An Agency Costs Theory of Trust Law

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March 2004

An Agency Costs Theory of Trust Law

Robert Sitkoff

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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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INTRODUCTION

Agency cost theories of the firm dominate the modern literature of corporate law and economics. Meanwhile, the private express trust, an entity from which the corporation traces its roots, has been left largely untouched by agency cost analysis. Yet, in an echo of Adolph Berle and Gardiner Means's famous critique of the corporation's "separation of ownership and control," the central feature of the private trust is that it "separate[s] the benefits of ownership from the burdens of ownership." 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. 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-


ysis should be amenable to extension in future work to commercial and charitable trusts. 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. 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, 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. The positive claim is that, at least with respect to tradi-

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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.


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,
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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), 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? 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, 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.

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. 1503 (2003); Sterk, supra note 3; Angela M. Vailario, 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).

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. 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.

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. L. Rev. 559, 562 (2003).

See Schwarcz, supra note 13, at 560, 573–84 (comparing commercial trusts with 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 & Matetz, supra note 6, at 472–78 (comparing the trust form and the corporate 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, 15 DUK. 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.
who are the relevant parties? What is the role of markets—including labor, product, and capital\textsuperscript{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?\textsuperscript{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.\textsuperscript{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-


\textsuperscript{16} See Dukeminier & Krier, \textit{supra} note 11; Sterk, \textit{supra} note 11, at 1037–38; Sterk, \textit{supra} note 3, at 2098; Sitkoff & Corsico, \textit{supra} note 11.

\textsuperscript{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, \textit{supra} note 8; Hansmann & Mattei, \textit{supra} note 6; cf. Henry Hansmann & Reinier Kraakman, \textit{The Essential Role of Organisational Law}, 110 YALE L.J. 387, 416 (2000) (describing trust law as a form of organizational law); Thomas W. Merrill & Henry E. Smith, \textit{The Property/Contract Interface}, 101 COLUM. L. REV. 773, 843–49 (2001) (same); Ogus, \textit{supra} note 3, at 188 (discussing agency costs in private trusts). Its more general inspiration is the nexus of contracts models of the firm. \textit{See} sources cited \textit{supra} note 1; \textit{see also} discussion \textit{infra} Part II.
ernance considerations relevant to the initial choice to make use of trust law rather than some other branch of organizational law.\textsuperscript{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).\textsuperscript{19} More recently, in both the United States and abroad, commentators have shown renewed interest in the debate,\textsuperscript{20} and in

\textsuperscript{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.

\textsuperscript{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).

A. Trust Law as Property Law

Trust law is most frequently classified as a species of property law. 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.” 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.” A leading English treatise contends that the law of trusts “is at the heart of the common law of property.” 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.

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. To be sure,

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21 See Langbein, supra note 8; Hansmann & Kraakman, supra note 17; Hansmann & Mattei, supra note 6.
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.
23 Restatement (Second) of Trusts § 197 cmt. b (1959); see Langbein, supra note 8, at 648–49.
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, 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).
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).
the existence of specifically identified property (the trust res) is necessary for trust formation. But continuing to deem trust law a species of property law on that basis, 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.”

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.

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.” 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

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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).

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.”).

30 1 Scott on Trusts, supra note 5, § 1, at 2.

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.

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”).
the agency cost theories of the firm. 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 expository purposes, as a third-party beneficiary contract between the settlor and trustee.

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. 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, 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. 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.

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—one that implicates some-

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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] CORP. L. 819, 822-23 (1999); see also infra Part II.C; sources cited supra note 1.

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”).

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).

36 See discussion infra Part IV.D.

37 See infra note 110 and accompanying text.

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.

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-
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); spendthrift trusts (the more common problem of beneficiary insolvency); equitable tracing principles; and the continuity of the office of the trustee despite turnover in its occupant. 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...
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." Hansmann and Mattei refer in particular to "the use of trust law to shield trust assets from claims of the trustee's personal creditors." Thus Hansmann and Mattei stressed the importance of trust law's "asset partitioning" function. 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) 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." This creation of two distinct legal persons could not feasibly be reproduced with explicit contracting. Asset partitioning therefore represents an important difference between organizational forms and simple contractual ar-

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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.\textsuperscript{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,\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{57} The default rules

\textsuperscript{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).

\textsuperscript{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).

\textsuperscript{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).

\textsuperscript{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.”).

\textsuperscript{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
governing trust investment now require something of a total return investment strategy consistent with modern portfolio theory. 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. 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. 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. 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-

58 See discussion infra Part IV.A.2.
61 Coase, supra note 60, at 390–93.
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." The core relationships that aggregate into the trust as an organizational form, however, are generally open-market transactions rather than intra-firm transfers. 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. 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." 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.

64 See Rock & Wachter, supra note 2, at 664-66.
65 See Jensen & Meckling, supra note 1, at 310 & n.12; sources cited supra note 1.
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.
B. The Economics of Agency

Using the vocabulary of agency in economic rather than legal parlance, 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, it will be difficult for the principal to prevent shirking by the agent. This is the problem of "hidden action," sometimes called "moral hazard." The problem is one of post-contractual asymmetric information.

Real estate agents are a common illustration in the literature. Consider an agent working on a five percent commission. 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
$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. 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. 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. In particular, the literature of enterprise organizations has explored managerial labor markets, incentive compensation, alienable residual claims, flexible sharing rules and mutual monitoring, the market for corporate control (i.e., the takeover

73 Jensen & Meckling, supra note 1, at 308.
74 See supra notes 65–66 and accompanying text.
76 See, e.g., Fama, supra note 1, at 294–95.
78 See, e.g., Fama & Jensen, Residual Claims, supra note 1, at 332–33.
79 See id. at 335–36 (discussing professional partnerships).
market), disclosure rules, and liability rules such as fiduciary duties as devices for minimizing agency costs.

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

III
THE AGENCY COSTS MODEL

In comparison to the agency costs approach to corporate law, 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. 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.

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-


See supra note 3 and accompanying text.


ternal 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. 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.

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. 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);

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).
89 Jensen and Meckling argued that most organizations, including the corporation, could be characterized as a "legal fiction[,] . . . [a]n 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)).
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.


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).
B. The Office of the Trustee

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

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. 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. 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.

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. They are mandatory with respect to the settlor, because as to

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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 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 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.

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, § 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; Merrill & Smith, supra note 17, at 846-47.

97 See Hansmann & Mattei, supra note 6, at 454. See generally Macnair, supra note 20, at 224-29 (discussing the evolution of trustee liability); Worthington, supra note 27, at 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.\(^9\) 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.\(^10\) 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.\(^11\)

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.\(^12\) 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

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\(^9\) 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).

\(^10\) As a practical matter, this liability is often fixed in an accounting proceeding made incident to the removal action.

\(^11\) 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).

\(^12\) See, e.g., Unif. Trust Code § 105, 7C U.L.A. 139 (Supp. 2003); Langbein, supra note 8, at 651, 660–63.
settlor may opt out of individual fiduciary duties, she cannot authorize a bad faith trusteeship or oust fiduciary law in its entirety.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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).\textsuperscript{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."\textsuperscript{107}

C. The Relative Position of the Settlor

The settlor's intent to create a trust is a prerequisite to trust formation.\textsuperscript{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

\begin{footnotesize}
\begin{enumerate}
\item[103] See Langbein, \textit{supra} note 98.
\item[104] See, e.g., Ayres & Gertner, \textit{supra} note 38, at 95–107; see also \textit{infra} note 116 and accompanying text (discussing exoneration clauses).
\item[105] Cf. Merrill & Smith, \textit{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 \textit{Restatement (Third) of Trusts} § 5(h) \& \textit{comment h} (2003); \textit{Restatement (Second) of Trusts} §§ 10 & \textit{comments} a–b (1959); 1 \textit{Scott on Trusts}, \textit{supra} note 5, §§ 10, 10.3, 10.4; see, e.g., Ogle v. Durley, 77 So.2d 688, 691–92 (Miss. 1955).
\item[106] See Langbein, \textit{supra} note 98; \textit{supra} Part I.B–C; \textit{infra} Part IV.C.
\end{enumerate}
\end{footnotesize}
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
hand, and settlors on the other, there is room as a normative matter for the occasional information-forcing default rule.\textsuperscript{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.\textsuperscript{116} By ensuring transparency, the rule helps to ensure that the clause was not unwittingly embraced by the settlor.\textsuperscript{117}

Third, in contrast to the founder of a corporation or a commercial trust,\textsuperscript{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.\textsuperscript{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-

\begin{itemize}
\item \textsuperscript{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).
\item \textsuperscript{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. 535, 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).
\item \textsuperscript{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.
\item \textsuperscript{118} See Schwarcz, supra note 13, at 562–63 (comparing commercial and donative trusts).
\item \textsuperscript{119} Cf. Jensen & Meckling, supra note 1, at 313.

[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.
\end{itemize}

\textit{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.\textsuperscript{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.\textsuperscript{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,\textsuperscript{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.\textsuperscript{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,\textsuperscript{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

\textsuperscript{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.

\textsuperscript{121} See Langbein, supra note 98.

\textsuperscript{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.

\textsuperscript{123} Easterbrook & Fischel, supra note 1, at 31; see also id. at 17, 23–25; cf. Langbein, supra note 98.

\textsuperscript{124} See supra note 109 and accompanying text.
other claims are settled. That is, as residual claimants, they bear the residual risk.

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. 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.

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, 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-

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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 Schwarz, supra note 13, at 562-63.

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).

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.

128 See Langbein, supra note 8, at 642.

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


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).

133 See Langbein, supra note 14, at 178; Sitkoff, supra note 15, at 587-88.

AN AGENCY COSTS THEORY OF TRUST LAW

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), 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.

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."

A. Donative Beneficiaries as Residual Claimants

Agency cost analysis prompts the classification of donative trust beneficiaries as residual claimants. Claims on the assets of the trust by all the other relevant parties—most notably the trustee and those with whom the trustee transacts as trustee—are usually set by express contract and have a higher priority than the beneficiaries' 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. In this respect, modern trust beneficiaries are beginning more closely to resemble the residual

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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.

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.

138 See supra Part III.D.

139 See supra note 128 and accompanying text.
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.\(^\text{140}\) 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.\(^\text{141}\)

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.\(^\text{142}\) 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."\(^\text{143}\)

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

\(^\text{141}\) See, e.g., Ogus, supra note 3, at 187.
\(^\text{142}\) 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 Daurning Principal and Income Problem, 32 Real Prop. Prob. & Tr. J. 255 (1997) (discussing the tension between income and remainder beneficiaries).
\(^\text{143}\) Fama & Jensen, Residual Claims, supra note 1, at 329.
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.\footnote{144}{See Frank H. Easterbrook & Daniel R. Fischel, \textit{Voting in Corporate Law}, 26 J.L. & ECON. 395, 405–06 (1983); Roberta Romano, \textit{Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws}, 89 COLUM. L. REV. 1599, 1611–12 (1989); Robert H. Sitkoff, \textit{Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters}, 69 U. CHI. L. REV. 1103, 1110 n.28 (2002).}

Trust law's evolutionary response for aggregating the otherwise conflicting interests of different classes of beneficiaries is the fiduciary duty of impartiality.\footnote{145}{See Halbach, \textit{supra} note 8, at 1912–13.} This duty requires the trustee to "act impartially in investing, managing, and distributing the trust property, giving due regard to the beneficiaries' respective interests."\footnote{146}{\textit{Unif. Trust Code} § 803, 7C U.L.A. 204 (Supp. 2003); \textit{see also} Restatement (Second) of Trusts §§ 183, 232 (1959).} 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.\footnote{147}{\textit{See Restatement (Third) of Trusts: Prudent Investor Rule} § 227 cmt.s. c & i (1992); Edward C. Halbach, Jr., \textit{Significant Trends in the Trust Law of the United States}, 32 VAND. J. TRANSNAT'L L. 531, 549 (1999) [hereinafter Halbach, \textit{Significant Trends}]; Edward C. Halbach, Jr., \textit{Trust Investment Law in the Third Restatement}, 27 REAL. PROP. PROB. & TR. J. 407, 441–44 (1992) [hereinafter Halbach, \textit{Trust Investment}]; Halbach, \textit{supra} note 8, at 1913. \textit{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, \textit{supra} note 5, § 232, at 7. For example, T could lawfully tip the balance in favor of B1 if B1 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 interest or remainder beneficiaries] might be justified.” Id.}}

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.\footnote{148}{\textit{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, \textit{supra} note 5, § 232, at 7. For example, T could lawfully tip the balance in favor of B1 if B1 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 interest or remainder beneficiaries] might be justified.” Id.}} This stands in contrast to the law of corporations, which requires managers to favor the...
claimant with the most residual claim in the case of conflict, \textsuperscript{149} though of course within the same class of stock all shareholders must be treated equally. \textsuperscript{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, \textsuperscript{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. \textsuperscript{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." \textsuperscript{153}

2. 

Total Return Investing

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

\textsuperscript{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).

\textsuperscript{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. Leven, 280 A.2d 717, 721-22 (Del. 1971); Bainbridge, supra note 1, § 7.4, at 338-42.

\textsuperscript{151} See Schwarcz, supra note 13, at 575-80.

\textsuperscript{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. Wols, Pension and Employee Benefit Law 680, 848 (3d ed. 2000).

\textsuperscript{153} Schwarcz, supra note 13, at 579.

\textsuperscript{154} See, e.g., Lyman W. Welch, Brave New World of Total Return Laws, Tr. & Est., June 2002, at 24.

cent revisions to the prudent investor standards that underpin trust law's fiduciary duty of care. A 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. A contemporary reform, which revised the definitions of "principal" and "income," made the boundary between the two porous. 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. 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. The so-called unitrust, 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, likewise eases the tension between capital appreciation and income production.


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.


With equitable adjustment or a unitrust, the higher the total return, the better all the beneficiaries do. 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. Authorization for the trustee to invade principal for the benefit of the income beneficiaries was also not uncommon.

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, the beneficiaries cannot easily diversify, and when diversification is unavailable, the standard economic assumption is that of risk averseness. 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. Corporate trustees are by definition risk neutral.
(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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{171} In the absence of the fiduciary obligation or other corrective mechanisms, trustees would often be less averse to volatility than the beneficiaries.\textsuperscript{172} Trust law’s particular flavor of the fiduciary duty of care can be understood as an answer to this challenge.\textsuperscript{173} Care in trust law is the functional equivalent of the objective reasonable person standard in tort law.\textsuperscript{174} The trustee must “exercise such care and skill as a man of ordinary prudence would exercise in

\begin{itemize}
  \item Legal malpractice insurance, for example, is available with coverage for negligence in fiduciary administration.
  \item 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.
  \item Agency relationships, in other words, present both incentive and risk-sharing problems. See, e.g., Eisenhardt, supra note 67, at 58.
  \item 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 659, 651. There is, 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 1909. See generally Vollmar et al., supra note 101, at 1059 (describing various compensation schemes); Gordon, supra note 12, at 82-83 (discussing trustee compensation).
  \item 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 “reasonable” care in tort and fiduciary law).
\end{itemize}
dealing with his own property." 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.

The contrast between the operation of the duty of care in trust law and in corporate law is instructive. 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. This is a loose constraint, 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. And diversified (risk-neutral) shareholders are advantaged by the business judgment rule because insulating managers from liability in the absence of egregious conduct helps


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 decision making. 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.

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

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).

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 decision making, 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 non-existent. See, e.g., Bainbridge, supra note 1, §§ 6.2, 6.4; Allen & Kraakman, supra note 10, § 8.4.2, at 254.

offset the managers' incentives—including large investments of human capital and personal wealth in the firm—to avoid risk.\textsuperscript{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.\textsuperscript{182} In donative trusts diversification for the residual claimants is usually obtained internally.\textsuperscript{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.\textsuperscript{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.”\textsuperscript{185}

\section*{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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\textsuperscript{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.

\textsuperscript{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).


\end{flushleft}
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.\textsuperscript{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),\textsuperscript{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.\textsuperscript{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.\textsuperscript{189} The American rule, which originated with \textit{Claflin v. Claflin},\textsuperscript{190} is unfriendly to termination and modifica-

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\item\textsuperscript{186} See Ogus, supra note 3, at 214–16.
\item\textsuperscript{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, \textit{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., \textit{Limiting Dead Hand Control of 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.
\item\textsuperscript{189} Cf. 2 SCOTT ON TRUSTS, supra note 5, § 107.3, at 124–25 (discussing removal of trustee by beneficiaries). Note, however, that the relevant considerations for modification versus termination are not entirely the same. See \textit{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.
\item\textsuperscript{190} 20 N.E. 454 (Mass. 1889); see \textit{Restatement (Third) of Trusts} § 65 cmt. a (2003).
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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. 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. Thus, as a practical matter, unless the trustee consents, 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. 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. The idea is that, in the aggregate, beneficiaries fare better with more trusts, and thus more gifting.

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

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.

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.”).

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.

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

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; 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, supra note 136, at 412–13. If S is willing to transfer resources to B, but B anticipates that S 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.

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, one-time 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 sett-

\(^{198}\) See supra note 188 and accompanying text.

\(^{199}\) See supra note 115.

\(^{200}\) See Dukeminier & Krier, *supra* note 11, at 1331–32.


An agency costs theory of trust law

dor's assumed broader aim of benefiting the beneficiaries.\textsuperscript{203} Certainly the recent Uniform Trust Code and Restatement (Third) of Trusts embrace this view.\textsuperscript{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.\textsuperscript{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.\textsuperscript{206}

Note, however, that these liberalizations are designed to advance the settlors' probable intent.\textsuperscript{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.\textsuperscript{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.\textsuperscript{209} Re-

\begin{footnotesize}
\textsuperscript{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).
\textsuperscript{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").
\textsuperscript{207} See Langbein, supra note 59, at 68–69.
\textsuperscript{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.
\textsuperscript{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-
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

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).

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.


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 465–64 (same).
the beneficiaries. 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.

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." 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.

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


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").

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.").

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 cmt. b–c (1959); Restatement (Third) of Trusts § 37 cmt. e(1) (2003); 2 Scott on Trusts, supra note 5, § 107, at 108–09.

\(^{220}\) 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; cf. English, supra note 204, at 197–99 (discussing removal under the UTC in situations “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.

\(^{222}\) See, e.g., Langbein, supra note 8, at 652–33, 637–39; see also supra note 57.

\(^{223}\) See supra note 197 and accompanying text.

\(^{224}\) See supra note 57 and accompanying text.
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).

\(^{226}\) See supra note 91.

\(^{227}\) 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.


\(^{230}\) 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”).
institutional fiduciaries. 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. 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.

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. 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. 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-

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

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 Price, supra note 227, § 10.43.1, at 1161–62 (describing trust management by corporate trustees).

233 Cf. Dukeminier & Johanson, supra note 28, at 661 (considering whether beneficiaries 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, 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).

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.\footnote{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.\footnote{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.\footnote{238} But doing so would likely subject the trust to undesirable tax consequences.\footnote{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.

\footnote{236} See Gordon, supra note 12, at 76–79 (discussing beneficiary free-rider problems).

\footnote{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.

\footnote{238} See Restatement (Second) of Trusts § 200 & cmt. b (1959); 3 Scott on Trusts, supra note 5, § 200.1, at 211–12.

\footnote{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 \ldots has been freed of both and is answerable to neither.\" 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.\footnote{See Easterbrook & Fischel, supra note 1, at 38.} 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.\footnote{See Easterbrook & Fischel, supra note 1, at 38.}

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 feeble, unborn, minor, unidentifiable, or otherwise incompetent beneficiaries,\footnote{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.} and given the possibility of a free-rider problem among the beneficiaries,\footnote{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 § 1-405(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).} 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\footnote{See, e.g., Fischel & Langbein, supra note 152, at 1114–15, 1118–19; Gordon, supra note 12, at 82.} 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
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). 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. In this scenario, S’s standing would help ensure that T respects S’s limitations on the use of the trust funds.

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246 For a complementary doctrinal analysis, see Hayton, supra note 20, at 103–05.
247 See supra note 194 and accompanying text.
4. Trust Protectors

An emerging feature of modern managerial trusts is the appointment of a trust "protector." 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. Although originally conceived as a check on local trustees in offshore asset-protection trusts, 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, 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.

Thus, for all the reasons that settlor standing might reduce agency costs, the appointment of a trust protector might similarly re-

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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).

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.

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

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.

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, 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. 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.
255 See sources cited supra notes 11, 188.
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.
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. 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.

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. Recourse for a broken contract, however, does not normally include a suit against the outsider who benefited by the breach. 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, 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.”

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”).
259 See Hansmann & Mattei, supra note 6, at 438.
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).
262 See supra note 44 and accompanying text.
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).
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, 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]." 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.

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. 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," 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.
265 Hansmann & Mattei, supra note 6, at 464.
268 See English, supra note 204, at 209.
the burden on the trust's governance regime (the cost of this reform).\textsuperscript{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.\textsuperscript{270} This is true even if the trust instrument requires mandatory payouts, as such payments could be made directly to the beneficiaries' service providers.\textsuperscript{271} Not surprisingly, there is a substantial body of literature on the soundness of the policy behind the spendthrift trust.\textsuperscript{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,\textsuperscript{273} do not enforce them. In contrast, spendthrift provisions are valid throughout the United States,\textsuperscript{274} are included in customary American estate planning boilerplate,\textsuperscript{275} and by statute the spendthrift trust is even the default trust form in New York.\textsuperscript{276}

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

\begin{footnotesize}
\begin{enumerate}
\item The classic English case is \textit{Brandon v. Robinson}, 34 Eng. Rep. 379 (Ch. 1811). For further discussion and references, see \textit{Moffat et al.}, supra note 20, at 211–24.
\item See \textit{Dukeminier \& Johanson}, supra note 28, at 632.
\item See \textit{Hirsch}, supra note 272, at 3 & n.7.
\item N.Y. \textit{Est. Powers \& Trusts Law} § 7–1.5 (McKinney 2002).
\end{enumerate}
\end{footnotesize}
beneficiaries on the one hand and the protection of voluntary and, more clearly, involuntary creditors on the other. 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. 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.

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.

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

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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.

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.

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.
would be channeled, as they are in England, toward discretionary trusts. 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. 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. Since the remedy for an underpayment is merely an order that the payments out of the trust be increased, but the remedy for an overpayment is to surcharge the trustee personally for the excess amounts disbursed, trustees are skewed toward caution. 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

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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).


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. The potential agency costs to the beneficiaries and to the settlor of this approach, which would hardly benefit the beneficiaries’ creditors, are manifest.

D. Fiduciary Litigation

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. 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.

Indeed, drawing on earlier

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

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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.

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”).

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.

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.

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

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. 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.

Litigation incentives are likely to be different in the world of donative trusts, however, thanks to the typically smaller number of residual claimants. 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. Moreover, awards of attorneys’ fees (out of the trust corpus) to one or both sides in suits over trust administration are not uncommon. 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

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298 See Gordon, supra note 12, at 76–79.
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.”).
301 See Gordon, supra note 12, at 76–79.
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).
the litigation costs for both sides. 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. Thus, as Fischel and Langbein have suggested, many of these duties can be understood as “substitutes for monitoring by the directly interested parties.”

Moreover, the modern trend is toward further expansion of the duty to furnish beneficiaries with relevant information regarding the management of the trust. This analysis throws light on the relevance of the number of residual claimants to the choice of organizational form. 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.

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).

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).

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).


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

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
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. 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. 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.

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. 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.

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


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);
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.\(^\text{314}\)

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.\(^\text{315}\) 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.\(^\text{316}\) 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.\(^\text{317}\)

The function of these sub-rules is to provide the benefits of rules (as compared to standards) without inviting strategic behavior by trustees.\(^\text{318}\) 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\(^\text{319}\)—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-

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\(^{314}\) See sources cited supra notes 188 & 248; see also Macey, supra note 3, at 315, 319.

\(^{315}\) Easterbrook & Fischel, supra note 85, at 291.

\(^{316}\) See id. at 281–86.


\(^{319}\) 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.
filling role owing to "the impossibility of writing contracts completely specifying the parties' obligations."\textsuperscript{320}

Recall that in the modern managerial trust, the fiduciary obligation has eclipsed limited powers as the chief device for controlling managerial agency costs.\textsuperscript{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,\textsuperscript{322} and overarching standards.\textsuperscript{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

\textsuperscript{320} Easterbrook & Fischel, supra note 173, at 426.
\textsuperscript{321} See supra note 59 and accompanying text.
\textsuperscript{322} On the relevance of ex ante programmability to agency costs analysis, see Eisenhardt, supra note 67, at 62.
\textsuperscript{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.