and orphans). Because there is no well-developed market for beneficial interests in trusts,[166] the beneficiaries cannot easily diversify, and when diversification is unavailable, the standard economic assumption is that of risk averseness.[167] Owing to the trend toward professional trustees, however, 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.[168] Corporate trustees are by definition risk neutral

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).

163 *See generally* MACEY, *supra* note 155, at 77–80 (describing the advantages of a more flexible trust-investment law). R

164 *See* POSNER, *supra* note 113, § 15.6, at 455; Getzler, *Legislative Incursions*, *supra* note R
20, Art. 2, at 3–4; Gordon, *supra* note 12, at 75–76 & n.99. R

165 *See, e.g.*, Guar. Trust Co. of N.Y. v. N.Y. City Cancer Comm., 144 A.2d 535, 538–37 (Conn. 1958) (holding that the trust instrument authorized the trustee to invade principal for the income beneficiary).

166 *See infra* note 278 and accompanying text. R

167 *See* VARIAN, INTERMEDIATE MICROECONOMICS, *supra* note 67, at 228; Eisenhardt, *supra* R
note 67, at 60–61. Behavioral studies are critical of this assumption. *See, e.g.*, Nicholas R
Barberis & Ming Huang, *Mental Accounting, Loss Aversion, and Individual Stock Returns*, 56 J. FIN. 1247, 1254 (2001).

168 Note, however, that the individual agents of an institutional fiduciary who are assigned to manage a particular trust are likely to be risk-averse. But this is an agency prob-

(this is the standard assumption for business organizations), and individual trustees are able to diversify and in some cases are even able to insure against loss.[169]

This is not to suggest that trustees are indifferent to risk or that beneficiaries will never prefer aggressive portfolios and high-risk investments. Rather, the point concerns the relative discounts, if any, that the parties assign to expected values in the face of uncertainty.[170] The basic intuition is that individuals who cannot diversify have a distaste for volatility and prefer instead lower expected returns with less risk of a substantial loss. This is true even if the probability that the substantial loss will materialize is relatively small. The more risk averse an investor is, the more likely the investor will prefer a smaller but certain sum (say, $100) over the chance to obtain a larger sum (say, $200) even if the larger sum, when discounted by its probability (say, 60%), is still larger than the smaller but certain sum (here $120 versus $100).

The disparity in the trustee's and the beneficiaries' attitudes toward risk that stems from this institutional design poses a challenge for trust governance.[171] In the absence of the fiduciary obligation or other corrective mechanisms, trustees would often be less averse to volatility than the beneficiaries.[172] Trust law's particular flavor of the fiduciary duty of care can be understood as an answer to this challenge.[173] Care in trust law is the functional equivalent of the objective reasonable person standard in tort law.[174] The trustee must "exercise such care and skill as a man of ordinary prudence would exercise in

lem within the institution's organizational structure, and analysis of that problem is beyond the scope of this Article.

169 Legal malpractice insurance, for example, is available with coverage for negligence in fiduciary administration.

170 Robert Cooter and Thomas Ulen's textbook provides a clear introductory explanation of this concept. *See* ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 49–55 (4th ed. 2004); *see also* VARIAN, INTERMEDIATE MICROECONOMICS, *supra* note 67, at 224–29. R

171 Agency relationships, in other words, present both incentive and risk-sharing problems. *See, e.g.*, Eisenhardt, *supra* note 67, at 58. R

172 Commissions are often set as a percentage of the trust corpus. *See, e.g.*, N.Y. SURR. CT. PROC. ACT § 2309 (McKinney 1997); Langbein, *supra* note 8, at 639, 651. There is, R however, an emerging trend, supported by academics, toward a reasonable compensation standard. *See* CAL. PROB. CODE § 15681 (West 1991); RESTATEMENT (THIRD) OF TRUSTS § 38 (2003); UNIF. TRUST CODE § 708, 7C U.L.A. 197 (Supp. 2003); Halbach, *supra* note 8, at R 1909. *See generally* VOLLMAR ET AL., *supra* note 101, at 1059 (describing various compensa- R tion schemes); Gordon, *supra* note 12, at 82–83 (discussing trustee compensation). R

173 *See* Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 437 (1993).

174 *See* UNIF. PRUDENT INVESTOR ACT § 1 cmt., 7B U.L.A. 287 (2000); Langbein, *supra* note 8, at 656. *See generally* Cooter & Freedman, *supra* note 69, at 105–58 (comparing R "reasonable" care in tort and fiduciary law).

dealing with his own property."[175] This duty counsels caution, which is what undiversified, risk-averse beneficiaries would prefer. Accordingly, the frequent observation 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.[176]

The contrast between the operation of the duty of care in trust law and in corporate law is instructive.[177] In corporate law, the business judgment rule requires deference to the ordinary business decisions of management unless they are tainted by a conflict of interest or are so unreasonable as to amount to gross negligence.[178] This is a loose constraint,[179] but the business judgment rule is justifiable 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.[180] And diversified (risk-neutral) shareholders are advantaged by the business judgment rule because insulating managers from liability in the absence of egregious conduct helps

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175 RESTATEMENT (SECOND) OF TRUSTS § 174 (1959); *see also* RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 cmt. d (1992). *See generally* Joshua Getzler, *Duty of Care*, *in* BREACH OF TRUST 41 (Peter Birks & Arianna Pretto eds., 2002) (discussing the development of the duty of care in English law).

176 *See, e.g.*, Dukeminier & Krier, *supra* note 11, at 1335 ("Trustees have long been risk averse, conservative investors."). Conservatism might also stem from the common law rule of unanimity in trustee decisionmaking. *See* DUKEMINIER & JOHANSON, *supra* note 28, at 918; Ogus, *supra* note 3, at 209–10. This lends support to the rejection of the unanimity requirement by the Uniform Trust Code, *see* § 703, 7C U.L.A. 191 (Supp. 2003), and by the *Restatement (Third) of Trusts*, *see* § 39 (2003), as does the observation that in practice many drafters likewise reject the unanimity requirement. There has been considerable statutory activity in this area. *See* RESTATEMENT (THIRD) OF TRUSTS § 39 rep. note cmt. a (2003); UNIF. TRUSTEE'S POWERS ACT § 6(a), 7C U.L.A. 429 (2000); DUKEMINIER & JOHANSON, *supra* note 28, at 918 n.5. **R** **R** **R**

177 *See* Gordon, *supra* note 12, at 94–96; Sitkoff, *supra* note 15, at 574–79. **R**

178 *See, e.g.*, Brehm v. Eisner, 746 A.2d 244, 264 & n.66 (Del. 2000); BAINBRIDGE, *supra* note 1, § 6.4, at 269–83. The United Kingdom has in practice, though admittedly not in name, something of a business judgment rule. *See* BRIAN R. CHEFFINS, COMPANY LAW: THEORY, STRUCTURE, AND OPERATION 313 (1997). **R**

179 Of course, one must be careful about accepting doctrinal labels as conclusive on the issue of whether prudence in trust law and business judgment in corporate law beget different outcomes. There is ample authority for deferential review of trustee decisionmaking, *see, e.g.*, RESTATEMENT (SECOND) OF TRUSTS § 187 (1959), 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 6–9, 14–19 (Univ. of Cal., L.A., Sch. of Law, Law & Econ. Research Series, Working Paper No. 03-18, 2003), *available at* http://ssrn.com/abstract=429260. Still, the different emphases in the canonical statements are telling. Further, even though numerous courts have found a breach of the duty of care by a trustee, *see, e.g.*, 2A SCOTT ON TRUSTS, *supra* note 5, § 174, cases holding that a manager of a publicly-traded corporation breached the duty of care are almost nonexistent. *See, e.g.*, BAINBRIDGE, *supra* note 1, §§ 6.2, 6.4; ALLEN & KRAAKMAN, *supra* note 10, § 8.4.2, at 254. **R** **R**

180 *See, e.g.*, WILLIAM W. BRATTON, CORPORATE FINANCE 120 (5th ed. 2003).

offset the managers' incentives—including large investments of human capital and personal wealth in the firm—to avoid risk.[181]

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 standard. Viewed in this manner, the different understandings of the duty of care in corporate and trust law reflect different expectations regarding internal and external diversification.[182] In donative trusts diversification for the residual claimants is usually obtained internally.[183]

Of course, given their other holdings, some beneficiaries might be diversified irrespective of the trust portfolio. For this reason modern prudent investor standards require the trustee to consider the risk tolerance of the trust's particular beneficiaries in crafting the trust portfolio.[184] 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."[185]

B. The Settlor-Beneficiary Tension

In light of the agency cost considerations on both sides, this section explores four examples of how the law balances the ex post preferences of the beneficiaries with the ex ante wishes of the settlor. Consider once again the exemplary trust presented above, which was

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181 *See* Joy v. North, 692 F.2d 880, 886 & n.6 (2d Cir. 1982); BAINBRIDGE, *supra* note 1, § 6.3, at 259–63; EASTERBROOK & FISCHEL, *supra* note 1, 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, 182 (2001). R R

182 For a complementary analysis, see Rock & Wachter, *supra* note 2, at 652–71. Note also that managerial decisions regarding a portfolio of liquid assets are easier to monitor than decisions regarding net present value of a corporation's operating assets. *See* Macey, *supra* note 3, at 317-19; Hansmann & Mattei, *supra* note 6, at 477. 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 15, at 583–87. R R R

183 Hence the trustee's duty to diversify the trust portfolio. *See* UNIF. PRUDENT INVESTOR ACT § 3, 7B U.L.A. 296–98 (2000); Langbein, *The Uniform Prudent Investor Act, supra* note 91, at 646–49; Halbach, *Trust Investment, supra* note 147, at 424–45; *see also In re* Estate of Janes, 681 N.E.2d 332 (N.Y. 1997) (holding that a fiduciary may be surcharged for an imprudent lack of diversification). R

184 *See* UNIF. PRUDENT INVESTOR ACT § 2, 7B U.L.A. 289–90 (2000); RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 cmt. e (1992); Halbach, *Trust Investment, supra* note 147, at 436–37, 444–45; Langbein, *The Uniform Prudent Investor Act, supra* note 91, at 650. R R

185 UNIF. PRUDENT INVESTOR ACT § 2 cmt., 7B U.L.A. 291 (2000); *see* RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227(a) (1992). *See generally* Ogus, *supra* note 3, at 196 ("The diversification objective of individuals will reflect their degree of risk-aversion."). R

settled by S for the benefit of B1 and B2 (collectively the "Bs") with T as 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.[186] A variant of the well-known dead hand problem (which is perhaps a pejorative aphorism for the idea that the settlor's intent controls),[187] this tension has been exacerbated by the modern trend toward 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, which 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.[188]

1. *Modification and Termination*

A useful example of the potential for divergent interests between the settlor and the beneficiaries involves the possibility of the beneficiaries seeking premature termination of the trust. This problem includes the issue of whether the beneficiaries can obtain judicial modification of the trust's terms, because the power to terminate subsumes the power to modify.[189] The American rule, which originated with *Claflin v. Claflin*,[190] is unfriendly to termination and modifica-

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186 *See* Ogus, *supra* note 3, at 214–16. R

187 There is a considerable literature on the dead hand problem. *See, e.g.*, RONALD CHESTER, INHERITANCE, WEALTH AND SOCIETY *passim* (1982); POSNER, *supra* note 113, § 18.3, R at 518–20; Alexander, *supra* note 20, at 1254–64; Hirsch & Wang, *supra* note 3; Gareth H. R Jones, *The Dead Hand and the Law of Trusts, in* DEATH, TAXES AND FAMILY PROPERTY 119 (Edward C. Halbach, Jr. ed., 1977); Jeffrey G. Sherman, *Posthumous Meddling: An Instrumentalist Theory of Testamentary Restraints on Conjugal and Religious Choices*, 1999 U. ILL. L. REV. 1273.

188 *See* LAWRENCE W. WAGGONER ET AL., FAMILY PROPERTY LAW: CASES AND MATERIALS ON WILLS, TRUSTS, AND FUTURE INTERESTS 900–01, 1251–52 (3d ed. 2002); Dukeminier & Krier, *supra* note 11, at 1327–35; Sterk, *supra* note 3, at 2111–14; *see also* Richard A. Epstein, R *Past and Future: The Temporal Dimension in the Law of Property*, 64 WASH. U. L.Q. 667 (1986) (discussing temporal uncertainty and property law). 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, e.g.*, POSNER, *supra* note 113, § 18.4, at 520; Alex M. Johnson, Jr., *Limiting Dead Hand Control of* R *Charitable Trusts: Expanding the Use of the* Cy Pres *Doctrine*, 21 U. HAW. L. REV. 353, 356 (1999); Macey, *supra* note 3, at 300–06. R

189 *Cf.* 2 SCOTT ON TRUSTS, *supra* note 5, § 107.3, at 124–25 (discussing removal of R trustee by beneficiaries). Note, however, that the relevant considerations for modification versus termination are not entirely the same. *See* RESTATEMENT (THIRD) OF TRUSTS § 65 cmt. f (2003). In practice, termination usually pits the current against the remainder beneficiaries whereas modification usually touches only the settlor/beneficiary tension.

190 20 N.E. 454 (Mass. 1889); *see* RESTATEMENT (THIRD) OF TRUSTS § 65 cmt. a (2003).

tion.[191] Under the *Claflin* doctrine, a trust may be terminated prematurely only with the settlor's consent or, in the absence of the settlor's consent, if termination would not frustrate a "material purpose" of the trust.[192] Settlor's consent, however, is by definition unavailable when dealing with testamentary trusts, and courts have had little difficulty finding a "material purpose" that would be offended by a modification or termination.[193] Thus, as a practical matter, unless the trustee consents,[194] American trusts are difficult to amend or terminate once established. 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.

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 the beneficiaries' wishes, which is what the settlor likely would have wanted. The settlor, after all, chose a trust rather than an outright transfer or another organizational form.[195] Thus the *Claflin* doctrine is consistent with the model of the settlor as the primary principal. Moreover, though a particular beneficiary might prefer the power to terminate the trust once it is established, the *Claflin* doctrine is advantageous to potential beneficiaries as a class because it increases the willingness of grantors to create a trust in the first place.[196] The idea is that, in the aggregate, beneficiaries fare better with more trusts, and thus more gifting,[197]

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191 *See* Dukeminier & Krier, *supra* note 11, at 1328 (observing that, under *Claflin*, "termination or modification by a court[ ] is only grudgingly available"). R

192 *See* RESTATEMENT (THIRD) OF TRUSTS § 65 & cmt. a (2003); RESTATEMENT (SECOND) OF TRUSTS § 337 (1959); 4 SCOTT ON TRUSTS, *supra* note 5, §§ 337–340.2. R

193 *See generally* 4 SCOTT ON TRUSTS, *supra* note 5, §§ 337.1–337.8 (collecting and describing cases). 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 [the beneficiaries] would be defeated if termination of the trust were allowed."). R

194 *See* RESTATEMENT (SECOND) OF TRUSTS § 342 (1959); ROGER W. ANDERSEN, UNDERSTANDING TRUSTS AND ESTATES 110–111 (3d ed. 2003); 4 SCOTT ON TRUSTS, *supra* note 5, § 342, at 529–32. R

195 *Cf.* Langbein, *supra* note 8, at 632 ("The donor who structures a gift in this way expects compensating advantages."). R

196 That the trust is less easily modified than a contract might help solve the so-called Samaritan's dilemma. Because of its rigidity ex post, the trust provides a mechanism for the parties to commit to a particular donative structure. On the Samaritan's dilemma and related issues, see James M. Buchanan, *The Samaritan's Dilemma*, *in* ALTRUISM, MORALITY, AND ECONOMIC THEORY 71–85 (Edmund S. Phelps ed., 1975); Ogus, *supra* note 3, at 189; R Shavell, *supra* note 136, at 402, 406–08, 419; Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261, 1276–83 (1980); Posner, R *supra* note 136, at 412–13. If S is willing to transfer resources to B, but B anticipates that S R will do so, then B might behave more recklessly because S has provided a safety net. For further discussion of altruism and deferred gifts from an economic perspective, see also sources cited in *supra* note 136. R

197 The further assumption here is that in the absence of these rules, the overall volume of gifting would fall. If the level of overall gifting remained constant, then benefi-

albeit with potentially greater managerial agency costs, than they would fare with fewer trusts, albeit with reduced potential for managerial agency costs.

The downside of the *Claflin* doctrine 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 the beneficiaries are identifiable adults who would be better off if the trust were terminated (perhaps because its consequent administrative expenses would be eliminated), the trustee need not assent to their wishes. Against the rule, 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.

At its most extreme, this criticism amounts to nothing more than a statement that the beneficiaries cannot override the settlor's choice of form. As suggested above, however, the doctrine rests on the assumption that all the relevant parties fare better in the aggregate if settlors are allowed to bind the beneficiaries to the trust form of organization. And yet, if we assume that settlors of today's managerial trusts ultimately want to maximize the welfare of the beneficiaries, then a different rule might be preferable—especially in view of the ongoing erosion of the Rule Against Perpetuities and hence the increasing temporal durability of modern trusts.[198] On this view, onetime settlors do not know to opt out of the default *Claflin* regime, perhaps because their advisors are failing to call this to their attention (an altogether different agency problem[199]) or they did not obtain expert advice.[200]

It is hardly surprising, therefore, that there is a strong academic and slowly emerging decisional trend toward liberalizing these rules.[201] As in the classic (if then extraordinary) *Pulitzer* case,[202] courts are beginning to show a willingness to authorize deviation from the settlor's specific instructions that, over time, conflict with the set-

ciaries might fare 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.

198 *See supra* note 188 and accompanying text. R

199 *See supra* note 115. R

200 *See* Dukeminier & Krier, *supra* note 11, at 1331–32. R

201 *See* Halbach, *Significant Trends*, *supra* note 147, at 538; Halbach, *supra* note 8, at 1899–1901; *see, e.g.*, CAL. PROB. CODE § 15409 (West 1991); *see also* Gail Boreman Bird, *Trust Termination: Unborn, Living, and Dead Hands—Too Many Fingers in the Trust Pie*, 36 HASTINGS L.J. 563 (1985) (suggesting reforms to increase flexibility of trusts over time); 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) (arguing that the increase in long-term trusts requires loosening of the rules of modification and termination). R

202 *In re* Pulitzer's Estate, 249 N.Y.S. 87 (Sur. Ct. 1931), *aff'd mem.*, 260 N.Y.S. 975 (App. Div. 1932). For further discussion of *Pulitzer*, see Langbein, *supra* note 98.

tlor's assumed broader aim of benefiting the beneficiaries.[203] Certainly the recent *Uniform Trust Code* and *Restatement (Third) of Trusts* embrace this view.[204] In fact, they extend it to the power of "equitable deviation"—the idea that courts should permit modification of even the dispositive instructions of the trust instrument in light of circumstances not anticipated by the settlor.[205] Likewise, there is burgeoning authority, perfectly sensible from an agency-costs contractarian perspective, for trust modifications where tax exigencies arise after the settlor establishes the trust.[206]

Note, however, that these liberalizations are designed to advance the settlors' probable intent.[207] If, at the time of the trust's creation, a particular type of tax savings was not possible, then 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.[208] Similarly, the typical settlor would want the court to modify even the distributive provisions of the trust when, as a result of unanticipated circumstances, the settlor's prior regime is no longer sensible.[209] Re-

203 *See, e.g.*, *In re* Trusteeship Agreement with Mayo, 105 N.W.2d 900, 91 (Minn. 1960); Carnahan v. Johnson, 711 N.E.2d 1093, 1096–98 (Ohio Ct. App. 1998); RESTATEMENT (THIRD) OF TRUSTS rep. note § 66 cmt. b (2003) (collecting illustrative authority); ROGER W. ANDERSEN & IRA MARK BLOOM, FUNDAMENTALS OF TRUSTS AND ESTATES § 8.04, at 392 (2d ed. 2002).

204 *See* UNIF. TRUST CODE §§ 410–12, 7C U.L.A. 164–68 (Supp. 2003); RESTATEMENT (THIRD) OF TRUSTS §§ 65–66 (2003); *In re* Harris Testamentary Trust, 69 P.3d 1109, 1114–20 (Kan. 2003) (upholding various reformations and modifications under the Kansas adoption of the UTC); Chester, *supra* note 201, at 724–28; Dukeminier & Krier, *supra* note 11, at 1329–31; English, *supra* note 98, at 27–28; David M. English, *The Uniform Trust Code (2000): Significant Provisions and Policy Issues*, 67 MO. L. REV. 143, 169–76 (2002); Julia C. Walker, *Get Your Dead Hands Off Me: Beneficiaries' Right to Terminate or Modify a Trust Under the Uniform Trust Code*, 67 MO. L. REV. 443, 459–62 (2002). R R

205 *See* UNIF. TRUST CODE § 412, 7C U.L.A. 167 (Supp. 2003); RESTATEMENT (THIRD) OF TRUSTS § 66 & cmt. a (2003); Halbach, *supra* note 8, at 1900–01; *cf.* N.Y. EST. POWERS & TRUSTS LAW § 7–1.6(b) (McKinney 2002); Paul G. Haskell, *Justifying the Principle of Distributive Deviation in the Law of Trusts*, 18 HASTINGS L.J. 267, 294 (1967) (arguing in favor of flexibility to modify dispositive trust terms that would cause hardship without modification); Peter J. Wiedenbeck, *Missouri's Repeal of the* Claflin *Doctrine—New View of the Policy Against Perpetuities?*, 50 MO. L. REV. 805 (1985) (analyzing recent statutory reforms). R

206 *See* RESTATEMENT (THIRD) OF PROPERTY: WILLS AND OTHER DONATIVE TRANSFERS § 12.2 & rep. note (2003) (stating the rule and collecting authority); UNIF. TRUST CODE § 416, 7C U.L.A. 171 (Supp. 2003); *see also* 2A SCOTT ON TRUSTS, *supra* note 5, § 167, at 281 n.27 & 2003 Supp. at 329–34 (collecting authority); Halbach, *supra* note 8, at 1887; *cf.* Mary Louise Fellows, *In Search of Donative Intent*, 73 IOWA L. REV. 611, 613 (1988) (arguing that courts should construe intent by reference to "competent estate planning techniques"). R R

207 *See* Langbein, *supra* note 59, at 68–69. R

208 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.

209 These liberalizations are therefore different from reformation (which the English call rectification of documents in equity). *See In re* Harris Testamentary Trust, 69 P.3d 1109, 1114 (Kan. 2003) (distinguishing reformation and modification); Langbein, *supra* note 59, at 69 (describing reformation and rectification). Reformation conforms the docu- R

turning to the exemplary trust described above, settled by S for the benefit of B1 and B2, the supposition is that S would have preferred to favor B2 over B1 if subsequent to settling the trust the former was disabled in an accident while the business of the latter proved unusually successful.[210] 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 fulfill the beneficiaries' desires, but only when doing so would approximate what the settlor would have wanted. They add the nuance of a standard, as it were, to the hard-edged *Claflin* rule.

The more liberal English approach, in contrast, reflects a different dead-hand calculus. The leading English case on the question of premature termination, *Saunders v. Vautier*,[211] reaches the opposite result from *Claflin*.[212] Beneficiaries of English trusts, if they are all identifiable adults, can force the premature termination of a trust over the dissent of the trustee.[213] Indeed, owing not only to *Saunders* but also (and even more clearly) to the Variation of Trusts Act of 1958,[214] English law resolves significantly more of the settlor-beneficiary tension raised by questions of trust termination and modification in favor of

ment to what was actually intended at the time of execution. The innovation here is the extension of the reformation concept to testamentary trusts. *See* RESTATEMENT (THIRD) OF PROPERTY: WILLS AND OTHER DONATIVE TRANSFERS § 12.1 & cmt. a (2003); UNIF. TRUST CODE § 415, 7C U.L.A. 171 (Supp. 2003); *see, e.g.*, Pond v. Pond, 678 N.E.2d 1321, 1324 (Mass. 1997) (reforming trust where settlor's intent was frustrated by drafting error).

210 For an example of the traditional, contrary approach, see *In re* Stuchell, 801 P.2d 852, 854 (Or. Ct. App. 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, *supra* note 3, at 300–02 (defending narrower interpretations of settlor's intent). **R**

211 49 Eng. Rep. 282 (1841); *see also* Goulding v. James, 2 All E.R. 239, 247 (C.A. 1997) ("The principle recognises the rights of beneficiaries, who are sui juris and together absolutely entitled to the trust property, to exercise their proprietary rights to overbear 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.").

212 For a comparative discussion of *Saunders* and *Claflin* in their historical context, see Alexander, *supra* note 20, at 1200–04. **R**

213 *See* D.J. HAYTON, THE LAW OF TRUSTS 93–96 (3d ed. 1998); MOFFAT ET AL., *supra* note 20, at 249–52. **R**

214 VARIATION OF TRUSTS ACT, 1958, 6 & 7 Eliz. 2, c. 53, § 1 (Eng.). Well-drafted instruments can easily circumvent *Saunders*, for example by ensuring the existence of contingent interests. The 1958 Act, however, is mandatory—and it allows for the ex post variation of even discretionary trusts. *See* Dukeminier & Krier, *supra* note 11, at 1329; *see also* EDWARDS & STOCKWELL, *supra* note 20, at 156–58 (collecting English cases which hold that settlor's intent is not determinative and indeed often irrelevant); MOFFAT ET AL., *supra* note 20, at 272 (noting the "'triumph for the doctrine of equitable property over the doctrine of fidelity to the settlors' intentions'" (citation omitted)); PEARCE & STEVENS, *supra* note 25, at 463–64 (same). **R** **R** **R** **R**

the beneficiaries.[215] Unlike the recent liberalizations to American law, however, English law places little emphasis in resolving these matters on evidence of what the settlor would have wanted.[216]

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 as the settlor's property—and the dead hand continues to rule only by the sufferance of the beneficiaries."[217] 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, in contrast, is default. American settlors can choose the English or any other more permissive regime.

2. *Trustee Removal*

The question of on what grounds beneficiaries may obtain the removal of a trustee is another example of the potential for tension between the interests of the settlor and those of the beneficiaries. To return yet again to the exemplary trust discussed above, which was settled by S for the benefit of B1 and B2 with T as trustee, the question is when, if ever, a court will remove and replace T at the request of the Bs.

On the one hand, an important consideration for settlors when choosing a trustee is the trustee's 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 trustee's performance and, under standard doctrine, only the beneficiaries have standing to bring an action against the trustee for breach of trust.[218] The difficulty, then, is setting the threshold for trustee removal high enough so that the trustee can carry out the settlor's wishes (including the protection of future

215 *See* HAYTON, *supra* note 213, at 174; MOFFAT ET AL., *supra* note 20, at 248–73; PEARCE & STEVENS, *supra* note 25, at 450–66; Hayton, *supra* note 116, at 598–600; Jones, *supra* note 187, at 124–26; Ogus, *supra* note 3, at 202–04. *See generally* Chester, *supra* note 201, at 709–22 (discussing the history of English and American trust law). Canada is also more liberal than the American states. *See* Keith B. Farquhar, *Recent Themes in the Variation of Trusts*, 20 EST. TR. & PENSIONS J. 181 (2001). R R R

216 *See* MOFFAT ET AL, *supra* note 20, at 248–57, 273–86; TODD & WILSON, *supra* note 20, § 18.3.3.3, at 434; Farquhar, *supra* note 215, at 186–91; sources cited *supra* notes 211, 214-15; *see also* Wiedenbeck, *supra* note 205, at 817 (noting that *Saunders* permits termination "without regard to the settlor's purposes"). R R

217 DUKEMINIER & JOHANSON, *supra* note 28, at 651; *cf.* Jones, *supra* note 187, at 120 ("[American courts] have accepted the full implications of the principle that the property is the settlor's, even though settled on trust."). R

218 *See infra* Part IV.B.3.

beneficiaries) in the teeth of a contrary preference of the current beneficiaries without setting it so high as in effect to sanction shirking or mismanagement. The goal, in other words, is to minimize trustee-beneficiary agency costs, subject to the ex ante constraints imposed by the settlor.

The law's default approach authorizes courts to remove trustees who are dishonest or who have engaged in a "serious breach of trust," but it does not necessarily permit removal for breaches that are not "serious" or for simple disagreements.[219] 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.[220] Further, 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.[221]

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 when the typical trustee was an amateur rather than a fee-paid professional.[222] When the trustee's mission was simply to hold ancestral land, there were fewer opportunities for conflict between beneficiaries and trustees (where the agent's tasks are fewer and are readily observable, shirking is less of a problem). And, in the aggregate, beneficiaries fare better when settlors are comfortable establishing trusts if the alternative is that settlors would not make the transfer at all.[223] Thus the traditionally high threshold for trustee removal served 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 overarching aim has shifted to maximization of total return. Consider also the apparent shift toward use of professional trustees,[224] which suggests a weakened personal link between the settlor and the trustee. Both of these developments are related to the larger trend toward use of the trust as an organizing device for the professional management of financial as-

219 *See, e.g.*, RESTATEMENT (SECOND) OF TRUSTS § 107 cmts. b–c (1959); RESTATEMENT (THIRD) OF TRUSTS § 37 cmt. e(1) (2003); 2 SCOTT ON TRUSTS, *supra* note 5, § 107, at 108–09. R

220 *See, e.g.*, RESTATEMENT (SECOND) OF TRUSTS § 107 cmt. f (1959); RESTATEMENT (THIRD) OF TRUSTS § 37 cmt. f (2003); 2 SCOTT ON TRUSTS, *supra* note 5, § 107.1, at 117–18; R *cf.* English, *supra* note 204, at 197–99 (discussing removal under the UTC in situations R "where the personal link between the settlor and trustee has been broken").

221 *See, e.g.*, RESTATEMENT (SECOND) OF TRUSTS § 107 cmt. g (1959); RESTATEMENT (THIRD) OF TRUSTS § 37 cmt. f (2003); 2 SCOTT ON TRUSTS, *supra* note 5, § 107.1, at 118. R

222 *See, e.g.*, Langbein, *supra* note 8, at 632–33, 637–39; *see also supra* note 57. R

223 *See supra* note 197 and accompanying text. R

224 *See supra* note 57 and accompanying text. R

sets. With these changes, fiduciary law has replaced limited trustee powers as the beneficiaries' chief protective device.[225] Although modern trustees can, and in fact often should, delegate to specialists,[226] the trustee remains ultimately responsible for the exercise of the broader discretion afforded by modern law. This means that not only has the potential for managerial agency costs increased, but the importance of removal as a check on these costs has likewise increased.

Consistent with this analysis, anecdotal evidence suggests that modern settlors regularly contract out of the default removal rules in favor of easier substitution of trustees,[227] sometimes even authorizing a third-party (the so-called trust protector) to replace the trustee.[228] Consider also the analogy to the robust econometric evidence regarding the negative impact on shareholder welfare of corporate takeover defenses such as classified boards.[229] Putting aside concern about the effect of deterring the settling of trusts in the first place, this analogy lends support to the view that reducing the threshold for the removal of trustees should improve beneficiary welfare.

The foregoing therefore provides an argument in favor of the somewhat more liberal removal standards stated in the new *Uniform Trust Code* and *Restatement (Third) of Trusts*.[230] The argument is particularly strong with respect to removal of large (as compared to bou-

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225 *See* Langbein, *supra* note 8, at 640–43; Langbein, *supra* note 59, at 71; *see also* Alexander, *supra* note 24, at 775 (arguing that the rise of institutional trustees required "trust-inducing mechanisms" such as fiduciary law); Jones, *supra* note 187, at 121–23 (noting the historically limited powers of trustees). R R R

226 *See supra* note 91. R

227 *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS § 34 cmt. c (2003) ("It is also common for the terms of trusts to provide for the appointment of new trustees."); AM. JUR., *Legal Forms—Trusts* §§ 251:370–251:373, 251:388 (2d ed. 2001); JOHN R. PRICE, PRICE ON CONTEMPORARY ESTATE PLANNING § 10.41, at 1152 (2d ed. 2000). In correspondence with the author about an earlier draft of this Article, Jeffrey Schoenblum observed that the beneficiaries are commonly given authority to replace the trustee with another, provided that the substitute is also independent. *See, e.g.*, 7 JEFFREY A. SCHOENBLUM, PAGE ON THE LAW OF WILLS 497–98 (2d. ed. 2000). This limitation is important not only to maintain the broad structure of the settlor's plan, but also to avoid a finding under agency law that the trustee is an agent of the beneficiaries. *See* RESTATEMENT (SECOND) OF AGENCY §§ 14, cmt. c, 14B, cmt. c (1958).

228 *See* discussion *infra* Part IV.B.4.

229 *See generally* Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy,* 54 STAN. L. REV. 887 (2002) (finding that staggered boards have a negative impact on shareholder welfare); Robert M. Daines, Do Classified Boards Affect Firm Value? Takeover Defenses After the Poison Pill (2002) (unpublished manuscript, on file with the Cornell Law Review) (same).

230 *See* UNIF. TRUST CODE § 706, 7C U.L.A. 194–95 (Supp. 2003); RESTATEMENT (THIRD) OF TRUSTS § 37 & cmt. e (2003); English, *supra* note 98, at 28 (noting that the UTC provisions on trustee removal were "among the more significant" deviations from traditional doctrine); English, *supra* note 204, at 197–99; Langbein, *supra* note 59, at 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"). R

tique) institutional fiduciaries.[231] Unlike an individual with whom the settlor might have had a personal connection, one institutional fiduciary is unlikely to have a comparative advantage over another in effecting the settlor's intent, especially after a corporate reorganization or turnover in the company's account managers.[232] This is not to suggest that reputational concerns, particularly with respect to large banks and trust companies, do not militate toward fidelity. Rather, the point is that making it easier, at least as a default matter, for beneficiaries to substitute one institution for another might help create an ex post competition between institutional fiduciaries for trust control that would complement the current ex ante competition for selection by the settlor.[233]

3. *Settlor Standing*

The question of settlor standing to enforce the terms of the trust provides a further example of the settlor-beneficiary tension. Traditionally, because the creation of a trust was viewed as a conveyance of property after which the settlor had no further legal interest, courts held that only beneficiaries had standing to bring an action against the trustee for breach in an irrevocable trust.[234] As a policy matter, this rule plausibly follows from the position of the beneficiaries as residual claimants; certainly it mirrors the similar approach in other organizational forms, most obviously the corporation.[235] Once the settlor establishes the trust, neither she nor any other non-beneficiary has a tangible stake in enforcing its terms. The beneficiaries, in contrast, bear the marginal costs and benefits of the trustees' decision-

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231 *See* Chester & Ziomek, *supra* note 20, at 247 (analyzing "the problem of beneficiary removal of a corporate trustee"). R

232 *See* RESTATEMENT (THIRD) OF TRUSTS § 37 cmt. f (2003) ("[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 20, at 274; *see also* R PRICE, *supra* note 227, § 10.43.1, at 1161–62 (describing trust management by corporate R trustees).

233 *Cf.* DUKEMINIER & JOHANSON, *supra* note 28, at 661 (considering whether benefi- R ciaries should be permitted to change trustees under certain circumstances). Note, however, that this approach would further burden the fiduciary apparatus that protects future beneficiaries from excessive favoring of the current beneficiaries. *See* discussion *supra* Part IV.A.1.

234 *See* RESTATEMENT (SECOND) OF TRUSTS § 200 (1959); 3 SCOTT ON TRUSTS, *supra* note 5, §§ 200–200.1, at 207–12; Langbein, *supra* note 8, at 664. *See generally* John T. Gaubatz, R *Grantor Enforcement of Trusts: Standing in One Private Law Setting*, 62 N.C. L. REV. 905 (1984) (discussing instances where courts allow settlors to maintain an action to enforce a trust); Note, *Right of a Settlor to Enforce a Private Trust*, 62 HARV. L. REV. 1370 (1949) (arguing that a settlor's remedial rights should include the right to bring suit against the trustee).

235 *See* BAINBRIDGE, *supra* note 1, § 9.2, at 410–18; EASTERBROOK & FISCHEL, *supra* note R 1, at 36–38; Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making* R *Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 23 (1991).

making. Accordingly, it is the beneficiaries who have an incentive to bring litigation only when it is cost justified, provided that there is at least one competent beneficiary and his stake is large enough to counter the problem of collective action.[236]

But this analysis is too simple. The rule's origin in the property law, conveyance-based conception of the trust has obscured the relevance of the parties' probable intent. Thus, because he believes that most settlors would prefer to retain the right to bring enforcement actions against the trustee, Langbein argues that the underlying default rule should be reversed in favor of settlor standing in the absence of a contrary instruction in the trust instrument.[237] There are, however, two further relevant considerations, the second of which is most 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 and trustees is not necessarily indicative of their preferences. Under current doctrine, the settlor must retain some sort of beneficial interest in the trust in order to have standing to sue.[238] But doing so would likely subject the trust to undesirable tax consequences.[239] This means that the general failure by settlors in practice to retain standing rights is not good evidence of their preferences. In particular, this failure does not prove that increased trustee commissions, which such standing would likely prompt, have deterred settlors from retaining a beneficial interest. In fact, the proliferation of the trust protector, which will be discussed below, is evidence to the contrary.

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236 *See* Gordon, *supra* note 12, at 76–79 (discussing beneficiary free-rider problems). R

237 Langbein, *supra* note 8, at 664; *see also* Hayton, *supra* note 20, at 103–07 (discussing settlors as trust enforcers). 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* UNIF. TRUST CODE § 602, 7C U.L.A. 182–83 (Supp. 2003); RESTATEMENT (THIRD) OF TRUSTS § 63 & cmt. b (2003); Halbach, *supra* note 8, at 1898–99; Langbein, *supra* note 59, at 70–71. There is also overlap with the question of standing under the Uniform Management of Institutional Funds Act, 7A U.L.A. 485 (1999), which is currently being revised. R R

238 *See* RESTATEMENT (SECOND) OF TRUSTS § 200 cmt. b (1959); 3 SCOTT ON TRUSTS, *supra* note 5, § 200.1, at 211–12. R

239 *See* I.R.C. §§ 2036, 2038 (2001); GEORGE T. BOGERT, TRUSTS § 145, at 516 & n.16 (6th ed. 1987). In correspondence with the author, Joel Dobris 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 I.R.C. sections 2036 and 2038. Note also that recent authorities suggest that a reservation of power to replace a trustee would not trigger liability under sections 2036 or 2038. *See* Estate of Wall v. Comm'r, 101 T.C. 300 (1993); IRS Rev. Rul. 95-58. If stable, this might provide an alternative means to achieve the benefits of settlor standing without the tax risk. *See* Michael Houston, Estate of Wall v. Commissioner: An Answer to the Problem of Settlor Standing in Trust Law? (unpublished manuscript, on file with the Cornell Law Review).

Second, the agency cost implications 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 over the trustee: "[A] manager told to serve two masters . . . has been freed of both and is answerable to neither."[240] 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.[241] And this objection might have particular salience in the trust context, because the fear of litigation with parties other than the beneficiaries might further inhibit already overly cautious trustees. After all, an important rationale for the recent reforms to the standards of prudent investing was to encourage trustees to be less conservative.[242]

On the other hand, the donative settlor's motivation for interposing a trustee between the trust assets and the beneficiary, tax considerations aside, is often a lack of faith in the beneficiaries' judgment. Given the likelihood of feckless, unborn, minor, unidentifiable, or otherwise incompetent beneficiaries,[243] and given the possibility of a free-rider problem among the beneficiaries,[244] settlor standing might minimize agency costs by making the threat of litigation more viable as a deterrent against actions by the trustee that are not in the best interests of the beneficiaries or that breach a contrary instruction of the settlor. Many trust beneficiaries, as other commentators have noted, are not particularly effective monitors,[245] and even when they are, their preferences are not necessarily congruent with the settlor's.

The foregoing analysis therefore contributes to Langbein's discussion by highlighting the importance of two inquiries: first, whose

240 EASTERBROOK & FISCHEL, *supra* note 1, at 38. R

241 *See, e.g.*, BAINBRIDGE, *supra* note 1, § 9.2, at 414–17; Macey, *supra* note 235, at 31–36. R

242 *See, e.g.*, Halbach, *Trust Investment*, *supra* note 147, at 407, 411–14; Langbein, *The Uniform Prudent Investor Act*, *supra* note 91, at 641–42; *supra* note 176 and accompanying text. R R

243 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) (noting the rigidity of the guardian ad litem's decisionmaking); *see also* UNIF. TRUST CODE § 305(c) & cmt., 7C U.L.A. 154 (Supp. 2003) (stating a more liberal rule of representation); Martin D. Begleiter, *The Guardian Ad Litem in Estate Proceedings,* 20 WILLAMETTE L. REV. 643 (1984). The doctrine of virtual representation requires an alignment of interests across generations. *See, e.g.*, N.Y. SURR. CT. PROC. ACT § 315(4) (McKinney 1994); *In re* Wolcott, 56 A.2d 641 (N.H. 1948); UNIF. PROBATE CODE § 1–403(2)(iii), 8 U.L.A. 69 (1998); UNIF. TRUST CODE § 304, 7C U.L.A. 153 (Supp. 2003); Lawrence B. Rodman & Leroy E. Rodman, *Virtual Representation: Some Possible Extensions,* 6 REAL PROP. PROB. & TR. J. 281, 281–82 (1971). *See generally* VOLLMAR ET AL., *supra* note 101, at 345–47 (discussing guardians ad litem and virtual representation). R

244 *See* discussion *infra* Part IV.D.1.

245 *See, e.g.*, Fischel & Langbein, *supra* note 152, at 1114–15, 1118–19; Gordon, *supra* note 12, at 82. R R

claim the settlor would be permitted to advance, and second, whether the settlor's approval of an action would insulate the trustee from a later suit by the beneficiaries (or a beneficiary's guardian ad litem).[246] These questions are specific manifestations of the larger issue of determining whether the settlor is, or the beneficiaries are, the trustee's dominant principal. If the aim of trust law were simply to maximize the welfare of the beneficiaries, 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. Our model of the trust, however, is one in which the trustee should maximize the welfare of the beneficiaries subject to the initial constraints of the settlor. Under this approach, recognition of unqualified settlor standing could reduce two very different types of agency costs.

First, returning again to the exemplary trust discussed above, which S settled for the benefit of B1 and B2 with T as trustee, T is more likely to act appropriately if S, in addition to B1 and B2, had standing to sue. Here S's standing would provide a backstop check on managerial agency costs. Second, if S had standing to sue, T would be less likely to enter into a side bargain with the Bs to avoid the ex ante constraints imposed by S. For example, the Bs might offer to pay T to disburse the corpus of the trust. This would raise no duties of loyalty or impartiality problems if B1 and B2 were competent adults who agreed to the transaction.[247] In this scenario, S's standing would help ensure that T respects S's limitations on the use of the trust funds.[248]

246 For a complementary doctrinal analysis, see Hayton, *supra* note 20, at 103–05. R

247 *See supra* note 194 and accompanying text.

248 Given the lack of identifiable beneficiaries in charitable trusts, the foregoing analysis may be relevant to the ongoing debate over donor standing in that context as well. *See* UNIF. TRUST CODE § 405(c), 7C U.L.A. 160 (Supp. 2003); 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 204, at 180; Paula Kilcoyne, Note, *Donor Standing Under the Uniform Management of Institutional Funds Act in Light of* Carl J. Herzog Foundation, Inc. v. University of Bridgeport, 21 W. NEW ENG. L. REV. 131, 147–48 (1999); *see also* Ilana H. Eisenstein, Comment, *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) (arguing that charitable trust law would benefit from consideration of public interest); Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 606–11 (1981) (advocating for patron enforcement against nonprofit corporations); Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227 (advocating the creation of for-profit monitoring companies to reduce the agency costs associated with oversight of nonprofit charitable organizations); Symposium, *The Bishop Estate Controversy*, 21 U. HAW. L. REV. 353 (1999) (discussing the problems associated with the Bishop estate charitable trust). R

4. *Trust Protectors*

An emerging feature of modern managerial trusts is the appointment of a trust "protector."[249] To return again to the exemplary trust, which S settled for the benefit of B1 and B2 with T as trustee, S might also name her 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 terms because 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 if S had been able.[250] Although originally conceived as a check on local trustees in offshore asset-protection trusts,[251] the trust protector has today migrated into ordinary trusts, an unsurprising result in light of the protector's usefulness in minimizing agency costs.

Putting aside the doctrinal question of when, if ever, protectors should be held to stand in a fiduciary relationship with the beneficiaries,[252] the ability of the protector to check agency costs is relatively straightforward. An office of the trust protector allows the settlor to appoint a trusted friend or confidant to monitor the trustee's management.[253] Thus, for all the reasons that settlor standing might reduce agency costs, the appointment of a trust protector might similarly re-

249 *See* Restatement (Third) of Trusts § 64 rep. note cmts. b–d (2003); James L. Dam, *More Estate Planners Are Using 'Trust Protectors'*, Law. Wkly. U.S.A. (Oct. 29, 2001), at 14, 14; William A. Ensing, *Using a Trust Protector in Asset Protection Planning*, *in* Asset Protection Strategies: Planning with Domestic and Offshore Entities 87, 88 (Alexander A. Bove, Jr. ed., 2002); Hayton, *supra* note 116, at 579–90; *see also* S.D. Codified Laws § 55–1B–1(2) (defining "trust protector") (Michie 2001); Unif. Trust Code § 808(c) & cmt., 7C U.L.A. 207 (Supp. 2003) (discussing trust protectors); Donovan W. M. Waters, *The Protector: New Wine in Old Bottles?*, *in* Trends in Contemporary Trust Law 63, 66, 104–05 (A. J. Oakley ed., 1996) (discussing the increased use of trust protectors). A related phenomenon is the so-called "letter of wishes," on which see Antony G.D. Duckworth, *The Trust Offshore*, 32 Vand. J. Transnat'l L. 879, 910 (1999); David Hayton, *The Irreducible Core Content of Trusteeship*, *in* Trends in Contemporary Trust Law 47, 52–53 & n.35 (A.J. Oakley ed., 1996); *see also* James Wadham, Willoughby's Misplaced Trust 141–54 (2d ed. 2002) (discussing protectors and letters of wishes). R

250 *See, e.g.*, S.D. Codified Laws § 55–1B–6 (Michie 2001) (listing potential trust protector powers); Dam, *supra* note 249, at 23 (same); Hayton, *supra* note 116, at 583–84 (same); *see also* Halbach, *supra* note 8, at 1916–17 (considering how American trust law will receive trust protectors). *See generally* Antony Duckworth, *Protectors—Fish or Fowl? Part I*, 4 J. Int'l Tr. & Corp. Plan. 131 (1995) (discussing the various powers that protectors may exercise); Antony Duckworth, *Protectors—Fish or Fowl? Part II,* 5 J. Int'l Tr. & Corp. Plan. 18 (1996) (discussing the administrative powers of trust protectors); Paul Matthews, *Protectors: Two Cases, Twenty Questions*, 9 Tolly's Tr. L. Int'l 108 (1995) (suggesting that the role of trust protectors be considered from a power-based perspective). R R

251 Not surprisingly, offshore jurisdictions typically require the appointment of a local trustee, and doing so is critical to avoiding the jurisdiction of mainland courts. *See* Sterk, *supra* note 11, at 1089–1104; FTC v. Affordable Media, LLC, 179 F.3d 1228 (9th Cir. 1999).

252 On this question, which is beyond the scope of this Article, see, for example, Restatement (Third) of Trusts § 64 rep. note cmts. b–d (2003); Waters, *supra* note 249. R

253 *See* Waters, *supra* note 249, at 63. R

duce agency costs. Unlike settlor standing, however, it does not trigger undesirable tax consequences and it continues to function even after the settlor's death.

True, an appointment of a trust protector opens the door to new sources of agency costs—the settlor-protector and the beneficiaries-protector relationships. But the net reduction in agency costs is likely to outweigh these costs. By giving the protector the authority 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 protector even if this friend otherwise lacks the administrative or portfolio management skills necessary to be a good trustee or co-trustee.[254] Moreover, by giving the protector the power to select her successor, the office of the protector will continue to be occupied by persons connected to the settlor (albeit those connections become more attenuated over time). This is especially important in light of the erosion of the Rule Against Perpetuities and the emergence of so-called perpetual trusts.[255]

The broader point is that the emergence of trust protectors is a response to the settlor's uncertainty about the future. Like powers of appointment,[256] a trust protector can be used to build flexibility into a trust.

C. Internal Governance and External Transactional Authority

By including creditors within its scope, the agency costs model of the trust as an organizational form highlights the interrelationship between internal governance and the scope of the authority of insiders to transact with outsiders. The agency cost considerations relevant to the substantive content of the rules of internal trust governance are a function of the scope of the authority of the principal parties to transact with outsiders. Similarly, the extent to which the trust insiders might safely be granted authority to transact over trust assets with outsiders is a function of the effectiveness of the internal governance structure.[257] Thus the agency costs approach to the trust advanced in this Article should not be understood as embracing the sort of con-

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[254] The evolution of the protector might thus be understood as falling within the framework of Langbein's predicted "fractionation of trusteeship." *See* Langbein, *The Uniform Prudent Investor Act*, *supra* note 91, at 665–66. **R**

[255] *See* sources cited *supra* notes 11, 188. **R**

[256] *See* George Gleason Bogert & George Taylor Bogert, The Law of Trusts and Trustees § 299 (2d rev. ed. 1992); Dukeminier & Krier, *supra* note 11, at 1331–33. **R**

[257] 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), one should not study the rules of the external relations of the principal parties with respect to trust property without reference to the rules of internal trust governance (and vice versa).

tractarian nihilism that leads to the conclusion that organizations have no boundaries.[258] On the contrary, the approach recognizes that the existence of boundaries and asset partitioning (i.e., the de facto separate legal entity of the trust or its equivalent—the trustee as trustee) are crucial features of trust law.[259]

This section advances the claim that the rules of internal governance are necessarily intertwined with the rules of external relations. Any change in one set of rules will have a ripple effect on the terms to which the relevant parties would have agreed concerning the other. Accordingly, agency cost analysis of trust law speaks not only to matters of internal governance and external relations, but it also brings into view the interrelationship between the two.

1. *Equitable Tracing*

Perhaps the best example of the interrelationship between internal governance and external transactional authority is the principle of equitable tracing. Under standard doctrine, beneficiaries may assert an equitable lien on property transferred by the trustee to a third-party in breach of trust, provided that the transferee is not a bona fide purchaser for value without notice.[260] Recourse for a broken contract, however, does not normally include a suit against the outsider who benefited by the breach.[261] Hence there is tension between this doctrine and the notion of the trust as a third-party beneficiary contract. Langbein's response, in addition to concluding that the trust is a hybrid of contract and property,[262] is to characterize the rule as embodying "a judgment about how far to impinge on outsiders to the trust deal between settlor and trustee in order to vindicate that deal."[263]

In contrast, there is no tension between this doctrine and the agency costs model of the trust as an organizational form. By including those who deal with the trustee in the relevant set or nexus of

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258 *See, e.g.*, Jensen & Meckling, *supra* note 1, at 311 (contending that "it makes little or no sense to try to distinguish those things which are 'inside' the firm (or any other organization) from those things that are 'outside' of it"). **R**

259 *See* Hansmann & Mattei, *supra* note 6, at 438. **R**

260 *See, e.g.*, Kline v. Orebaugh, 519 P.2d 691, 696 (Kan. 1974) (discussing the rule of equitable tracing); *see* RESTATEMENT (SECOND) OF TRUSTS §§ 283–295 (1959). *See generally* 4 SCOTT ON TRUSTS, *supra* note 5, §§ 283–95 (discussing liabilities of third parties). **R**

261 The qualification is for fraudulent conveyances, *see* UNIF. FRAUDULENT CONVEYANCE ACT, 7A U.L.A. 6 (1999); UNIF. FRAUDULENT TRANSFER ACT, 7A U.L.A. 274 (1999), and for tortious interference with a contract, *see* Speakers of Sport, Inc. v. Proserv, Inc., 178 F.3d 862, 865–66 (7th Cir. 1999); Fred S. McChesney, *Tortious Interference with Contract Versus "Efficient" Breach: Theory and Empirical Evidence*, 28 J. LEG. STUD. 131, 164–66 (1999).

262 *See supra* note 44 and accompanying text. **R**

263 Langbein, *supra* note 8, at 647–48; *see also* Hansmann & Kraakman, *supra* note 31, at 378–79 (discussing contract and property rights as imposing distinct sets of liabilities on outsiders). **R**

relationships, the rule of equitable tracing appears to reflect the parties' presumed intent in light of the comparative advantage of the outsider to bear the agency costs associated with this particular potential breach by the trustee. Thus, even though Hansmann and Mattei regard the default rules of internal trust governance as "relatively unimportant" when compared with the rules that control the relations of the principal parties with outsiders,[264] 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 transferee is almost by definition a lower-cost monitor of the [trustee's] breach of duty than is the [beneficiary]."[265] In the absence of a contrary agreement, efficiency militates toward allocating this risk to the outsider rather than increasing the burden on the trust's internal governance devices.[266]

This analysis not only provides a functional explanation for equitable tracing as a positive matter, but it also brings into view pertinent normative considerations for trust law reform. Recognition of the interrelationship between internal governance and the scope of external transactional authority reveals that the price for relaxing one is an increase in the problems associated with the other. Recognition of this tradeoff offers a means of ascertaining the costs and benefits of law reform on the margins of this issue.

Recent efforts to liberalize the rules that govern the dealings with third parties of the trustee as trustee provide a concrete example.[267] The foregoing analysis suggests that the price for enlarging the trustee's transactional authority will be an increase in potential agency costs and so a greater burden on the trust's internal governance devices. Thus, when David English, the Reporter for the *Uniform Trust Code*, wrote that "beneficiaries are helped more by the free flow of commerce than they were by the largely ineffective protective features of former law,"[268] he was in effect arguing that increasing the value of property held in trust by expanding the trustee's transactional opportunities (the benefit of this reform) outweighs the minimal increase in

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264 Hansmann & Mattei, *supra* note 6, at 438; *see supra* note 47 and accompanying text. **R**

265 Hansmann & Mattei, *supra* note 6, at 464. **R**

266 *Cf.* Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEG. STUD. 83, 94–95 (1977) (analyzing the relative abilities of various parties to foresee, bear, and insure against risk).

267 UNIF. TRUST CODE §§ 1010–13, 7C U.L.A. 227–31 (Supp. 2003). These provisions, which are based on similar provisions in the 1969 *Uniform Probate Code* and the *Uniform Trustee Powers Act*, are the culmination of a decades-long process of statutory reform. *See* English, *supra* note 204, at 144–49 (outlining the history of the Code and its relation to other uniform acts). **R**

268 *See* English, *supra* note 204, at 209. **R**

the burden on the trust's governance regime (the cost of this reform).[269]

2. *The Spendthrift Trust*

The spendthrift trust provides another example of the importance of the interrelationship between internal governance and the scope of the principal parties' external transactional authority. Spendthrift trusts, in comparison to ordinary trusts, shield the trust's assets from the beneficiaries' creditors.[270] This is true even if the trust instrument requires mandatory payouts, as such payments could be made directly to the beneficiaries' service providers.[271] Not surprisingly, there is a substantial body of literature on the soundness of the policy behind the spendthrift trust.[272] There is also considerable divergence among the common law nations on the enforcement of spendthrift provisions. The majority of common law countries, most prominently England,[273] do not enforce them. In contrast, spendthrift provisions are valid throughout the United States,[274] are included in customary American estate planning boilerplate,[275] and by statute the spendthrift trust is even the default trust form in New York.[276]

The existing normative commentary on the spendthrift trust tends to present a tradeoff between paternalistic protection of feckless

[269] *See id.* at 208–11. This is consistent with the move away from controlling trustees through limited powers and toward the fiduciary obligation as the trust's chief governance device. *See* Langbein, *supra* note 8, at 640–43; text accompanying *supra* notes 57–59. R

[270] *See* RESTATEMENT (THIRD) OF TRUSTS § 58 (2003); RESTATEMENT (SECOND) OF TRUSTS §§ 152–53 (1959); UNIF. TRUST CODE § 502, 7C U.L.A. 175 (Supp. 2003). State law restrictions on transfer are applicable in bankruptcy. *See* 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 (2003); UNIF. TRUST CODE § 503, 7C U.L.A. 176 (Supp. 2003); 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, 699–720 (1994).

[271] *Cf.* DUKEMINIER & JOHANSON, *supra* note 28, at 647 (noting circumstances under which the trustee might pay third parties directly "for the support of the beneficiary"). R

[272] *See, e.g.*, JOHN CHIPMAN GRAY, RESTRAINTS ON THE ALIENATION OF PROPERTY (1883); ERWIN N. GRISWOLD, SPENDTHRIFT TRUSTS: RESTRAINTS ON THE ALIENATION OF EQUITABLE INTERESTS IMPOSED BY THE TERMS OF THE TRUST OR BY STATUTE (1936); Robert T. Danforth, *Rethinking the Law of Creditors' Rights in Trusts*, 53 HASTINGS L.J. 287, 291–306 (2002); Anne S. Emanuel, *Spendthrift Trusts: It's Time to Codify the Compromise*, 72 NEB. L. REV. 179 (1993); Fellows, *supra* note 86; Adam J. Hirsch, *Spendthrift Trusts and Public Policy: Economic and Cognitive Perspectives,* 73 WASH. U. L.Q. 1 (1995); Alan Newman, *The Rights of Creditors of Beneficiaries Under the Uniform Trust Code: An Examination of the Compromise*, 69 TENN. L. REV. 771, 782–803 (2002). R

[273] The classic English case is *Brandon v. Robinson*, 34 Eng. Rep. 379 (Ch. 1811). For further discussion and references, see MOFFAT ET AL., *supra* note 20, at 211–24. R

[274] *See* DUKEMINIER & JOHANSON, *supra* note 28, at 632. R

[275] *See* Hirsch, *supra* note 272, at 3 & n.7.

[276] N.Y. EST. POWERS & TRUSTS LAW § 7-1.5 (McKinney 2002).

beneficiaries on the one hand and the protection of voluntary and, more clearly, involuntary creditors on the other.[277] The usual focus, in other words, is on the soundness of limiting the scope of the beneficiaries' external transactional authority in view of how this limitation impacts both the beneficiaries and the outsiders with whom the beneficiaries might transact. This approach, however, overlooks the interrelationship between the ability of the trust insiders to transact with third parties and the details of the trust's internal governance regime.

One governance benefit of enforcing spendthrift provisions is that payouts 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 a potential check on agency costs—the theoretical possibility of the residual claimants' exit—is foreclosed as a matter of law. Although exit is, in theory, a powerful governance device, in practice its potential has not been realized in the context of donative trusts because there is no well-developed market for trust residual interests.[278] Such a market, however, would provide price signals about the quality of the particular trust's management. Unlike the initial gratuitous transfer by the settlor, a subsequent sale by the beneficiary of her interest would indeed involve reckoning a price.[279]

Moreover, alienable 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, then a spendthrift provision results in a $5 residual loss. This is the agency costs price of honoring the settlor's dead-hand interest in disabling the beneficiary from alienating her interest.[280]

In the absence of spendthrift recognition, settlors who wish to guard the trust's assets against an insolvent beneficiary's creditors

277 *See, e.g.*, POSNER, *supra* note 113, § 18.7, at 523–24; Emanuel, *supra* note 272, at 186–94; Hirsch, *supra* note 272, at 44–56; Ogus, *supra* note 3, at 217–18. R

278 Perhaps this is a consequence of the frequency of spendthrift, discretionary, and protective provisions. Indeed, the availability of the latter two also helps to explain the narrowness of the corresponding English market notwithstanding the unenforceability of spendthrift clauses in England. *See supra* note 273 and accompanying text; *infra* notes 281–82 and accompanying text. R

279 *See* Easterbrook & Fischel, *supra* note 81, at 274–77; Fama, *supra* note 1, at 292; Fama & Jensen, *Separation*, *supra* note 1, at 312–15; *cf.* Robert D. Hershey Jr., *Birthrights Up for Auction as Investments in London*, N.Y. TIMES, Mar. 6, 1978, at D1 (reporting on the English auction market in reversionary interests); *see supra* notes 118–23 and accompanying text. R

280 The settlor, in other words, must have figured that the beneficiary would alienate her interest for less than $10 if given the chance to do so. As Richard Posner has aptly remarked, such "[t]rusts are based on mistrust." POSNER, *supra* note 113, § 18.7, at 524. R

would be channeled, as they are in England,[281] toward discretionary trusts.[282] Discretionary trusts are common in American practice too, but American settlors who are concerned about a beneficiary's future insolvency also have the spendthrift alternative. At any rate, because discretionary trusts leave the payment decision to the discretion of the trustee, neither the beneficiary nor her creditors have a right to a payout.[283] The cost of this alternative disabling restraint is that the internal governance regime, primarily the fiduciary obligation, is further burdened with the task of regulating the trustees' exercise of this discretion over disbursements.[284] Since the remedy for an underpayment is merely an order that the payments out of the trust be increased,[285] but the remedy for an overpayment is to surcharge the trustee personally for the excess amounts disbursed,[286] trustees are skewed toward caution.[287] Moreover, as there is no guarantee of future payment, it is difficult for beneficiaries to sell their interests. Thus discretionary trusts, like spendthrifts, do not allow for exit.

These differing routes to giving effect to the settlor's interest in limiting the right of a beneficiary to alienate her interest in the trust—a mandatory trust with a spendthrift limitation versus a discretionary

281 *See* Hansmann & Mattei, *supra* note 6, at 452 n.57; Halbach, *supra* note 8, at 1893–96.

282 *See, e.g.*, Restatement (Second) of Trusts § 155 (1959); Unif. Trust Code § 504, 7C U.L.A. 177 (Supp. 2003); Evelyn Ginsberg Abravanel, *Discretionary Support Trusts*, 68 Iowa L. Rev. 273, 277–80 (1983); Newman, *supra* note 272, at 803–17. Yet another alternative, also common in England, is a trust with a "protective provision"—a clause that conditions the beneficiary's interest on her solvency or the nonoccurrence of any event that, but for the protective provision, would have allowed a third party to reach the beneficiary's interest. *See* Trustee Act 1925 § 33 (Eng.); Restatement (Third) of Trusts § 57 (2003); Bogert, *supra* note 239, § 44; Todd & Wilson, *supra* note 20, § 2.6, at 74–75; Hayton, *supra* note 116, at 590–92; Ogus, *supra* note 3, at 205; *see also* Emanuel, *supra* note 272, at 185–88 (discussing protective clauses and discretionary trusts).

283 *See, e.g.*, Goforth v. Gee, 975 S.W.2d 448, 450 (Ky. 1998); United States v. O'Shaughnessy, 517 N.W.2d 574, 577 (Minn. 1994); Hamilton v. Drogo, 150 N.E. 496, 497 (N.Y. 1926); Restatement (Second) of Trusts § 155 & cmt. b (1959); Unif. Trust Code § 504(b), 7 U.L.A. 177 (Supp. 2003); 2A Scott on Trusts, *supra* note 5, § 155.1, at 159–64; *see also* Restatement (Third) of Trusts § 60 cmt. e (2003) (explaining when creditors can compel distribution).

284 *See, e.g.*, Restatement (Third) of Trusts § 50 (2003); Edward C. Halbach, Jr., *Problems of Discretion in Discretionary Trusts*, 61 Colum. L. Rev. 1425, 1426–27 (1961).

285 *See* Kolodney v. Kolodney, 503 A.2d 625, 628 (Conn. App. Ct. 1986); *In re* Estate of Lindgren, 885 P.2d 1280, 1283 (Mont. 1994); William M. McGovern, Jr. & Sheldon F. Kurtz, Wills, Trusts, and Estates § 9.5, at 339–40 (2001); Halbach, *supra* note 284, at 1427.

286 *See* Feibelman v. Worthen Nat'l Bank, 20 F.3d 835, 836–37 (8th Cir. 1994); *In re* Murray, 45 A.2d 636, 639 (Me. 1946); Austin v. U.S. Bank of Wash., 869 P.2d 404, 415 (Wash. App. 1994); McGovern & Kurtz, *supra* note 285, § 9.5, at 339–40; Halbach, *supra* note 284, at 1427.

287 A further (albeit illegitimate) reason for trustee conservatism is that fees are often a percentage of the trust corpus, though this schedule based approach is now giving way to a reasonableness standard. *See supra* note 172.

trust—present different agency costs consequences. It is not obvious that disapproval of the spendthrift trust either decreases agency costs or improves the position of the beneficiaries' creditors (though creditors of discretionary trust beneficiaries have leverage that creditors of spendthrift trust beneficiaries lack). Perhaps the divergence of opinion among the common law jurisdictions in part reflects the difficulty in reckoning the magnitudes of the foregoing effects.

Even if it does not help resolve the policy question of which form of protective measure is preferable, agency cost analysis does help explain the continued existence of one or more of these protective mechanisms in all 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 toward informal arrangements, such as outright transfers to trusted kin or friends with a wink and a nod that the transferee will take care of the would-be beneficiary.[288] The potential agency costs to the beneficiaries and to the settlor of this approach, which would hardly benefit the beneficiaries' creditors, are manifest.[289]

D. Fiduciary Litigation

The possibility of market-based governance devices for the donative trust is limited by the impediments—central to its often paternalistic function—to the beneficiaries' ability to alienate their stake in the trust and to their ability to replace the trustee. In today's trusts, in which the limits of yore on the trustee's powers have yielded to broad grants of discretion, this places much of the governance burden on the fiduciary obligation.[290] It is here that the agency costs approach to the trust most closely converges with Langbein's contractarianism: both point strongly toward a contractarian, hypothetical-bargain underpinning for the fiduciary obligation.[291] Indeed, drawing on earlier

288 *See* Hirsch, *supra* note 272, at 70–71. **R**

289 *See id.* at 71 & n.264.

290 *See* Langbein, *supra* note 8, at 640–43 (discussing the decline of powers law and the rise of fiduciary law for protecting the interests of the beneficiaries). **R**

291 There is no shortage of commentary on fiduciary duties generally. *See, e.g.*, Alexander, *supra* note 24; William W. Bratton, *Game Theory and the Restoration of Honor to Corporate Law's Duty of Loyalty*, *in* PROGRESSIVE CORPORATE LAW 139 (Lawrence E. Mitchell ed., 1995); Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians,* 65 WASH. L. REV. 1 (1990); Brian R. Cheffins, *Law, Economics and Morality: Contracting Out of Corporate Law Fiduciary Duties*, 19 CANADIAN BUS. L.J. 28 (1991); Robert C. Clark, *Agency Costs Versus Fiduciary Duties, in* PRINCIPALS AND AGENTS, supra note 67, at 55; Cooter & Freedman, *supra* note 69; Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879; Easterbrook & Fischel, *supra* note 173; Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209 (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. 299 (1993); Larry E. Ribstein, The Structure of the Fiduciary Relationship (Oct. 11, 2003) (unpublished manuscript, on file with the Cornell Law Review); L.S. Sealy, **R** **R** **R** **R** **R**

economic analyses of the fiduciary relationship more generally,[292] Langbein persuasively shows that notwithstanding "pulpit-thumping rhetoric about the sanctity of fiduciary obligations,"[293] the fiduciary duties imposed by the law of trusts are simply majoritarian default rules.[294]

Thus, this section will neither engage the debate over the contractarian basis for trust fiduciary law nor explore the congruence between the structure of the trust law fiduciary obligation and the agency problems embedded in the private trust (though I have offered some discussion of this earlier in this Article and elsewhere).[295] 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 primary check on managerial agency costs.[296] 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.[297]

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*, 25 U. TORONTO L.J. 1 (1975).

292 *See* Langbein, *supra* note 8, at 655–60 (citing Easterbrook & Fischel, *supra* note 173 and Cooter & Freedman, *supra* note 69); *see also* Fischel & Langbein, *supra* note 152, at 1113–17 (describing trust law fiduciary duties from an economic perspective). Alexander noted this point. *See* Alexander, *supra* note 24, at 767–68. R R R

293 Langbein, *supra* note 8, at 629. This is not to say that moral condemnation does not have utility as an expressive sanction, especially for institutional fiduciaries for which reputation is a valuable asset. *See* Cooter & Freedman, *supra* note 69, at 1073–74; *see also* Langbein, *supra* note 8, at 658 (noting that, "[e]ven though fiduciary duties are contractually assumed, they embody deep moral precepts about the behavior appropriate for a trustee or other fiduciary"); *cf.* Dan M. Kahan, *What do Alternative Sanctions Mean?*, 63 U. CHI. L. REV. 591 (1996) (discussing the "expressive dimension of punishment"). R R R

294 "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 8, at 658. R

295 *See supra* Part IV.A.1 (discussing the duty of impartiality); *supra* Part IV.A.3 (discussing the duty of care); *see also* Sitkoff, *supra* note 15, at 572–74, 579–80 (discussing the duties of loyalty and disclosure). For further discussion of fiduciary duties informed by agency theory, see W. Bishop & D.D. Prentice, *Some Legal and Economic Aspects of Fiduciary Remuneration*, 46 MOD. L. REV. 289 (1983); Cooter & Freedman, *supra* note 69, at 1047; Easterbrook & Fischel, *supra* note 173, at 426–27; Fischel & Langbein, *supra* note 152, at 1113–17. R R R

296 For a behavioral decision theory approach to this question, see Alexander, *supra* note 24. R

297 *See* BAINBRIDGE, *supra* note 1, § 8.3, at 365–68; John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, LAW & CONTEMP. PROBS., Summer 1985, at 5, 12; 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, 264–65 (1981); Fischel & Bradley, *supra* note 82, 262–63; Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733, 1735–37 (1994); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J. L. ECON. & ORG. 55, 84 (1991); *see also* Sitkoff, *supra* note 15, at 570–82 (comparing the governance of public corporations with that of donative trusts). R R R

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 support. The greater the number, the more serious the collective action dynamic that will weaken any individual's incentive to monitor and, if cost justified, to litigate.[298] Consider, for example, that the paradigmatic shareholder in a publicly-traded corporation has only a trivial stake in the company. So the typical shareholder 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.[299]

Litigation incentives are likely to be different in the world of donative trusts, however, thanks to the typically smaller number of residual claimants.[300] Donative trust beneficiaries are likely to have a nontrivial stake when measured either by the fraction of their wealth held in the trust or the fractional share of the trust to which each is entitled. Accordingly, fiduciary litigation in trust law is more likely to be prompted by the merits than in corporate law. The relatively smaller number of residual claimants and their relatively larger stakes lessens the impact of the collective action and free-rider dynamics.

Of course, trust beneficiaries do not have perfect litigation incentives. Some beneficiaries lack a sufficient stake to reckon the costs and benefits of bringing suit.[301] Moreover, awards of attorneys' fees (out of the trust corpus) to one or both sides in suits over trust administration are not uncommon.[302] Even though courts can use this as a tool to encourage meritorious litigation, reimbursement of attorneys fees out of the trust might nevertheless encourage strike suits or discourage meritorious claims; the beneficiaries often wind up paying

298 *See* Gordon, *supra* note 12, at 76–79. R

299 *See* ALLEN & KRAAKMAN, *supra* note 10, § 10.2, at 351, 355–57; BAINBRIDGE, *supra* note 1, § 8.3, at 367; EASTERBROOK & FISCHEL, *supra* note 1, at 100–02. *See generally* John C. Coffee, Jr., *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) (noting that plaintiff's attorneys are often risk-taking entrepreneurs); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991) (proposing reforms to reduce the agency costs that necessarily result where the attorney, not the client, controls litigation). R R R

300 *See* Macey, *supra* note 3, at 319; *see also* Hirsch & Wang, *supra* note 3, at 29 n.110 ("Agency costs are probably lower in a trust than in a corporation (or a government), because its principals are fewer and so have an incentive to monitor."). R

301 *See* Gordon, *supra* note 12, at 76–79. R

302 *See, e.g.*, Allard v. Pac. Nat'l Bank, 663 P.2d 104, 111–12 (Wash. 1983); UNIF. TRUST CODE § 1004, 7C U.L.A. 224 (Supp. 2003) (noting that a court may award fees); 3 SCOTT ON TRUSTS, *supra* note 5, § 188.4, at 62–69 (discussing trustees' authority to pay fees out of the trust corpus); Gordon, *supra* note 12, at 76–77 n.103 (analyzing when beneficiaries can recover litigation costs). R R

the litigation costs for both sides.[303] 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 to relying on liability rules to police trustees is 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 did not trust the beneficiaries enough to make an outright transfer, favoring instead a trust despite its inherent agency costs. Nevertheless, trust fiduciary law, especially the duty of loyalty, is stricter and more prophylactic than the fiduciary law of other organizational forms.[304] Thus, as Fischel and Langbein have suggested, many of these duties can be understood as "substitutes for monitoring by the directly interested parties."[305] Moreover, the modern trend is toward further expansion of the duty to furnish beneficiaries with relevant information regarding the management of the trust.[306]

This analysis throws light on the relevance of the number of residual claimants to the choice of organizational form.[307] The agency costs-checking mechanisms of the private trust depend on the existence of relatively few residual claimants. The corporation, in contrast, is constructed so that it can—but need not, as shown by the success of the close corporation—handle many residual claimants. Unlike the typical close corporation, the trust separates risk bearing and management; and unlike the public corporation, the trust's residual claim is typically split among a small number of claimants.[308]

303 *See generally* ALLEN & KRAAKMAN, *supra* note 10, § 10.2, at 351 (noting the role of attorneys' fees in prompting litigation); POSNER, *supra* note 113, § 21.11 (discussing the economics of the contingent fee system). R R

304 Consider, for example, the no-further-inquiry rule. For references, see *infra* note 319. *See also* discussion *supra* Part IV.A.3 (comparing the duty of care in trust law and corporate law). R

305 Fischel & Langbein, *supra* note 152, at 1114. 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/ (last visited Nov. 21, 2003); *see also* Lewis Beale, *An Heir-Raising Enterprise*, L.A. TIMES, Nov. 18, 1992, at E1 (discussing Heirs, Inc. and its founder, Standish Smith). R

306 *See* UNIF. TRUST CODE § 813, 7C U.L.A. 210 (Supp. 2003); Halbach, *supra* note 8, at 1914–15; *see, e.g.*, Allard v. Pac. Nat'l Bank, 663 P.2d 104, 110–11 (Wash. 1983); Langbein, *supra* note 59, at 74 (noting the "trend of the American case law to enhance the disclosure obligations of trustees regarding major transactions"); Langbein, *supra* note 98. For further discussion of disclosure in trust law, see Sitkoff, *supra* note 15, at 579–80. R R R

307 *See generally* Fama & Jensen, *Residual Claims*, *supra* note 1, at 328 (arguing that the "characteristics of residual claims distinguish" organizational forms). R

308 In a loose sense, then, the trust is closer to the Alchian and Demsetz conception of the firm, which imagines the residual claimant as the chief monitor, *see* Alchian & Demsetz, *supra* note 1, at 782, than it is to the later agency cost models of the public corporation, *see, e.g.*, Fama, *supra* note 1, at 289. But the trust is not as close to Alchian and Demsetz's R R

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 the frequency with which statutory business trusts provide voting rights, transferable or at least redeemable interests, and less rigorous processes for removing trustees.[309] These characteristics make the statutory business trust look more like a public corporation than a donative trust. Similarly, the governance of numerous commercial manifestations of the common law 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 governance of the donative trust.[310] It will therefore be interesting to see whether the ongoing relaxation of the Rule Against Perpetuities, and the consequent increase in the number of beneficiaries in donative trusts, will eventually move trust law toward more of a corporate governance model.[311]

It also seems likely that this agency costs analysis could be applied to employee benefit and pension trusts, upon which ERISA imposes a mandatory trust law paradigm.[312] 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 more closely resemble that of public corporations than that of the traditional gratuitous private trust. If so, this may explain some of the tension between the trust law paradigm and the realities of pension and employee benefit trusts in practice.[313]

model as the close corporation, for which the managers tend also to be the chief residual claimants. *See* Easterbrook & Fischel, *supra* note 85, at 273. **R**

309 *See* Wendell Fenton & Eric A. Mazie, *Delaware Business Trusts*, *in* 2 DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS ch. 19 (R. Franklin Balotti & Jesse A. Finkelstein eds., 3d ed. Supp. 2004); Tamar Frankel, *The Delaware Business Trust Act Failure as the New Corporate Law,* 23 CARDOZO L. REV. 325, 325–332 (2001); Schwarcz, *supra* note 13, at 562–63, 568–69. **R**

310 *See* Schwarcz, *supra* note 13, at 562–63, 568–69, 579; Sheldon A. Jones et al., *The Massachusetts Business Trust and Registered Investment Companies,* 13 DEL. J. CORP. L. 421, 430 (1988); *see also* Hecht v. Malley, 265 U.S. 144, 146–47 (1924) (describing the business trust as having an ownership form similar to the corporation); Nathan Issacs, *Trusteeship in Modern Business,* 42 HARV. L. REV. 1048 (1929) (discussing the popularity of the use of the trust form for business affairs); Langbein, *supra* note 14, at 179–85 (discussing trust attributes that invite commercial use of the trust form); Andrew Kopans, The Business Trust in the Mutual Fund Industry: Old Arguments in a New Industry with Two New Players 2–6 (May 1, 2002) (unpublished manuscript, on file with the Cornell Law Review). **R** **R**

311 *See generally* Dukeminier & Krier, *supra* note 11, at 1339 (noting the potential for "multiplication of beneficiaries" in perpetual trusts). **R**

312 Employee Retirement Income Security Act of 1974 § 403, 29 U.S.C. § 1103 (2000); LANGBEIN & WOLK, *supra* note 152, at 646–48. **R**

313 *See* Fischel & Langbein, *supra* note 152, 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 SUP. CT. REV. 20, 208–209 (criticizing recent Supreme Court ERISA decisions); **R**

The relevance of the number of residual claimants to the agency costs calculus is further supported by the widely-held view that the absence of identifiable beneficiaries causes serious problems for charitable trust governance.[314]

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 open ended nature.[315] But the donative trust differs importantly from the close corporation in that there is less variance in operating context from one trust to another. This relative homogeneity of context has allowed courts to develop a detailed scheme of fiduciary sub-rules that serve as specific agency cost-checking devices. In contrast, the law of close corporations depends instead on the parties' tailoring an arrangement to their particular circumstances.[316] Trust law's fiduciary sub-rules 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.[317]

The function of these sub-rules is to provide the benefits of *rules* (as compared to *standards*) without inviting strategic behavior by trustees.[318] When aggrieved beneficiaries can squeeze their claim into a specific sub-rule—and for these purposes, the ban on self-dealing known as the no-further-inquiry rule can be included within the analysis[319]—their case is simplified. As in the application of any rule, the costs of decision are lower than they are for a standard. When the aggrieved beneficiaries cannot fit their claim into a specific sub-rule, however, then the broad standards of care and loyalty serve as a backstop by allowing for a contextual, facts-and-circumstances judicial inquiry into the trustees' behavior. In such a case, courts serve a gap-

John H. Langbein, *What ERISA Means by "Equitable": The Supreme Court's Trail of Error in* Russell, Mertens, *and* Great-West, 103 COLUM. L. REV. 1317 (2003) (same).

314 *See* sources cited *supra* notes 188 & 248; *see also* Macey, *supra* note 3, at 315, 319. R

315 Easterbrook & Fischel, *supra* note 85, at 291. R

316 *See id.* at 281–86.

317 *See, e.g.*, RESTATEMENT (SECOND) OF TRUSTS §§ 172–185 (1959); UNIF. TRUST CODE §§ 801–13, 7C U.L.A. 200–10 (Supp. 2003).

318 *See, e.g.*, Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 258–59 (1974); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 586–88 (1992); *see also* MindGames, Inc. v. W. Publ'g Co., 218 F.3d 652, 657–58 (7th Cir. 2000) (comparing rules and standards); Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577 (1988) (noting that the law shifts back and forth between hard-edged rules, "crystals," and softer standards, "mud").

319 *See, e.g.*, Hartman v. Hartle, 122 A. 615, 615 (N.J. Ch. 1923); 2A SCOTT ON TRUSTS, *supra* note 5, § 170.2, at 320. For commentary, see Cooter & Freedman, *supra* note 69, at 1054–55; Easterbrook & Fischel, *supra* note 173, at 437; Sitkoff, *supra* note 15, at 572–74. R R

filling role owing to "the impossibility of writing contracts completely specifying the parties' obligations."[320]

Recall that in the modern managerial trust, the fiduciary obligation has eclipsed limited powers as the chief device for controlling managerial agency costs.[321] The effectiveness of the trust law fiduciary obligation as a check on agency costs is enhanced by use of a mix of sub-rules, which are made possible by the relative homogeneity of managerial context for donative trusts,[322] and overarching standards.[323]

Conclusion

This Article's agency costs approach to the donative private trust not only helps to advance the ongoing debate over whether trust law is closer to property law or contract law, but also, and more importantly, it provides a rich positive and normative framework for further economic analysis of trust law. Principal-agent economics 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 Article demonstrates how and why 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 that arises when risk-bearing and management are separated (whether the trustee-manager will act in the best interests of the beneficiaries-residual claimants).

The agency costs approach offers fresh insights into recurring problems in trust law including, among others, 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 Article's normative claim is that the law should minimize the agency costs inherent in 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

320 Easterbrook & Fischel, *supra* note 173, at 426. R

321 *See supra* note 59 and accompanying text.

322 On the relevance of ex ante programmability to agency costs analysis, see Eisenhardt, *supra* note 67, at 62. R

323 A similar sub-rule phenomenon exists within the law of agency. *See* Restatement (Second) of Agency §§ 380–86, 388–98 (1958). The detailed rules of legal ethics, *see, e.g.*, Model Rules of Prof'l Conduct R. 1.1–1.18 (2003); Model Code of Prof'l Responsibility DRs 5-101–5-107 (1988), might also be understood as a manifestation of this sub-rule phenomenon. Each of the rules cited here reflects the sort of generic agency cost pattern that is likely to recur in legal agency relationships on the one hand or attorney-client relationships on the other.

to the settlor over the beneficiaries as the trustee's primary principal. The positive claim is that, at least with respect to traditional doctrines, the law conforms to the suggested normative approach.