Trust Law, Corporate Law, and Capital Market Efficiency

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Robert H. Sitkoff
Northwestern University, rsitkoff@law.harvard.edu

UNIVERSITY OF MICHIGAN

JOHN M. OLIN CENTER FOR LAW & ECONOMICS

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ROBERT H. SITKOFF

PAPER #03-014
FORTHCOMING IN 28 J. CORP. L. (2003)

28 J. Corp. L. ___ (forthcoming 2003)

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Abstract

In both the publicly-traded corporation and the private donative trust a crucial task is to minimize the agency costs that arise from the separation of risk-bearing and management. But where the law of corporate governance evolved in the shadow of capital-market checks on agency costs, trust governance did not. Thus, even more than that of close corporations, the law and study of private trusts offers an illuminating counterfactual—a control, as it were—for a playful thought experiment about the importance of capital market efficiency to the law and study of public corporations. The animating idea for this essay is that many of the differences on the agency costs frontier between the public corporation and the private donative trust can be roughly attributed to their relative positions in modern capital markets and the related disparity in their residual claimants' ease of exit. Among other things, this approach reveals a correlation between the trust law model and the views of corporate law scholars who doubt the ECMH and its implications for corporate governance. The essay also discusses the use of market data for assessing breach and damages in corporate and trust litigation and for empirical evaluation of theoretical scholarly analysis in both fields. More generally, comparison of the governance of the public corporation and the private donative trust brings into view the importance of relative price efficiency for the modern approach to corporate governance.

* Assistant Professor of Law, Northwestern University. For helpful comments and suggestions on earlier drafts the author thanks Ronen Avraham, Richard Brooks, Ronald Chester, Charlotte Crane, Deborah DeMott, Joel Dobris, Tracey George, Joshua Getzler, Chris Guthrie, Adam Hirsch, Howell Jackson, John Langbein, Larry Mitchell, Richard Nolan, Larry Ribstein, Roberta Romano, Hillary Sale, Tamara Sitkoff, Albert Yoon, Kimberly Yuracko, and participants in the Symposium on Revisiting "The Mechanisms of Market Efficiency" at the University of Iowa College of Law. The author also thanks Litsa Georgantopoulos, Kathryn Hensiak, and Jeremy Polk for excellent research assistance and the Searle Fund for Policy Research and the Victor Family Research Fund for financial support.

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I. INTRODUCTION

The publicly-traded corporation separates risk-bearing and management.[1] Risk-bearing falls on the residual-claimant shareholders, managerial authority ultimately lies with the board of directors. In this regard there is a strong similarity between the publicly-traded corporation and the private donative trust. Donative trusts give managerial responsibility for specified property to the trustee(s), but the risk or reward of the trust portfolio's good or bad performance falls on the residual-claimant beneficiaries.[2] Thus,

* Assistant Professor of Law, Northwestern University. For helpful comments and suggestions on earlier drafts the author thanks Ronen Avraham, Richard Brooks, Ronald Chester, Charlotte Crane, Deborah DeMott, Joel Dobris, Tracey George, Joshua Getzler, Chris Guthrie, Adam Hirsch, Howell Jackson, John Langbein, Larry Mitchell, Richard Nolan, Larry Ribstein, Roberta Romano, Hillary Sale, Tamara Sitkoff, Albert Yoon, Kimberly Yuracko, and participants in the Symposium on Revisiting "The Mechanisms of Market Efficiency" at the University of Iowa College of Law. The author also thanks Litsa Georgantopoulos, Kathryn Hensiak, and Jeremy Polk for excellent research assistance and the Searle Fund for Policy Research and the Victor Family Research Fund for financial support.

1. Perhaps the most famous statement is ADOLPH A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

2. *See* Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. (forthcoming 2004), *available at* http://ssrn.com/abstract=412592 (last visited Sept. 3, 2003). As the Scott treatise puts it, the trust "separate[s] the benefits of ownership from the burdens of ownership." 1 AUSTIN W. SCOTT, SCOTT ON TRUSTS § 1 (4th ed. 1987) [hereinafter SCOTT ON TRUSTS]; *see also* Jonathan R. Macey, *Private Trusts for the Provision of Private Goods*, 37 EMORY L.J. 295, 315-20 (1988) (discussing "the separation of ownership and management" in the trust). The limitation to donative trusts is important because "the settlor in a commercial trust almost always retains a residual interest." Steven L. Schwarcz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, 58 BUS. LAW. 559, 562 (2003). On business trusts, see *infra* note 15.

putting the interests of the trust donor to one side,[3] in both the public corporation and the donative trust a crucial task is to minimize agency costs by aligning the interests of the managers with the interests of the residual claimants.

At the same time, however, the paradigmatic private donative trust and publicly-traded corporation operate on opposite sides of the capital markets. In rough terms, the corporation is organized to raise (or buy) capital; the modern donative trust sells capital.[4] Thus, where the public corporation is a buyer in capital markets, the modern donative trust is a seller. So both the donative trust and the public corporation separate risk-bearing and management, but they do so towards opposite ends in the capital markets. An important consequence of these differing orientations towards capital markets is the lack of a thick secondary market for trust residual claims, the sale of which are also stymied (if not altogether blocked) by several doctrinal impediments designed to give effect to the settlor's dead-hand interests.[5]

The animating idea for this essay is that many of the differences on the agency costs frontier between the publicly-traded corporation and the private donative trust can be attributed to their opposing, mirror-image positions in modern capital markets and the related disparity in their residual claimants' ease of exit. Of course, this involves some approximation and causation is unlikely to be exclusive. Nevertheless, a number of intriguing points about both corporate law and trust law are brought into view by this approach.[6] (Readers familiar with corporate law might wonder why the trust and not the close corporation. This question is taken up in Section II.)

The design for this essay is that of comparison. The essay contrasts the donative trust and the publicly-traded corporation with the hope of illuminating the impact of capital market efficiency, if any, on the evolution of the hypothetical bargain that is in effect codified in each.[7] More concretely, Section III looks to the law of private donative trusts

3. For discussion and references on the "dead hand" in trust law, see Adam J. Hirsch & William K.S. Wang, *A Qualitative Theory of the Dead Hand*, 68 IND. L.J. 1 (1992); Gregory S. Alexander, *The Dead Hand and the Law of Trusts in the Nineteenth Century*, 37 STAN. L. REV. 1189, 1254-64 (1985); RONALD CHESTER, INHERITANCE, WEALTH AND SOCIETY (1982); Gareth H. Jones, *The Dead Hand and the Law of Trusts*, *in* DEATH, TAXES AND FAMILY PROPERTY 119 (Edward C. Halbach, Jr. ed., 1977); *see also* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 18.3, 518-20 (6th ed. 2003).

4. John Langbein has broken down trusteeship into three components: administration, distribution, and investment. *See* John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 665-66 (1996). The discussion here focuses on the investment dimension of trusteeship.

5. These legal impediments to liquidity, which are related to the often (but hardly exclusively) paternalistic reasons why settlors use the trust to effect a donative transfer, are discussed in the text accompanying *infra* notes 20-24. For further discussion and references on the dead hand, see sources cited in *supra* note 3; Sitkoff, *supra* note 2, at Part IV.B. & C.2.

6. Connecting the two is part of a venerable tradition. *See* Frederic Maitland, *Trust and Corporation*, *in* 3 H. A. L. FISHER, THE COLLECTED PAPERS OF FREDERIC WILLIAM MAITLAND 321, 395 (1911) ("And now let me once more repeat that the connection between Trust and Corporation is very ancient."); *see also* RESTATEMENT (THIRD) OF TRUSTS § 5(g) & cmt. g (2003) (comparing corporations and trusts); Tatarian v. Commercial Union Ins. Co., 672 N.E.2d 997, 1000 (Mass. App. Ct. 1996) (analogizing the trust to a corporation).

7. The seminal contractarian statement in the literature of trust law is John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625 (1995) [hereinafter Langbein, *Contractarian*]. *See also* John H. Langbein, *Mandatory Rules in the Law of Trusts*, 98 NW. U. L. REV. (forthcoming 2004). The corporate law classic remains FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991) [hereinafter EASTERBROOK & FISCHEL, ES].

as a counterfactual—a control, as it were—for a playful thought experiment about what the agency costs calculus for, and the underlying doctrinal framework of, public corporations might look like without efficient capital markets. As we shall see, it might well have evolved into something that looks more like trust law. This is the means by which this essay will revisit *The Mechanisms of Market Efficiency*.[8]

The essay is organized as follows. Section II continues the discussion of the reasons to compare the donative trust with the public corporation. Unlike the close corporation, mutual fund, and partnership, the donative trust matches the relevant characteristics of the public corporation—except for its opposite position in the capital markets and its lack of an easy exit for the residual claimants.

Section III then undertakes the comparison along five margins. Each helps to illuminate the importance of market efficiency to corporate governance. A byproduct of the comparison is that it reveals a correlation between the views of corporate law scholars who have doubts about the validity of the efficient capital markets hypothesis ("ECMH") and the trust law model. The correlation follows from the need for trust governance to confront the separation of risk-bearing and management without recourse to the discipline of buy-side capital market participation. Although the correlation does not necessarily support the case for moving corporate law closer to the trust law model (it does not help resolve the antecedent question of whether the ECMH is indeed a good model of reality[9]), it does further validate the essay's design.

Finally, Section IV explores the potential for capital market price data to provide a measure of empirical precision, now routine in the (buy-side) corporate context, for the law and study of donative trusts. Empiricism is on the ascendancy in the corporate context in large part because pricing by capital markets provides abundant and widely-accessible data. The question, then, is whether similar empiricism might be feasible in the law and study of capital market sellers such as the donative trust. Among other things, the essay discusses the use of market data for assessing breach and damages in surcharge actions for imprudent portfolio management.

8. Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984). The question might therefore be posed as, without i) universally informed trading; ii) professionally informed trading; iii) derivatively informed trading; and iv) uninformed trading, how might the law of corporations have evolved differently? These mechanisms are now staples of finance literature and teaching materials. *See, e.g.*, WILLIAM W. BRATTON, CORPORATE FINANCE 155 (5th ed. 2003) (discussing Gilson & Kraakman's piece in the context of analyzing market efficiency); JONATHAN R. MACEY, AN INTRODUCTION TO MODERN FINANCIAL THEORY 59-61 (2d ed. 1998) (same); HOWELL JACKSON ET AL., ANALYTICAL METHODS FOR LAWYERS 254-58 (2003) (same).

9. The debate over whether capital markets are indeed efficient is ongoing. *See, e.g.*, Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. __ (2003)(PAGE JCL 28:4); Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets*, 97 NW. U. L. REV. 135 (2002); Alon Brav & J.B. Heaton, *Competing Theories of Financial Anomalies*, 15 REV. FIN. STUD. 575 (2002); S.P. Kothari, *Capital Market Research in Accounting*, 31 J. ACCT. & ECON. 105 (2001); Charles M.C. Lee, *Market Efficiency and Accounting Research*, 31 J. ACCT. & ECON. 233 (2001); Mark Rudenstein, *Rational Markets: Yes or No? The Affirmative Case*, FIN. ANALYSTS J., May-June 2001, at 15; John Y. Campbell, *Asset Pricing at the Millennium*, 55 J. FIN. 1515 (2000); ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE (2000); Eugene Fama, *Market Efficiency, Long-Term Returns, and Behavioral Finance*, 49 J. FIN. ECON. 283 (1998).

II. WHY LOOK TO TRUST LAW?

Before undertaking the comparison of the donative trust and the public corporation, it is worth pausing to ask: why the trust and not some other organizational form? Perhaps the most intuitive alternative is the close corporation. The close corporation employs precisely the same organizational form as its publicly-traded cousin, but it does so in the absence of a thick market for its stock. On this view, the close corporation might be a more interesting point of reference for the present endeavor because there are clear governance consequences of this absence.[10] But in close corporations risk-bearing and management are often consolidated in a few owner/managers.[11] To the extent this is so, it removes from the close corporation the crucial (for present purposes) analogue to the public corporation's shareholder/manager agency problem.[12]

In the typical donative trust, however, the shareholder/manager relationship finds an analogue in the beneficiary/trustee relationship—only the trust's residual claimants' interests, as we shall see in the next section,[13] are not alienable in thick capital markets. Nor do the trustees serve at the pleasure of the beneficiaries. The combination of these factors makes the donative trust the more apposite comparison. The goal here is to assess the importance of market-based checks on agency costs when risk-bearing and management are separated.[14] Because it is a seller and not a buyer in the capital markets, and because the primacy of honoring the settlor's intent limits the beneficiary's control rights, the donative trust generally lacks such checks.

Hence mutual funds are also less suitable for the present project, regardless of whether they are organized as business trusts or corporations.[15] True, like the publicly-

10. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 275-77 (1986) [hereinafter Easterbrook & Fischel, *CC*] (explaining the "ways in which the lack of an active market for shares can influence investors in closely-held corporations").

11. *See id.* at 273-74.

12. What is more, in practice the parties often contract around the default rules of close corporations to fit their particular circumstances. *See id.* at 281-86. This makes the content of the default rules both less important and less representative of the governance of close corporations.

13. See text accompanying *infra* notes 20-24.

14. True, beneficiaries of donative trusts do not risk their own capital in the same way that shareholders do. But such beneficiaries, like corporate shareholders, are nevertheless the residual claimants. They bear the agency costs of the donative trust's separation of risk-bearing and management.

15. *See generally* Wallace Wen Yeu Wang, *Corporate Versus Contractual Mutual Funds: An Evaluation of Structure and Governance*, 69 WASH. L. REV. 927 (1994) (evaluating the comparative merits of the structure and governance of the two dominant forms of mutual funds). Non-mutual fund business trusts are likewise ill-suited to the present project because of the frequency with which they provide transferable or at least redeemable interests, less rigorous processes for removing trustees, and voting rights. Together, these characteristics make the business trust something of a substitute for the corporation. *See generally* Wendell Fenton & Eric A. Mazie, *Delaware Business Trusts*, *in* R. FRANKLIN & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS (2003); Schwarcz, *supra* note 2; Steven L. Schwarcz, *Commercial Trusts as Business Organizations: An Invitation to Comparatists*, 13 DUKE J. COMP. & INT'L L. 321 (2003); Andrew B. Kopans, The Business Trust in the Mutual Fund Industry: Old Arguments in a New Industry with Two New Players (2003) (unpublished manuscript, on file with The Journal of Corporation Law); Tamar Frankel, *The Delaware Business Trust Act Failure as the New Corporate Law*, 23 CARDOZO L. REV. 325 (2001); John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165, 170-71, 183-85 (1997); Sheldon A. Jones et al., *The Massachusetts Business Trust and Registered Investment Companies*, 13 DEL. J. CORP. L. 421 (1988).

traded corporation and the donative trust, mutual funds separate risk-bearing and management. But the interests of the mutual fund's residual claimants are usually alienable in a thick market for the fund's shares. This facilitates market-based checks on agency costs. The mutual fund, in other words, is not a closed organizational form. Furthermore, mutual funds resist classification as buyers or sellers in the capital markets. They are on the buy-side in that their managers must combine good governance with good performance in order to attract and retain capital. But they are also on the sell-side in that their managers' primary task is to invest the fund's capital.

Adding partnerships to the mix,[16] the following matrix (Figure 1) summarizes the foregoing discussion.

Figure 1

	Donative Trust	**Close Corp**	**Mutual Fund**	**Partners**	**Public Corp**
Separates Risk and Management	*yes*	*often no*	*yes*	*sometimes*	*yes*
Residual Claim Thick Market	*no*	*no*	*yes*	*no*	*yes*
Capital Market Orientation	*seller*	*buyer*	*seller & buyer*	*unclear*	*buyer*

With the exception of the separation of risk-bearing and management, which they have in common, the donative trust is the mirror-image of the public corporation.

III. GOVERNANCE AND CAPITAL MARKETS

Consider the following thought experiment. Suppose an organizational form that separated risk-bearing from management but gave the residual claimants little freedom to replace the managers or sell their shares. If at the creation of such an organization you were offered a residual stake, what kind of governance arrangements would impact the price that you would be willing to pay for it?[17] Because these characteristics epitomize the donative trust, trust law provides a rough starting point for answering this question.

The prior paragraph is driving at the idea that, whereas the law of corporate govem-

16. *See generally* Eugene F. Fama & Michael C. Jensen, *Organizational Forms and Investment Decisions*, 14 J. FIN. ECON. 103 (1985). Whether a partnership separates risk-bearing and management depends in part on whether it is organized as a general or limited partnership, and its capital market position depends on the nature of the partnership business. On the choice between partnerships and corporations, see Larry E. Ribstein, *Why Corporations?*, BERKELEY BUS. L.J. Part II.A. (forthcoming 2004); *see also* Larry E. Ribstein, *Partnerships*, *in* 3 NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 10-13 (Peter Newman ed., 1998); Larry E. Ribstein, *An Applied Theory of Limited Partnerships*, 37 EMORY L.J. 835 (1988).

17. The seminal contribution in the agency theory literature on the moment the firm goes public is Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976), *reprinted in* MICHAEL C. JENSEN, FOUNDATIONS OF ORGANIZATIONAL STRATEGY 51 (1998).

ance evolved in the shadow of capital-market checks on agency costs, trust governance did not. In other words, because publicly-traded corporations are on the buy-side of capital markets, there is the potential for capital markets, through their pricing of securities, to discipline corporate managers.[18] Thus, if managers install a weak system of internal governance and in so doing expand their opportunities for mal-, mis-, or nonfeasance, then the price that investors will be willing to pay for the firm's securities will fall accordingly.[19]

But donative trust beneficiaries are awarded their stake in the trust by the donative fiat of the settlor, and there is no well-developed aftermarket for the beneficiaries' interests.[20] Indeed, in many American trusts the beneficiaries are disabled by so-called "spendthrift" clauses from alienating (even involuntarily) their interest in the trust.[21] Moreover, trust beneficiaries cannot easily replace the trustees.[22] Both of these limits on the beneficiaries' control are designed to give effect to the preferences of the settlor, thereby facilitating the donative trust's often (but not exclusively) paternalistic function.[23] The price of this, however, is that it significantly limits the opportunities for market-based checks on trust managerial agency costs. Hence, judicial oversight and the fiduciary obligation remain the beneficiaries' principal recourse.

Against this, readers familiar with English law might object that it allows for less dead-hand control than American law.[24] Even so, there is no thick market with reliable

18. *See, e.g.*, Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

19. "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." Jensen & Meckling, *supra* note 17, at 58.

20. *See* Sitkoff, *supra* note 2, at Part III.C.

21. *See generally* RESTATEMENT (SECOND) OF TRUSTS §§ 152-53; RESTATEMENT (THIRD) OF TRUSTS § 58 (2003); UNIF. TRUST CODE § 502 (2001) [hereinafter UTC]. A few privileged creditors, however, including children, spouses, and former spouses, may sometimes reach the beneficiaries' interest despite a spendthrift clause. *See* RESTATEMENT (THIRD) OF TRUSTS § 59; UTC § 503. For further discussion and references, see Sitkoff, *supra* note 2, at Part IV.C.2; Alan Newman, *The Rights of Creditors of Beneficiaries Under the Uniform Trust Code: An Examination of the Compromise*, 69 TENN. L. REV. 771 (2002); Robert T. Danforth, *Rethinking the Law of Creditors' Rights in Trusts*, 53 HASTINGS L.J. 287 (2002); Adam J. Hirsch, *Spendthrift Trusts and Public Policy: Economic and Cognitive Perspectives*, 73 WASH. U. L.Q. 1 (1995); Anne S. Emanuel, *Spendthrift Trusts: It's Time to Codify the Compromise*, 72 NEB. L. REV. 179 (1993); Mary Louise Fellows, *Spendthrift Trusts: Roots and Relevance for Twenty-First Century Planning*, 50 REC. ASS'N BAR N.Y. 140 (1995).

22. *See* John H. Langbein, *The Uniform Trust Code: Codification of the Law of Trusts in the United States*, 15 TR. L. INT'L 66, 75-76 (2001) (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"); JOHN R. PRICE, PRICE ON CONTEMPORARY ESTATE PLANNING § 10.43.6 at 1165 (2d ed. 2000) (noting that "it is difficult, if not impossible, to obtain the judicial removal of a trustee unless the trustee has engaged in an egregious breach of trust"). There is anecdotal evidence of settlors opting out of trust law's default rules concerning trustee removal. *See* Sitkoff, *supra* note 2, at Part IV.B.2. For further discussion and references, see Ronald Chester & Sarah Reid Ziomek, *Removal of Corporate Trustees Under the Uniform Trust Code and Other Current Law: Does a Contractual Lens Help Clarify the Rights of Beneficiaries?*, 67 MO. L. REV. 241, 253-56 (2002); Ronald Chester, *Modification and Termination of Trusts in the 21st Century: The Uniform Trust Code Leads a Quiet Revolution*, 35 REAL PROP. PROB. & TR. J. 697 (2001).

23. *See, e.g.*, Fellows, *supra* note 21; *see also* sources cited *supra* note 3.

24. The classic authorities are Brandon v. Robinson, 34 Eng. Rep. 379 (Ch. 1811); Saunders v. Vautier, 49 Eng. Rep. 282, Cr. & Ph. (1841); and the Variation of Trusts Act of 1958, 6 & 7 Eliz. 2, c. 53, § 1 (Eng.). Although English law does not recognize spendthrift trusts, beneficiaries can still be disabled from alienating their interests through the use of discretionary and protective trusts. *See* Sitkoff, *supra* note 2, at IV.C.2; *see gener-*

pricing for beneficial interests in England either. Thus, in English trusts too the fiduciary obligation is the principal means of governance. What is more, trustees of both English and American trusts are not constrained by an ongoing need to appeal to capital markets for financing in the same way that entrepreneurs and corporate managers are so constrained.[25]

Taken together, the foregoing implies that if one has doubts about the ECMH, then there is likely to be correlation between traditional Anglo-American trust law and the kinds of corporate governance reforms to which one is attracted—stronger fiduciary obligations,[26] freer derivative litigation,[27] mandatory disclosure,[28] and so on.[29] There is correlation because in the absence of effective market-based checks on managerial agency costs the publicly-traded corporation begins to resemble the donative private trust. The debate, therefore, is over the premise—whether the ECMH is a good model of reality and, accordingly, whether its implications for corporate governance hold.[30]

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ally GRAHAM MOFFAT, TRUSTS LAW: TEXT AND MATERIALS 211-24, 248-73 (3d ed. 1999) (explaining the English law).

25. Although there may be something of an ex ante competition among professional trustees to attract settlors, there is no ex post "market for trust control," as it were. *Cf.* JESSE DUKEMINIER & STANLEY M. JOHANSON, WILLS, TRUSTS, AND ESTATES 661 (6th ed. 2000) (discussing whether beneficiaries should be allowed to change trustees).

26. *See, e.g.*, William W. Bratton, *Game Theory and the Restoration of Honor to Corporate Law's Duty of Loyalty*, *in* PROGRESSIVE CORPORATE LAW 139-83 (Lawrence E. Mitchell ed. 1995); Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L.J. 425, 475-91 (1993); Paul N. Cox, *Reflections on Ex Ante Compensation and Diversification of Risk as Fairness Justifications for Limiting Fiduciary Obligations of Corporate Officers, Directors, and Controlling Shareholders*, 60 TEMP. L. REV. 47 (1987) [hereinafter Cox, *Reflections*]; *see generally* Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209 (1995); Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795 (1983) [hereinafter Frankel, *Fiduciary Law*]; Deborah A. DeMott, *Beyond Metaphor: An Analysis of the Fiduciary Obligation*, 1988 DUKE L.J. 879 (1988).

27. *See, e.g.*, James D. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745 (1984); Robert B. Thompson & Randall S. Thomas, *Shareholder Litigation: Reexamining the Balance Between Litigation Agency Costs and Management Agency Costs* (Vand. L. & Econ. Working Paper No. 02-10, 2002), *available at* http://ssrn.com/abstract_id=336162 (last visited Sept. 3, 2003).

28. For a sampling of the extensive literature on mandatory disclosure, see Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675, 690 (2002); Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023 (2000); Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999); Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995); Lawrence A. Cunningham, *Capital Market Theory, Mandatory Disclosure, and Price Discovery*, 51 WASH. & LEE L. REV. 843 (1994); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 672 (1984) [hereinafter Easterbrook & Fischel, *MD*]; John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984); Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1 (1983); *see also* Robert B. Thompson & Hillary Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 872-86 (2003).

29. *See* Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); *see also* Melvin Aron Eisenberg, *The Structure of Corporate Law*, 89 COLUM. L. REV. 1461 (1989); Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761 (1985). For a historical discussion of the competing approaches to corporate law, see William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471 (1989).

30. *See* sources cited *supra* note 9.

A. The Duty of Loyalty

As a potential residual claimant in the hypothetical organization sketched above, you might try to bargain for a more robust duty of loyalty than is ordinarily provided by corporate law. The fiduciary obligation, and in particular the duty of loyalty, is something of a crude substitute for active monitoring.[31] Applied here, the fiduciary obligation is a crude substitute for the mechanisms of market efficiency that cause prices to reflect all available information and so underpin the rationality of shareholder passivity in the corporate context.[32]

Take the application of the duty of loyalty to self-dealing, which is to say deals between the enterprise and one of its managers acting on his or her own account. The agency problem is acute here.[33] Corporate law's answer is a liability rule under which a self-dealing manager must show that the transaction was fair. If so, then it will be upheld, sometimes even if the manager failed properly to disclose his or her conflict in advance.[34] But self-dealing transactions are often difficult to detect, especially when they involve only a few managers who actively cover their tracks.[35] Thus, without efficient capital markets backing up your monitoring efforts, you might rationally conclude that banning all self-dealing transactions is easier than dealing with them on a case-by-case basis. Put differently, you might find it easier simply to assume disloyalty from the appearance of misappropriation[36]—especially if, as is the case in trust law, the joint value to the parties of the prohibited transactions is small.[37]

This is the trust law approach. Under the no-further-inquiry rule, even if the self-dealing transaction is objectively fair, the beneficiaries need only show the existence of the trustee's self-interest in order to prevail.[38] Once the beneficiaries prove the fact of self-dealing, there is "no further inquiry" and the transaction is voided.[39] By rendering all

31. *See* Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1114-15, 1118-19 (1988); Sitkoff, *supra* note 2, at Part IV.D.

32. For discussion and references, see Bernard Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395 (1983).

33. *See* EASTERBROOK & FISCHEL, ES, *supra* note 7, at 103 (noting that "duty-of-loyalty problems often involve spectacular, one-shot appropriations, of the 'take the money and run' sort").

34. *See, e.g.*, Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 366 n.34 (Del. 1993); Marciano v. Nakash, 535 A.2d 400, 403-05 (Del. 1987); STEPHEN M. BAINBRIDGE, CORPORATE LAW AND ECONOMICS § 7.2, at 311 n.8, 315-16 (2002). *But see* Deborah A. DeMott, *The Figure in the Landscape: A Comparative Sketch of Directors' Self-Interested Transactions*, 62 LAW & CONTEMP. PROBS. 243 (1999).

35. *See* BAINBRIDGE, *supra* note 34, § 7.1, at 306.

36. *See* Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1054-56 (1991).

37. "[C]ompliance with the prohibition against self-dealing is ordinarily not burdensome, because the trustee is forbidden only one tiny sliver of the world of investment opportunities, namely, the assets in the trust." Langbein, *Contractarian*, *supra* note 7, at 665. In contrast corporate managers "may undertake some self-interested transactions in order to encourage (by allowing reward) the process of finding new opportunities for effectively risk-neutral firms." Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 437 (1993) [hereinafter Easterbrook & Fischel, *CFD*].

38. *See* Hartman v. Hartle, 122 A. 615 (N.J. Ch. 1923); 2A SCOTT ON TRUSTS, *supra* note 2, § 170.2, at 320. For discussion and references, see Karen E. Boxx, *Of Punctilios and Paybacks: The Duty of Loyalty Under the Uniform Trust Code*, 67 MO. L. REV. 279 (2002).

39. *See* In re Farrell's Will, 91 N.Y.S.2d 89, 92 (N.Y. Sur. Ct. 1949) (citing Albright v. Jefferson County

evidence of intrinsic fairness irrelevant and employing a disgorgement remedy,[40] the no-further-inquiry rule creates a strong incentive for trustees to abstain from self-dealing or at least to obtain the ex ante consent of all the beneficiaries.[41] The underlying assumption is that in the trust law context these deals are so frequently undesirable that the costs of extirpating the entire class of transaction (a *rule*) are less than the costs of case-by-case adjudication (the fairness *standard*).[42] "These stricter rules substitute for the weaker private or market-type constraints,"[43] something that was more common in corporate law's treatment of self-dealing in the late nineteenth and early twentieth centuries.[44]

B. The Duty of Care[45]

Portfolio theory teaches that shareholders can and should diversify. Corporate managers, however, often have considerable firm-specific human capital, and much of their financial wealth is likewise often tied up in the firm. So the paradigmatic corporate arrangement is that of risk-neutral (well-diversified) shareholders and risk-averse (poorly-diversified) managers.[46]

The donative trust's mirror-image position in the capital markets reverses this alignment of attitudes towards risk. Without a market for trust residual claims, beneficiar-

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Nat'l Bank, 53 N.E.2d 753 (N.Y. 1943)).

> If a fiduciary places himself in a position where his personal interest may conflict with the interests of the [beneficiaries], the law stops the inquiry when the relationship is disclosed, and at the instance of the [beneficiaries] a transaction involving self-dealing will be set aside regardless of its fairness or unfairness.

Id. at 757.

40. *See* Cooter & Freedman, *supra* note 36, at 1052; Easterbrook & Fischel, *CFD*, *supra* note 37, at 442-43; *see also* E. Allan Farnsworth, *Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract*, 94 YALE L.J. 1339 (1985) (discussing the limitations, history, uses, and possible extensions of the disgorgement principle).

41. Even then the deal would also have to pass scrutiny for substantive fairness, so well-counseled fiduciaries would seek ex ante judicial instruction. *Cf.* Langbein, *Contractarian*, *supra* note 7, at 666-67 (exploring "conflict-tainted" transactions).

42. On rules and standards see, for example, Louis Kaplow, *Rules Versus Standards: An Economic* Analysis, 42 DUKE L.J. 557 (1992); Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257 (1974); Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577 (1988).

43. Fischel & Langbein, *supra* note 31, at 1116; *see also* Easterbrook & Fischel, *CFD*, *supra* note 37, at 437.

44. *See* Harold Marsh, Jr., *Are Directors Trustees?: Conflicts of Interest and Corporate Morality*, 22 BUS. LAW. 35, 36-53 (1966) (collecting authority); BAINBRIDGE, *supra* note 34, § 7.2, at 308-10; BRATTON, *supra* note 8, at 143-44; JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS § 10.10, at 206-07 (2d ed. 2003); WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS § 9.2.1, at 292-93 (2003); *see also* Mitchell, *supra* note 26; Alison Grey Anderson, *Conflicts of Interests: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738 (1978). On the appropriateness of analogizing the fiduciary obligation in one organizational context to another, see Frankel, *Fiduciary Law*, *supra* note 26, at 804-08.

45. This subsection draws on Sitkoff, *supra* note 2, at Part IV.A; *see also* A.I. Ogus, *The Trust as Governance Structure*, 36 U. TORONTO L.J. 186, 191-92 (1986) (analyzing the duty of care in trust law with reference to corporate law). For a complementary approach, see Edward Rock & Michael Wachter, *Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 NW. U. L. REV. 651 (2002).

46. *See, e.g.*, EASTERBROOK & FISCHEL, ES, *supra* note 7, at 29-30, 99-100.

ies cannot easily diversify; and when one cannot diversify, the standard economic assumption is that of risk-averseness.[47] The idea is that the undiversified have a distaste for volatility, preferring instead lower expected returns with less risk of a substantial loss—and this even if the probability that the substantial loss will materialize is relatively small. Moreover, because they have no personal wealth tied up in the trust and typically have not developed much particular trust-specific human capital, trustees can more easily diversify and insure. Given this institutional design, in the absence of the fiduciary obligation, trustees would be less risk-averse than beneficiaries. That is, they would be less averse to volatility.

These opposite assumptions about the parties' risk-preferences provide a partial explanation for the differences between duty of care in trust law and corporate law.[48] Absent conflict of interest or gross negligence, the business judgment rule commands judicial deference to the ordinary business decisions of corporate managers.[49] By insulating managers from liability in the absence of egregious conduct, the business judgment rule helps offset their incentives towards avoiding risk.[50] And diversified shareholders do better when managers are encouraged to select opportunities with high expected values even if doing so involves exposure to a low-probability risk of substantial loss.

Trust law's fiduciary duty of care, in contrast, is not similarly buffered.[51] Ordinary managerial decisions by trustees are reviewed with what is the functional equivalent of tort law's objective reasonable person standard.[52] The trustee must "exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property."[53] This helps offset the structural design whereby trust beneficiaries would otherwise be more risk-averse than the trust's managers. In other words, the position of these organizations relative to capital markets helps explain the choice of whether internal or external diversification is expected. In trust law, the duty of prudence counsels caution,

47. *See* Kathleen M. Eisenhardt, *Agency Theory: An Assessment and Review*, 14 ACAD. MGMT. REV. 57, 60-61 (1989). For general discussion, see ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 50-53 (4th ed. 2003). Behavioral studies, however, are critical of these assumptions. *See, e.g.*, Nicholas Barberis & Ming Huang, *Mental Accounting, Loss Aversion, and Individual Stock Returns*, 56 J. FIN. 1247, 1254 (2001).

48. This point is noted in Fischel & Langbein, *supra* note 31, at 1116, and discussed in Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. REV. 52, 94-96 (1987). The broader point is that principal-agent relations involve both *incentive* and *risk-sharing* problems. For a general discussion, see Eisenhardt, *supra* note 47, at 58.

49. *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (stating a gross negligence standard for director liability); BAINBRIDGE, *supra* note 34, § 6.4; COX & HAZEN, *supra* note 44, § 10.1.

50. *See* EASTERBROOK & FISCHEL, ES, *supra* note 7, at 93-102; Peter V. Letsou, *Implications of Shareholder Diversification on Corporate Law and Organization: The Case of the Business Judgment Rule*, 77 CHI.-KENT L. REV. 179 (2001); Joy v. North, 692 F.2d 880, 885-86 & n.6 (2d Cir. 1982) (Winter, J.); BAINBRIDGE, *supra* note 34, § 6.3, at 259-63.

51. Of course, one must be careful about accepting doctrinal labels as conclusive as to whether prudence in trust law and business judgment in corporate law beget different outcomes. Still, the different emphases in the canonical statements is telling. Although in numerous cases courts have found a breach of the duty of care by a trustee, *see* 2A SCOTT ON TRUSTS, *supra* note 2, § 174, cases holding that a manager of a publicly-traded corporation breached the duty of care are almost nonexistent. *See* BAINBRIDGE, *supra* note 34, §§ 6.2, 6.4.

52. *See* UNIF. PRUDENT INVESTOR ACT § 1 cmt. (1994); Langbein, *Contractarian*, *supra* note 7, at 656. *See generally* Cooter & Freedman, *supra* note 36, at 1057-59.

53. RESTATEMENT (SECOND) OF TRUSTS § 174 (1959); *see also* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. d (2003).

and that is what undiversified, risk-averse beneficiaries would prefer. Accordingly, the frequent observation that trustees in practice are overly cautious likely reflects some combination of too much deterrence from the duty of care and/or a selection effect in the initial choice of trustee by the settlor.[54]

The foregoing analysis also helps explain the corollary obligation of trustees to consider the "risk tolerance" of the trust's beneficiaries in crafting the trust portfolio.[55] Given the diversity of status of trust beneficiaries (some will be diversified because of their other holdings while others will not), this rule requires trustees to tailor their investment strategies to the beneficiaries' individual attitudes towards risk. Young scions of great wealth can better absorb higher volatility than elderly widows of modest means. So a "trust whose main purpose is to support an elderly widow of modest means will have a lower risk tolerance than a trust to accumulate for a young scion of great wealth."[56] Corporate law, in contrast, draws from portfolio theory a paradigmatic shareholder who is well-diversified; and anyway, the larger number of residual claimants in publicly-traded corporations makes individualized consideration of risk tolerance impractical.

Note the correspondence between the content of trust law's fiduciary duty of care and the views of reform-minded corporate law scholars who have doubts about the efficacy of market-based checks on corporate agency costs. Reaction to the famous case of *Smith v. Van Gorkom*[57] is instructive. *Van Gorkom* involved review of the Trans Union board's swift acceptance of a merger offer that included a substantial premium over the stock's trading price.[58] On appeal, the Delaware Supreme Court held it a breach of the duty of care for the board not to have deliberated longer. Notwithstanding the substantial premium, the court held that the failure to obtain further information removed the presumption of regularity granted by the business judgment rule.

Thus, until it was effectively reversed by statute,[59] *Van Gorkom* more or less pushed the duty of care in corporate law closer to the trust law model.[60] True believers in the

54. *See, e.g.*, Jesse Dukeminier & James A. Krier, *The Rise of the Perpetual Trust*, 50 UCLA L. REV. 1303, 1335 (2003) (stating that "[t]rustees have long been risk averse, conservative investors").

55. *See* UNIF. PRUDENT INVESTOR ACT § 2 (1994); RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 cmt. e (1992); Edward C. Halbach, Jr., *Trust Investment Law in the Third Restatement*, 27 REAL PROP. PROB & TR. J. 407, 436-37, 444-45 (1992).

56. UNIF. PRUDENT INVESTOR ACT § 2(b) cmt. (1994); *see also* RESTATEMENT (THIRD) OF TRUSTS § 227(a); *see generally* Ogus, *supra* note 45, at 196 (discussing the relation between risk-aversion and trust-investment law).

57. 488 A.2d 858 (Del. 1985). For further discussion see *Roundtable Discussion: Corporate Governance*, 77 CHI.-KENT L. REV. 235 (2001) (transcript of remarks by Robert Pritzker, then Vice-Chancellor Jack Jacobs, and three law professors about the decision).

58. "[T]he merger price . . . represented a premium of 62% over the average of the high and low prices at which Trans Union stock had traded in 1980, a premium of 48% over the last closing price, and a premium of 39% over the highest price at which the stock . . . had traded any time during the prior six years." *Van Gorkom*, 488 A.2d at 869 n.9; *see also id*. at 875-76.

59. DEL. CODE ANN. tit. 8, § 102(b)(7) (2003). *See* Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160-61 (1990) (noting the swift legislative overturning of *Van Gorkom*); ALLEN & KRAAKMAN, *supra* note 44, § 8.4.3, at 254-55.

60. *See* Rock & Wachter, *supra* note 45, at 677. Some have suggested that despite the duty of care language in the opinion, *Van Gorkom* is nonetheless best understood as a change of control case, to which heightened duties normally attach. *See* Jonathan R. Macey & Geoffrey P. Miller, *Trans Union Reconsidered*, 98 YALE L.J. 127, 135-40 (1988); ALLEN & KRAAKMAN, *supra* note 44, § 8.4.2, at 253-54, § 13.4, at 513, 518-19.

ECMH revile the decision. To them, the merger premium was all the information that Trans Union's managers required. Indeed, to some the premium alone justified the merger decision.[61] In contrast, those dubious of the efficacy of market-based monitoring and neoclassical assumptions of rationality applaud *Van Gorkom*'s more rigorous standard and emphasis on procedure.[62] If one is weary of the ECMH and the cognate teachings of portfolio theory, then one will be less willing to embrace the implications that follow from the assumption of shareholder diversification.[63] This is to say that one will likely prefer the trust law fiduciary model to corporate law's reigning market model.

C. Ex Ante Contracting and Ex Post Settling Up

The usual corporate managerial function is to deploy the firm's operating assets in accordance with their highest net present value.[64] "The only promise that makes sense in such an open-ended relation is to work hard and honestly. In other words, the corporate contract makes managers the agents of [shareholders] but does not specify the agents' duties."[65] Viewed in this manner, the fiduciary obligation in corporate law is a second-best solution to the optimal contracting problem.[66] Instead of getting bogged down in the impossibility of specifying conduct ex ante, fiduciary duties supply liability rules that call for an "ex post settling up" in accordance with what the parties would have bargained for in advance.[67]

A similar phenomenon is apparent in trust law. The typical settlor today seeks not to preserve ancestral land, but rather to ensure the professional management of wealth over time (tax exigencies and controlling personalities to one side).[68] With the ascendancy of the trustee's managerial function, the fiduciary obligation has eclipsed detailed schedules of trustees' powers as the chief protection for beneficiaries against trustee mis-, mal-, or nonfeasance.[69] But the differing orientations towards capital markets of the publicly-

61. *See, e.g.*, Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1455 (1985) (calling it "one of the worst decisions in the history of corporate law").

62. *See, e.g.*, Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of* Smith v. Van Gorkom *and the Business Judgment Rule*, 96 NW. U. L. REV. 675 (2002); Hillary Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. (forthcoming 2004). For further discussion and references, see Charles M. Elson & Robert B. Thompson, Van Gorkom*'s Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives*, 96 NW. U. L. REV. 579, 587-93 (2002).

63. *See, e.g.*, Daniel J.H. Greenwood, *Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021 (1996); Cox, *Reflections*, *supra* note 26.

64. *See generally* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 93-150 (6th ed. 2000) (discussing net present value and comparison of alternative investment strategies).

65. EASTERBROOK & FISCHEL, ES, *supra* note 7, at 91.

66. This is the contractarian approach to the fiduciary obligation. *See, e.g.*, Easterbrook & Fischel, *CFD*, *supra* note 37; Cooter & Freedman, *supra* note 36; Langbein, *Contractarian*, *supra* note 7, at 656-58; Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV 1 (1990); *see generally* Eisenhardt, *supra* note 47, at 60. ("The focus of the principal-agent literature is on determining the optimal contract, behavior versus outcome, between the principal and the agent.").

67. *See* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1444-46 (1989); Easterbrook & Fischel, *CFD*, *supra* note 37, at 425-26; Gordon, *supra* note 48, at 92. For a critical analysis, see BRATTON, *supra* note 8, at 149-50.

68. This evolution is lucidly detailed in Langbein, *Contractarian*, *supra* note 7.

69. *See* Langbein, *Contractarian*, *supra* note 7, at 640-43; Sitkoff, *supra* note 2, at Part I.D.; Gregory S. Alexander, *A Cognitive Theory of Fiduciary Relationships*, 85 CORNELL L. REV. 767, 774-75 (2000). Note the

traded corporation and the donative trust suggests that ex post settling up is likely to be simpler, and so the fiduciary obligation a more effective tool, in trust governance.

Specifically, managerial decisions regarding financial assets are easier to monitor than decisions regarding operating assets. For the latter, observable profits might be good or bad as a result of factors unrelated to the performance of the management team. For the former, however, market prices for securities are easy to discover and then to compare against market-indexes or other hypothetical portfolios.[70] Such a comparison minimizes exogenous noise by in effect netting out secular market trends. This in turn helps justify the law's greater scrutiny of trustees than corporate managers under the duty of care—it is simpler (i.e., the balance of decision and error costs is more favorable).[71]

On similar reasoning there is likely to be greater homogeneity in context across trust management than corporate management. Thus, it should be easier for the fiduciary law of trusts to be more specific in its content ex ante.[72] And, in fact, the law of trusts has evolved a schedule of detailed fiduciary sub-rules that are responsive to recurring agency cost fact patterns.[73] Among these sub-rules are the no-further-inquiry rule and the duties to keep and control trust property, to enforce claims, to defend actions, to keep trust property separate, and to minimize costs (including taxes).[74]

These sub-rules provide the benefits of *rules* (as compared to *standards*) without inviting strategic loop-holing by trustees.[75] Hence the existence of these sub-rules enhances the effectiveness of the fiduciary obligation as a check on managerial agency costs within the trust relationship. When aggrieved beneficiaries can squeeze their claim into a specific sub-rule, their case is simplified. As in the application of any rule, the costs of decision are lower than for a standard. But when the beneficiaries cannot squeeze their claim into a specific sub-rule, the broad standards of care and loyalty serve as a backstop to allow for contextual, facts-and-circumstances inquiry into the trustees' behavior as a part of the fiduciary obligation's ordinary gap-filling role.[76]

This is not to say that there are no fiduciary sub-rules in corporate law. The corporate opportunities doctrine is a nice example of one.[77] Rather, the point is that sub-rules abound in trust law in a way that they do not in corporate law because there is more homogeneity in agency cost patterns across donative trusts than across public corpora-

parallel to the decline of the *ultra vires* doctrine in corporate law. *See* EASTERBROOK & FISCHEL, ES, *supra* note 7, at 102-03.

70. *See infra* Part IV.A.

71. This is consistent with the observation that corporations which perform trust-like functions, chiefly financial institutions, receive greater scrutiny in practice. *See* ALLEN & KRAAKMAN, *supra* note 44, §13.4, at 518 n.17; Frances v. United Jersey Bank, 432 A.2d 814, 821 & n. 1 (N.J. 1981).

72. The ensuing discussion of sub-rules in trust fiduciary law draws on Sitkoff, *supra* note 2, at Part IV.D.

73. A similar sub-rule phenomenon is apparent in the law of agency and the professional responsibility of lawyers. *See* RESTATEMENT (SECOND) OF AGENCY §§ 380-86, 388-98 (2000) (stating various specific rules); MODEL RULES OF PROF'L CONDUCT R. 1.1–.16 (1983) (stating various specific rules); MODEL CODE OF PROF'L RESPONSIBILITY DR 5-101 to 5-107 (1969) (same).

74. *See, e.g.*, RESTATEMENT (SECOND) OF TRUSTS §§ 172-85 (1987) (stating various specific duties); UTC §§ 801-13 (2003) (same).

75. On rules and standards, see *supra* note 42 and accompanying text.

76. Langbein, *supra* note 4, at 657-60; Easterbrook & Fischel, *CFD*, *supra* note 37, at 426.

77. *See, e.g.*, BAINBRIDGE, *supra* note 34, § 7.3; COX & HAZEN, *supra* note 44, § 11.08.

tions.[78] That is, because there is more variance in the corporate managerial function than the trust managerial function, the former is less amenable to ex ante specification than the latter.[79]

Not surprisingly, again there is correlation between the governance of donative private trusts and the views of those who doubt the ECMH and its implications for corporate governance. The recent Sarbanes-Oxley Act, for example, establishes a number of specific rules regarding corporate governance and disclosure.[80] The Act, in effect, sets forth an ex ante schedule of managerial obligations that concern what in the wake of the Enron implosion are thought to be common agency cost patterns across publicly-traded corporations.[81]

D. Disclosure Rules

Trust beneficiaries are entitled to information reasonably related to their interest in enforcing their rights under the trust.[82] Trustees who make regular accountings, moreover, are protected from liability to the extent that the factual basis for any subsequent claim was disclosed in an accounting to which the beneficiaries failed seasonably to object.[83] The former is a stick with which beneficiaries can compel disclosure. The latter is a carrot designed to encourage full and regular disclosure. Modern authorities continue this approach, and indeed the trend is towards greater disclosure.[84]

Implicit in the foregoing must be the idea that trust beneficiaries (or their agents such as guardians ad litem)[85] can effectively digest and then act upon the disclosed information. Admittedly there is tension between this point and the idea, advanced earlier,

78. True, the sub-rule phenomenon manifests in agency law, too, even though agency covers a broader range of relationships than trust law. But the specific sub-rules of agency law, *see supra* note 73, reflect the sort of generic agency cost patterns that are likely to recur in (legal) agency relationships.

79. *See generally* Macey, *supra* note 2, at 317 ("It is significantly easier to discern whether a trustee has reached [the trust's] objectives than it is to determine whether the officers and directors of a publicly held corporation are doing everything within their power to maximize firm profits."). On programmability in agency relationships, see Eisenhardt, *supra* note 47, at 62.

80. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15, 18 U.S.C.) (2002). The substantive provisions of the Act are canvassed in Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 941-76 (2003).

81. For discussion and references, see Cunningham, *supra* note 80; Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1 (2002). *See generally* Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233 (2002).

82. *See* RESTATEMENT (SECOND) OF TRUSTS § 173 (1959); 2A SCOTT ON TRUSTS, *supra* note 2, § 173.

83. *See* RESTATEMENT (SECOND) OF TRUSTS § 172 (1959); 2A SCOTT ON TRUSTS, *supra* note 2, § 172; UTC § 1005 (2000).

84. *See* Edward C. Halbach, Jr., *Uniform Acts, Restatements, and Trends in American Trust Law at Century's End*, 88 CAL. L. REV. 1877, 1914-15 (2000) [hereinafter Halbach, *Trends*]; *see also* Allard v. Pac. Nat'l Bank, 663 P.2d 104, 110-11 (Wash. 1983); UTC § 813 (2000); John H. Langbein, *The Uniform Trust Code: Codification of the Law of Trusts in the United States*, 15 TR. L. INT'L 66, 74 (2001).

85. This is a problem of agents monitoring agents, which also exists in the corporate context. *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992). On guardians ad litem in the trust law context, see VALERIE J. VOLLMAR ET AL., AN INTRODUCTION TO TRUSTS AND ESTATES 345-46 (2003); Martin D. Begleiter, *The Guardian Ad Litem in Estate Proceedings*, 20 WILLAMETTE L. REV. 643 (1984).

that the fiduciary obligation is a crude substitute for active monitoring. However, trust law's fiduciary obligation is something of a substitute for monitoring chiefly with respect to the prophylactic rules of the duty of loyalty. On the question of prudence, beneficiaries (or their agents) should indeed be able to comprehend disclosure by the trustees. As will be discussed in greater detail below, the trust portfolio's level of diversification and its overall risk/return tradeoff can be assessed and then evaluated for prudence.[86]

Corporate disclosure, however, touches not only the efficacy of monitoring by shareholders, but also the paradox of capital market efficiency that motivated Gilson and Kraakman's inquiry in the first place.[87] The form and nature of disclosure by corporate managers manifestly impacts the form and nature of the rivalrous competition for information that pushes toward market efficiency. Thus, even Frank Easterbrook and Daniel Fischel concede that there are some good grounds for routinized mandatory disclosure.[88] Market checks and direct monitoring by the interested parties might be rough substitutes. But this is an area in which the necessary predicate of both appear to collide.

Accordingly, those weary of the ECMH have two (albeit related) defenses for mandatory disclosure in corporate law. One is the usual argument, which again parallels the trust law model, that increased disclosure improves the ability of the residual claimants to monitor management. The other, however, goes to the core of the ECMH and the mechanisms of market efficiency. If rivalrous competition for information does not in fact cause the market to act as if all publicly-available information was immediately available to all, then that is a reason for rules designed to ensure that information is promptly and widely disseminated.

E. Litigation Incentives[89]

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 effectively support. The greater the number, the more serious the collective action dynamic that will weaken the incentive to monitor and then to bring litigation.[90] Thus, a further lesson of the comparison of the donative trust with the publicly-traded corporation is that efficient capital markets—and the mechanisms that make them efficient—are crucial to the vast number of residual claimants who are effectively aggregated by the latter.[91]

Consider that the paradigmatic shareholder of a publicly-traded corporation has only a trivial stake in the company, so he or she has little incentive to reckon the costs and benefits of litigation from the perspective of all the shareholders. Indeed, he or she has little incentive to monitor management when instead he or she can free-ride on the mar-

86. *See infra* Part IV.A.

87. Gilson & Kraakman, *supra* note 8.

88. Easterbrook & Fischel, *MD*, *supra* note 28, at 696-707. For further discussion and references, see sources cited *supra* note 28.

89. This subpart draws on Sitkoff, *supra* note 2, at Part IV.D.

90. *See* Gordon, *supra* note 48, at 76-78 (discussing beneficiary free-riding).

91. Similar reasoning helps explain concerns about the governance of charitable trusts, for which the beneficiaries are by definition diffuse. *See generally* Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227; Ronald Chester, *Grantor Standing to Enforce Charitable Transfers Under Section 405(C) of the Uniform Trust Code and Related Law: How Important is it and How Extensive Should it be?*, 37 REAL PROP. PROB. & TR. J. 611 (2003).

ket. Consequently, in corporate fiduciary litigation the real party in interest is often the lawyer.[92]

Litigation incentives are different in the world of donative trusts, however, thanks to the (typically) smaller number of residual claimants. Beneficiaries are likely to have a nontrivial stake when measured either by the fraction of his or her wealth held in the trust or the fractional share of the trust to which he or she is entitled. So fiduciary litigation in trust law is more likely than in corporate law to be prompted by the merits. The relatively smaller number of residual claimants and their relatively larger stakes lessens the impact of the collective action and free-rider dynamics that would otherwise imperil the effectiveness of the fiduciary obligation as a check on trustees.[93]

Of course, litigation incentives for trust beneficiaries are not perfect. Some beneficiaries lack a sufficient stake to reckon the costs and benefits of bringing litigation,[94] and awards of attorneys' fees out of the trust corpus to one or both sides in suits over trust administration are not uncommon.[95] Still, the more modest claim holds. In general, trust beneficiaries have better incentives regarding litigation than do the shareholders of publicly-traded corporations. This helps explain why trust law contractarians, such as John Langbein, believe that fiduciary litigation has evolved into an effective check on trustees, but corporate law contractarians, such as Frank Easterbrook and Daniel Fischel, believe that corporate fiduciary litigation is often not worthwhile.[96]

Again there is correlation between the trust law model and the views of scholars who have doubts about the ECMH. With Berle and Means being perhaps the best example, those who are most worried about the shareholder/manager agency problem specifically identify diffuse shareholders as an impediment to effective monitoring by the enterprise's "owners."[97] This leads to a different reckoning of the agency costs balance between plaintiffs lawyers and the residual claimants on the one hand, and managers and

92. *See* EASTERBROOK & FISCHEL, ES, *supra* note 7, at 100-02; BAINBRIDGE, *supra* note 34, § 8.3, at 367; ALLEN & KRAAKMAN, *supra* note 44, § 10.2, at 351-52, 355-57; *see generally* John C. Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986).

93. It will therefore be interesting to see whether the ongoing relaxation of the rule against perpetuities, on which see Note, *Dynasty Trusts and the Rule Against Perpetuities*, 116 HARV. L. REV. 2588 (2003); Stewart E. Sterk, *Jurisdictional Competition to Abolish the Rule Against Perpetuities: R.I.P. for the R.A.P.*, 24 CARDOZO L. REV. 2097 (2003); Joel C. Dobris, *The Death of the Rule Against Perpetuities, or the RAP Has No Friends: An Essay*, 35 REAL PROP. PROB. & TR. J. 601 (2000); Angela M. Vallario, *Death By A Thousand Cuts: The Rule Against Perpetuities*, 25 J. LEGIS. 141 (1999), and the consequent increase in the number of beneficiaries in donative trusts will eventually push trust law towards more of a corporate governance model. *See* Dukeminier & Krier, *supra* note 54, at 1339; *cf.* Macey, *supra* note 2, at 319 (noting that in private trust governance there is often "a clear residual claimant with strong incentives to monitor the trustee's performance").

94. *See* Gordon, *supra* note 48, at 76-78.

95. *See, e.g.*, UTC § 1004 (court may award fees); 3 SCOTT ON TRUSTS, *supra* note 2, § 188.4 (discussing trustees' authority to pay fees out of the trust corpus); Gordon, *supra* note 48, at 76-77 n.103 (discussing the rules and collecting authority).

96. *Compare* Langbein, *supra* note 4, at 640-43 (trust law), *and* Sitkoff, *supra* note 2, at Part IV.D (trust law), *with* EASTERBROOK & FISCHEL, ES, *supra* note 7, at 100-102 (corporate law), Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55 (1991) (corporate law), *and* Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261 (1986) (corporate law).

97. BERLE & MEANS, *supra* note 1.

the residual claimants on the other.[98] And that, in turn, leads to a more charitable view of shareholder litigation.

F. Summary and Extensions

Both the private donative trust and the publicly-traded corporation separate risk-bearing and management. But the agency costs calculus relevant to the governance of each are different. As we have seen, their differing orientations towards capital markets, when coupled to trust law's solicitousness of the preferences of the settlor, reduces the viability of market-based governance devices in trust law. Comparing corporate and trust governance therefore helps illuminate the importance of efficient markets, and the mechanisms that make them efficient, for corporate law.

Adding rows for incentive-based compensation[99] and reputation transmission,[100] both of which are commonly mentioned in the literature of corporate governance as potential checks on agency costs, the following matrix (Figure 2) summarizes the discussion of this section.

98. *See* Thompson & Thomas, *supra* note 27; *see also* Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733 (1994); Coffee, *supra* note 92; John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5 (1985); ALLEN & KRAAKMAN, *supra* note 44, § 10.2, at 355-57. Similarly, arguments in favor of shareholder activism often center on the potential for institutional investors who own large blocks of shares—and so perhaps have better incentives—to serve as effective monitors and lead class action litigants. This is reflected in both modern securities litigation reform, *see, e.g.*, THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 7.17, at 397 (4th ed. 2002), and the literature of shareholder activism more generally, *see, e.g.*, Black, *supra* note 85; MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994); Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174 (2001) [hereinafter Romano, *Less is More*]; Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J.L. & PUB. POL'Y 671 (1995); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993); BAINBRIDGE, *supra* note 34, § 10.7, at 514-17.

99. Commissions are often set by the trust instrument or by statute at a fixed percentage of the trust's corpus. *See, e.g.*, N.Y. Surr. Ct. Proc. Act § 2309; Langbein, *Contractarian*, *supra* note 7, at 639, 651. There is, however, an emerging trend, supported by academics, towards a "reasonableness" standard. *See, e.g.*, Halbach, *Trends*, *supra* note 84; CAL. PROB. CODE § 15681 (2003); UTC § 708; RESTATEMENT (THIRD) OF TRUSTS § 38 (2003); *see generally* VOLLMAR ET AL., *supra* note 85, at 1059-60. Compensation for corporate managers resists easy classification because it varies across companies and even within companies across time. It is a fair generalization, however, to say that corporate managerial compensation purports more closely to attempt to align the interests of the managers with the interests of the residual claimants. Whether these efforts have in practice been successful is unsettled. *See, e.g.*, Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002); Tod Perry & Marc Zenner, *CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?*, 35 WAKE FOREST L. REV. 123 (2000).

100. Although professional fiduciaries have reputations that are known to drafters (who then steer clients accordingly), reputational information is more robust in the context of publicly-traded corporations. The performance of donative trusts, and hence the performance of the trustees' investment decisions, are not subject to a public disclosure regime.

Figure 2

	Donative Trust	**Public Corporation**
Capital Market Orientation	*seller*	*buyer*
Managerial Function	*prudently invest*	*maximize value of operating assets*
Residual Claimants' Structural Attitude Toward Risk	*risk-averse (poor diversification)*	*risk-neutral (well-diversified)*
Number of Residual Claimants	*fewer*	*greater*
Managers' Structural Attitude Toward Risk	*risk-neutral or less risk-averse (possibly diversified)*	*risk-averse (poor diversification)*
Legal Institutional Response	*harder fiduciary obligation*	*softer fiduciary obligation*
Norms Response/Selection Effect	*cautious managers*	*risk-taking managers*
Incentive Compensation	*often fixed*	*variable*
Reputation Transmission	*low*	*high*

IV. MARKET PRICES AND EMPIRICAL ANALYSIS

To say that the donative trust is something of a counterfactual for what the public corporation might have looked like in the absence of efficient capital markets is not to say that the ECMH has no relevance to trust law. Because the private donative trust is a seller in modern capital markets, the ECMH and the antecedent work of Harry Markowitz on portfolio selection are indeed quite relevant.[101] In fact, since Gilson and Kraakman's observation twenty years ago that the ECMH was then permeating the academic literature on trust-investment law,[102] modern finance theory has today been assimilated into the law itself. Perhaps the clearest indication of this assimilation is that the 1994 Uniform Prudent Investor Act, which fully embraces modern portfolio theory and the ECMH,[103]

101. *See generally*, Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952); HARRY M. MARKOWITZ, PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENTS (1959); *see also* WILLIAM F. SHARPE, PORTFOLIO THEORY AND CAPITAL MARKETS (1970).

102. Gilson & Kraakman, *supra* note 8, at 549 n.1. *See, e.g.*, Harvey E. Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine*, 76 COLUM. L. REV. 721 (1976). Influential early applications to trust-investment law include John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law*, 1976 AM. B. FOUND. RES. J. 1; John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law: II*, 1977 AM. B. FOUND. RES. J. 1; BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE (1986).

103. *See* UNIF. PRUDENT INVESTOR ACT (1994); John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 665-66 (1996); *see also* Edward C. Halbach, Jr., *Trust Investment Law in the Third Restatement*, 27 REAL PROP. PROB. & TR. J. 407 (1992) [hereinafter Halbach, *TIL*]; John H. Langbein, *The New American Trust-Investment Act*, 8 TR. L. INT'L 123 (1994); REVISED UNIF. PRINCIPAL AND INCOME ACT (1997); Joel C. Dobris, *Changes in the Role and the Form of the Trust at the New Millennium, or, We Don't Have to Think of England Anymore*, 62 ALB. L. REV. 543, 567-71 (1998); Joel C. Dobris, *New Forms of Private Trusts for the Twenty-First Century—Principal and Income*, 31 REAL PROP. PROB. & TR. J. 1 (1996).

has been adopted in at least 40 states and the District of Columbia.[104]

Given the empirical precision that market data has provided for the law and study of public corporations (on the buy-side), the question for this section is whether such data might hold similar potential for the law and study of private donative trusts (on the sell-side). In particular, the focus here will be on the use of market data for damages calculations and for empirical scholarship. As we shall see, the potential for empirical analysis is another margin on which the buy-/sell-side dichotomy has explanatory traction.

A. Calculation of Damages

The notion that market prices might facilitate the reckoning of damages in corporate and securities litigation abounds in both the law and the literature. Consider, for example, the market exception to corporate law's appraisal remedy and the use of abnormal returns to show the effect of (allegedly) fraudulent statements in securities litigation.[105] Of course, the appropriateness of recourse to market data in these contexts boils down to the question of whether market prices are reliable, meaning at least relative price efficiency. Though on this issue there is ongoing debate,[106] for present purposes it is enough to note that the ready availability of market data offers the potential for simplified and more accurate damages analyses in corporate and securities litigation.

So what of damages in trust law? Because the core managerial function of trustees is prudently to invest the trust's assets (i.e., to sell capital), market data might be useful for ascertaining *both* breach *and* damages in surcharge actions for imprudence—breach and damages being separate, albeit related, questions.

On the question of breach, which is the initial question in these cases, it is now well understood that trustees are no longer constrained by antiquated notions of speculation and court-approved lists of appropriate investments.[107] Going forward, this idea in practice should involve assessing the tightness of fit between the portfolio's design and the risk-tolerance of the trust's beneficiaries.[108]

On the question of remedy, which arises only after the fact of a breach has been

104. *See* The National Conference of Commissioners on Uniform State Laws, *A Few Facts About the Uniform Prudent Investor Act*, *at* http://www.nccusl.org/nccusl/uniformact_factsheets/uniformacts-fs-upria.asp (last visited Sept. 3, 2003); *see also* Lyman W. Welch, *Brave New World of Total Return Laws*, TR. & EST., June 2002, at 24 (June 2002) (examining the differences between the states' total return legislation). England adopted similar rules in 2000. *See, e.g.*, PENELOPE REED & RICHARD WILSON, THE TRUSTEE ACT 2000: A PRACTICAL GUIDE (2001).

105. *See generally* William T. Allen, *Thoughts on Price and Value in U.S. Securities Markets*, 28 J. CORP. L. __(2003); Daniel R. Fischel, *Market Evidence in Corporate Law*, 69 U. CHI. L. REV. 941, 961 (2002); Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1 (1995); EASTERBROOK & FISCHEL, ES, *supra* note 7, at 145-61; Hideki Kanda & Saul Levmore, *The Appraisal Remedy and the Goals of Corporate Law*, 32 UCLA L. REV. 429 (1985); Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1 (1982).

106. For discussion and references, see sources cited in *supra* note 9.

107. *See* sources cited *supra* note 103. *See also* Joel C. Dobris, Speculations on the Idea of "Speculation" in Trust Investing: An Essay (2003) (unpublished manuscript, on file with The Journal of Corporation Law).

108. For discussion of relevant considerations, see RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 cmt. k (1992). *Cf.* MACEY, *supra* note 8, at 80-84 (discussing econometric techniques for evaluating portfolio risk and return). The temporal perspective is the time at which the decision was or should have been made. *See* RESTATEMENT (THIRD) OF TRUSTS: PRUDENTIAL INVESTOR RULE § 227 cmt. b (1992).

shown, so-called "total return damages" is what the future holds. This means the use of historical data to model how a proper portfolio would have performed and then a comparison of this hypothetical against the actual portfolio's performance. As Edward Halbach explained with reference to the Restatement (Third) of Trusts (with which the 1994 Uniform Prudent Investor Act is consistent):

> Unlike traditional policy, the Restatement Third generally measures a trustee's liability for improper investment conduct by reference to total return, positive or negative. Thus, in most situations, the new restatement allows the recovery through surcharge actions to be increased or decreased to reflect the gains and losses in value that reasonably should have been expected from an appropriate investment program. A major objective of the new rule is to assure that trustees who have ignored important aspects of their fiduciary obligations by employing inadequate investment strategies will not be insulated from liability merely because their investment programs escaped loss of dollar value during periods of significantly rising markets, from which their trust estates should have but did not benefit.[109]

Market data, in other words, offers the potential for more closely aligning awards of damages for imprudence with the underlying remedial aim of traditional doctrine, which resembles that of the familiar expectations measure from contract law,[110] of putting the beneficiaries in the position that they would have been in but for the trustee's imprudence (the "make-whole" standard).[111] Make-whole has long been the standard for relief in trust law;[112] what the market-based approach to total return damages sketched here adds is a means more accurately to "restore the values of the trust estate and trust distributions to what they would have been if the trust had been properly administered."[113]

In opposition it is sometimes suggested that the market-based, total return approach is too speculative or too difficult for courts to administer.[114] The recent and influential

109. Halbach, *TIL*, *supra* note 103, at 458-59*; see also* RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE Reporter's Notes to §§ 205, 208-11 (1992).

110. *See, e.g.*, E. ALLAN FARNSWORTH, CONTRACTS §§ 12.1, 12.8 (3d ed. 1999).

111. *See* RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 205 (1992); UTC § 1002(a)(1); *see also* GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 701, at 198 (rev. 2d ed. 1982); Halbach, *TIL*, *supra* note 103, at 460.

112. *See, e.g.*, RESTATEMENT (SECOND) OF TRUSTS § 205 cmt. a (1959) (explaining that the beneficiary may pursue "a remedy which will put him in the position in which he would have been if the trustee had not committed the breach of trust"); 3 SCOTT ON TRUSTS, *supra* note 2, § 205, at 237 ("The beneficiaries are entitled to be put in the position that they would have occupied if no breach of trust had been committed."); sources cited *supra* note 111; *see generally* John H. Langbein, *What ERISA Means by "Equitable": The Supreme Court's Trail of Error in* Russell, Mertens, *and* Great-West, 103 COLUM. L. REV. (forthcoming 2003) (discussing trust law's make-whole standard in the context of its application to ERISA litigation).

113. RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 205 (1992).

114. *See, e.g.*, Williams v. J.P. Morgan & Co. Inc., 248 F. Supp. 3d 320, 332-33 (S.D.N.Y. 2003) (rejecting as "speculative" a damages measure based on "hypothetically" invested assets); Williams v. J.P. Morgan & Co., Inc., 199 F. Supp. 2d 189, 193-95 (S.D.N.Y. 2002) (same); Matter of Kellog's Trust, 230 N.Y.S.2d 836, 847-48 (N.Y. Sup. Ct. 1962); Halbach, *TIL*, *supra* note 103, at 459-60 (collecting illustrative authority); C. Boone Schwartzel, *Is the Prudent Investor Rule Good for Texas?*, 54 BAYLOR L. REV. 701, 813-814 (2002); *see also* RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE Reporter's Notes to §§ 205, 208-11 (1992); *cf.* Richard V. Wellman, *Punitive Surcharges Against Disloyal Fiduciaries—Is* Rothko *Right?*, 77 MICH. L. REV. 95 (1978) (arguing against instituting "appreciation damages").

decision of the New York Court of Appeals in *Estate of Janes* is illustrative.[115] Even though the court embraced a portfolio theory mode of analysis on the question of breach,[116] it nonetheless rejected a total return measure of damages in favor of "capital lost" plus interest at the discretion of the trial court.[117] The logic behind the court's reasoning is obscure. A total return measure would hardly have been speculative or difficult to calculate. Indeed, total return damages would have been both simpler and more consistent with the make-whole standard than "capital lost" plus discretionary interest.

The more general point is that the evolution of modern finance theory and the abundance of easily accessible market data should make the process of calculating total return damages straightforward. All that will be required in the typical case is a backward looking comparison of the trust's actual performance with that of a prudent hypothetical portfolio, one that would have satisfied the initial breach analysis.[118] Hence, in most cases there will likely be little need to trundle out the high-powered tools of modern financial economics.

True, there will be some uncertainty if more than one hypothetical portfolio would have been prudent. But this residual uncertainty is the fault of the trustee who opted for an imprudent portfolio design in the face of by hypothesis multiple prudent alternatives. And it is a venerable principle of the law of remedies that "reasonable doubts as to remedy ought to be resolved against the wrongdoer."[119] Here the "wrongdoer" is the trustee who has been shown to have crafted an imprudent portfolio and hence to have caused the uncertainty in the first place.

The courts' experience with market-based measures of making beneficiaries whole in pension litigation, upon which ERISA imposes a trust law paradigm,[120] is instructive.

115. 681 N.E.2d 332 (N.Y. 1997). *See* JOEL C. DOBRIS ET AL., ESTATES AND TRUSTS 1061-68 (2d ed. 2003); LAWRENCE W. WAGGONER ET AL., FAMILY PROPERTY LAW 1334-45 (3d ed. 2002); ROGER W. ANDERSEN & IRA MARK BLOOM, FUNDAMENTALS OF TRUSTS AND ESTATES 521-26, 580-81 (2d ed. 2002); ELIAS CLARK ET AL., GRATUITOUS TRANSFERS 691-99 (4th ed. 1999); *see also* EUGENE F. SCOLES ET AL., DECEDENTS' ESTATES AND TRUSTS 902, 971 (6th ed. 2000).

116. *Janes*, 681 N.E.2d at 335-39. For discussion of this point, see Martin D. Begleiter, *Does the Prudent Investor Need the Prudent Investor Act—An Empirical Study of Trust Investment Practices*, 51 ME. L. REV. 28, 70-71 (1999).

117. *Janes*, 681 N.E.2d at 339-40 (rejecting a "lost profits" measure of damages). Because it was decided under the prudent investor standards in existence before the new Uniform Act and Restatement Third, *see id*. at 336 n.*, there is hope that the opinion's approach to damages will not be followed in cases that will be decided under the modern law of trust investment. In New York this would be "investments 'made or held' by a trustee on or after January 1, 1995." *Id.*

118. *See supra* note 108 and accompanying text. Such a portfolio might, but need not, correspond to a well-known index. *See* MACEY, *supra* note 8, at 82; *see also* Dominic J. Campisi & Patrick J. Collins, *Index Returns As A Measure of Damages in Fiduciary Surcharge Cases*, TR. &. EST., June 2001, at 18; Halbach, *TIL*, *supra* note 103, at 461.

119. Jones Motor Co. v. Holtkamp, Liese, Beckemeier & Childress, P.C., 197 F.3d 1190, 1194 (7th Cir. 1999); *see, e.g.*, Story Parchment Co. v. Paterson Parchment Paper Co., 282 U.S. 555, 563 (1931) ("The wrongdoer is not entitled to complain that [damages] cannot be measured with the exactness and precision that would be possible if the case, which he alone is responsible for making, were otherwise."); U.S. Naval Inst. v. Charter Communications, Inc., 936 F.2d 692, 697 (2d Cir. 1991) (same point); *see also* Armory v. Delamirie, 1 Strange 504, 93 Eng. Rep. 664 (K.B. 1722).

120. *See* ERISA § 403, 29 U.S.C. § 1103; Langbein, *supra* note 112, at Part I.A-B; JOHN H. LANGBEIN & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 646-48 (3d ed. 2000).

As the leading case of *Donovan v. Bierwirth*[121] explained, when restoring "the trust beneficiaries to the position they would have occupied but for the breach of trust," the trial court

> should presume that the funds would have been treated like other funds being invested during the same period in proper transactions. Where several alternative investment strategies were equally plausible, the court should presume that the funds would have been used in the most profitable of these. The burden of proving that the funds would have earned less than that amount is on the fiduciaries found to be in breach of their duty. Any doubt or ambiguity should be resolved against them.[122]

Once a prudent hypothetical portfolio has been selected, there is nothing speculative or impractical in the calculation of how it would have performed over a past period. One need only collect the historical data, weight the performance of each constituent asset in accordance with its relation to the composition of the hypothetical portfolio as a whole, and then adjust for taxes and other expenses that would have been incurred. In this sense the analogy to expectation damages in contract law is arresting. There, too, damages must be proved with reasonable certainty.[123] And there, too, modern financial sophistication has rendered what might formerly have been speculative or impractical now routine.[124]

B. Empirical Scholarship

In trying to get a handle on the agency costs load borne by the beneficiaries of donative trusts, one is struck by the unempirical (which is not to say unhelpful) way in which trust scholarship proceeds. Existing commentary is for the most part theoretical.[125] Thus, if one wants to know if fiduciary litigation works; or if one wants to know the welfare effects of midstream modifications to the deal; or if one wants to know the welfare consequences of jurisdictional competition, then one's inquiry will likely be anecdotal, quali-

121. 754 F.2d 1049 (2d Cir. 1985).

122. *Id*. at 1056-57. The court continued, this "is nothing more than application of the principle that, once a breach of trust is established, uncertainties in fixing damages will be resolved against the wrongdoer." *Id.* Additional illustrative cases involving both ERISA plans and traditional private trusts are collected at Halbach, *TIL*, *supra* note 103, at 461-62; RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE Reporter's Notes to §§ 205, 208-11 (1992).

123. *See* FARNSWORTH, *supra* note 110, § 12.15, at 830; RESTATEMENT (SECOND) OF CONTRACTS § 352 (1981); Ashland Mgmt. Inc. v. Janien, 624 N.E.2d 1007 (N.Y. 1993).

124. A recent example is *Mindgames, Inc. v. W. Publ'g Co., Inc.*, 218 F.3d 652 (7th Cir. 2000). In rejecting the so-called "new business rule" in favor of the ordinary "reasonable certainty" test, Chief Judge Posner explained:

> The rule may have made sense at one time; the reduction in decision costs and uncertainty brought about by avoiding a speculative mire may have swamped the increased social costs resulting from the systematically inadequate damages that a "new business" rule decrees. But today the courts have become sufficiently sophisticated in analyzing lost-earnings claims, and have accumulated sufficient precedent on the standard of undue speculativeness in damages awards, to make the balance of costs and benefits tip against the rule.

Id. at 658; *see also* FARNSWORTH, *supra* note 110, § 12.15, at 833-34; RESTATEMENT (SECOND) OF CONTRACTS § 352 cmt. b (1981) (noting the appropriateness of expert testimony and economic and financial data).

125. A nice example is my own. *See* Sitkoff, *supra* note 2.

tative, comparative (American and English trust law have nontrivial differences), and hopefully in the future more rigorously empirical in a sociologist's sense—surveys and data sets built with proper sampling techniques.[126] Given the absence of price feedback in trust governance, this may be the best for which we can hope.

Contrast this limited aspiration with the highly empirical trend in the modern literature of corporate law.[127] Is fiduciary litigation and the derivative suit any good? Empirical studies are too numerous to count.[128] Is jurisdictional competition and Delaware's hegemony good or bad? Empirical analyses abound.[129] These theoretical questions have analogues in the study of trust law, but as yet they have not been studied in a rigorously empirical way. The chief explanation is that empirical work in the corporate context is simplified by the abundance of readily available market data and the assumption of relative price efficiency. Together, these factors make it feasible rigorously to test theoretical predictions.

This is not to say that corporate empiricism is easy. Rather it is to say that, if one accepts that the mechanisms of market efficiency are working at least well enough so that prices are efficient in a relative sense, then one has a means to rapid and sharp analysis of important policy questions—the market's price feedback.

V. CONCLUSION

In order to assess the importance of understanding the mechanisms of market efficiency—and hence to revisit the contribution of Gilson and Kraakman's *The Mechanisms of Market Efficiency*[130]—this essay looked to the law of private donative trusts for inspiration about what the law and study of public corporations might look like without efficient capital markets. The donative trust supplies something of a control for such a thought experiment, because it matches the relevant characteristics of the public corporation, chiefly the separation of risk-bearing and management. Only it separates risk-bearing and management toward an opposite end in the capital markets (it is a seller, not a buyer), and it does so without an effective exit option for its residual claimants. Among

126. *See, e.g.*, Begleiter, *supra* note 116, at 72-85 (surveying corporate trustees to evaluate the impact of trust-investment law reform); Gordon, *supra* note 48, at 76 n.99 (collecting survey-based studies); *see also* JACKSON ET AL., *supra* note 8, at 503-07 (discussing the utility of survey data). For discussion of the assimilation of interdisciplinary and empirical approaches into legal scholarship, see Shari Seidman Diamond, *Empirical Marine Life in Legal Waters: Clams, Dolphins, and Plankton*, 2002 U. ILL. L. REV. 803.

127. *See, e.g.*, Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part I: Technique and Corporate Litigation*, 4 AM. L. & ECON. REV. 141 (2002); Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part II: Empirical Studies of Corporate Law*, 4 AM. L. & ECON. REV. 380 (2002). Even today's theoretical work makes use of the empirical analyses of others. My prior work again supplies an example. *See* Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 U. CHI. L. REV. 1103, 1141, 1150-51 (2002) (referring to empirical studies in support of a theoretical argument).

128. *See, e.g.*, Romano, *Less is More*, *supra* note 98; Thompson & Thomas, *supra* note 27; *see also* Fischel & Bradley, *supra* note 96.

129. *See, e.g*., Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. (forthcoming 2004); Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775 (2002); Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985).

130. Gilson & Kraakman, *supra* note 8.

other things, this approach reveals a correlation between the trust law model and the views of corporate law scholars who doubt the ECMH and its implications for corporate governance. The essay also discussed the use of market data for assessing breach and damages in corporate and trust litigation and for empirical evaluation of theoretical scholarly analysis in both fields. More generally, comparison of the governance of the public corporation and the private donative trust brings into view the importance of relative price efficiency for the modern approach to corporate governance.