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Trusting Trustees: Fiduciary Duties and the Limits of Default Rules

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Trusting Trustees: Fiduciary Duties and the Limits of Default Rules

MELANIE B. LESLIE*

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INTRODUCTION

Over the next ten to fifteen years, Americans will transfer as much as \$12 trillion dollars to their descendants.¹ The trust mechanism has assumed a central role in the transfer of intergenerational wealth and is now a staple in most estate plans. The legal term “trust” evokes images of well-managed assets to be used fruitfully into the future, with generous but firm support from dependable managers and strategists. At the center of this image is the notion of trust itself. The settlor seeks a capable and conscientious individual or institution—an individual or institution that she trusts—to ensure the steady growth and continued availability of significant sums of money.² And it is this image that leads many, both affluent and not, to seek out money managers to create trusts for loved ones. Nonetheless, evolving legal doctrine threatens to undermine the image of the trust based on trust.

In steadily increasing numbers, trust scholars are embracing the view that fiduciary duties are mere default rules, freely waivable by the parties to the trust document. This view parallels the default rule model developed in corporate law by Frank Easterbrook and Daniel Fischel, who have argued that fiduciary duties are “contract” terms that shareholders and management would have agreed to had they anticipated agency cost problems.³ Management, they argue, should be free to modify—or even eliminate—fiduciary duties in the corporate charter.⁴

This argument—the subject of vigorous debate amongst corporate scholars⁵—

1. V. Gerard Comizio & Jeffrey L. Hare, *Regulatory Developments for Banks and Thrifts Conducting Trust and Fiduciary Activities*, 59 BUS. LAW. 1299, 1299 (2004).

2. The trust divides legal and beneficial title, granting a trustee legal title of the trust assets with instructions to manage the assets for the benefit not of the trustee itself, but for the beneficiaries. JOEL C. DOBRIS, STEWART E. STERK & MELANIE B. LESLIE, *ESTATES AND TRUSTS* 473 (2d ed. 2003).

3. Judge Frank Easterbrook and Professor Daniel Fischel have argued that fiduciary duties are the terms that parties would have chosen to govern the agency relationship if they had thought to bargain to reduce agency costs. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 8–10, 91–93 (1991). For an application of agency costs theory to trust, see Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621 (2004).

4. See EASTERBROOK & FISCHEL, *supra* note 3, at 90–108; Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 427 (1993) [hereinafter Easterbrook & Fischel, *Contract and Fiduciary Duty*] (stating that “[f]iduciary duties are not special duties . . . [a]ctual contracts always prevail over implied ones”).

5. Not all corporate scholars accept the default rule model of fiduciary duties. See, e.g., Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879 (arguing that fiduciary duties have a mandatory core); Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211 (1995) [hereinafter Eisenberg, *Limits of Cognition*] (arguing

has its parallel in trust scholarship. Most notably, John Langbein, drawing on the work of Frederic W. Maitland⁶ and corporate law scholarship,⁷ argues that trustees' fiduciary duties are default rules, generally modifiable by the parties to the trust document.⁸ Henry Hansmann and Ugo Mattei also readily accept the characterization of trustees' fiduciary duties as freely waivable default terms.⁹ The default rule paradigm has increasingly influenced doctrine and permeates the recently promulgated Uniform Trust Code ("UTC").¹⁰

Of course, parties to a trust instrument may, to a considerable extent, tailor a trustee's fiduciary duties to facilitate the settlor's objectives. But it is a long leap from the proposition that fiduciary duties can be tailored to further individual objectives to the conclusion that fiduciary duties are merely gap-filling default rules, similar to those found in the Uniform Commercial Code's ("U.C.C.") Article Two.¹¹ As even default rule proponents recognize, trustees' fiduciary duties are not, and never have been, completely waivable. For example, no court would uphold a trust provision purporting to eliminate the trustee's duty of loyalty in its entirety. In addition, by statute or common law some states invalidate or sharply circumscribe parties' power to eviscerate the trustee's duty of care through a clause that exculpates the trustee from liability for ordinary or gross negligence.¹² These doctrinal rules are inconsistent with a pure default rule paradigm. If legislatures and courts regarded fiduciary duties as pure default rules, then both the duty of care and the duty of loyalty would be entirely optional, and courts would adjudicate trust disputes like other contract disputes: they simply would interpret and enforce contractual provisions, even if

that the limits of cognition justify the imposition of certain mandatory fiduciary duties); Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 *FORDHAM L. REV.* 437 (1993) [hereinafter Eisenberg, *Divergence of Standards*]; Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 *OR. L. REV.* 1209 (1995) [hereinafter Frankel, *Fiduciary Duties*].

6. See John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 *YALE L.J.* 625, 628, 634 (1995) (citing *FREDERIC W. MAITLAND, EQUITY: A COURSE OF LECTURES* (1909)).

7. See *infra* text accompanying notes 44–45.

8. See, e.g., Langbein, *supra* note 6, at 629 (stating that "fiduciary duties in trust law are unambiguously contractarian"); *id.* at 659 (stating that "the duty of loyalty is default law that yields to contrary terms of the trust deal"); Sitkoff, *supra* note 3, at 678 (characterizing as "persuasive" Langbein's conclusion that "fiduciary duties imposed by the law of trusts are simply majoritarian default rules").

9. See Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 *N.Y.U. L. REV.* 434, 447–49 (1998) (characterizing rules that govern the settlor-beneficiary-trustee relationship as a set of default terms, and emphasizing that fiduciary duties in particular are merely default terms).

10. The Uniform Trust Code of 2000 (hereinafter "UTC") has been enacted in Kansas (2002), Wyoming (2003), Nebraska (2003), New Mexico (2003), the District of Columbia (2004), Utah (2004), Maine (2004), Tennessee (2004), New Hampshire (2004), and Missouri (2004). Arizona enacted the UTC in 2003 but quickly repealed it in 2004. Twenty other states are currently considering legislation. Cf. *Five Jurisdictions Enact UTC, One Repeals*, UTC NOTES (Nat'l Conference of Comm'rs on Unif. State Laws), Summer 2004, at 1, http://www.nccusl.org/nccusl/newsletters/UTCNotes/UTCNotes_Jul04_print.pdf.

11. See Easterbrook & Fischel, *Contract and Fiduciary Duty*, *supra* note 4, at 427 (stating that "[f]iduciary duties are not special duties. . . . [a]ctual contracts always prevail over implied ones").

12. See *infra* text accompanying notes 161–88.

those provisions waived all fiduciary protections entirely. Scholars have not offered an account that explains why trust law differs from contract law in this important respect. Moreover, even those scholars who subscribe to the default rule paradigm acknowledge that there are—and should be—a few limits on parties' ability to waive fiduciary duties.¹³ But they have not offered a coherent theory to explain that conclusion, or for determining what those limits should be.

This Article argues that characterizing trustees' fiduciary duties as pure "default rules" too easily equates trusts with contracts and blinds academics and courts to the need to develop a coherent theory about the extent to which fiduciary duties can be modified. Any such theory must take into account the trust mechanism's unique characteristics. Transplanting Easterbrook and Fischel's thesis to the trust context is problematic, because market forces, which (arguably) act to discipline corporate fiduciaries, impose no significant constraints on trustees. Information asymmetries between trust settlors and professional trustees make it unlikely that certain types of express waivers incorporated in trust documents reflect a settlor's judgment that the provision would be value-maximizing.¹⁴

Finally, labeling fiduciary duties "default rules" threatens to strip fiduciary rules of their moral content. Fiduciary duties are most effective when they function both as legal rules and moral norms. A label that equates the duty of loyalty with, say, a U.C.C. provision allocating risk of loss undermines the duty's normative force. The erosion of the social norm may create significant external costs for all future settlors and beneficiaries, in two respects.¹⁵ First, destigmatizing opportunist behavior may encourage trustees to stretch the boundaries of acceptable conduct. Second, erosion of the norm will create uncertainty about the content of the fiduciary standard, which will increase transaction costs for all settlors.

These deficiencies in the default rule model are critical, because default-rule rhetoric has already influenced the positive law, and now is poised to affect a quiet revolution in trust law, most notably with respect to the duty of loyalty.

13. In trust law, Langbein acknowledges that there are, and should be, outer limits on the extent to which a trust document may dispense with fiduciary duties. See John H. Langbein, *Mandatory Rules in the Law of Trusts*, 98 NW. U. L. REV. 1105, 1111–17, 1121–25 (2004). He acknowledges the need for a narrow mandatory regime to deal with potential trustee fraud, *id.* at 1124–25, and suggests that policies against perpetuating inefficient dead-hand control might justify a court's refusal to enforce a settlor's directive to concentrate trust investments in only one asset (a waiver of the duty to diversify). *Id.* at 1111–17. He also suggests that concern for effectuation of the settlors' intent justifies Uniform Trust Code provisions that do not allow a settlor to waive the trustee's duty to act in good faith, or to waive all of the trustee's fiduciary duties. *Id.* at 1121–25. In so concluding, Langbein posits that no informed settlor would agree to such extreme waivers. *Id.* at 1124. This Article builds upon this insight, picking up where Langbein leaves off to ask whether and to what extent information asymmetries might justify courts' treatment of other fiduciary duties as mandatory.

14. See *infra* text accompanying notes 87–102; 166–70.

15. See *infra* text accompanying notes 109–15.

First, the UTC, which is permeated with default rule rhetoric,¹⁶ authorizes exculpatory provisions that insulate trustees from liability for breach of the duty of care. Here, the UTC simply purports to reaffirm well-established law. And indeed, corporate trustees routinely insert exculpatory clauses into trust documents, and cases suggesting that exculpatory clauses are enforceable date from the turn of the twentieth century.¹⁷ Yet the statement that exculpatory clauses are freely enforceable is a misreading of the case law.¹⁸ Moreover, the comments to the UTC provide that an exculpatory provision is conclusively enforceable if the settlor was represented by counsel.¹⁹ This is an ill-advised departure from common law. Finally, several states have held firm to rules or statutes that prohibit institutional trustees from invoking exculpatory clauses to shield them from liability for negligence;²⁰ the UTC would change the law in those states.

Moreover, default rule rhetoric is beginning to erode the normative force of

16. For example, the Prefatory Note to the UTC states:

Default Rule: Most of the Uniform Trust Code consists of default rules that apply only if the terms of the trust fail to address or insufficiently cover a particular issue. Pursuant to Section 105, a drafter is free to override a substantial majority of the Code's provisions. The exceptions are scheduled in Section 105(b).

Paragraph 7 of the Prefatory Note states:

Article 7—Office of Trustee—This article contains a series of default rules dealing with the office of trustee, all of which may be modified in the terms of the trust.

The first sentence of The General Comment to Article I states:

The Uniform Trust Code is primarily a default statute. Most of the Code's provisions can be overridden in the terms of the trust. The provisions not subject to override are scheduled in Section 105(b).

Section 105, titled "Default and Mandatory Rules" states:

(a) Except as otherwise provided in the terms of the trust, this [Code] governs the duties and powers of a trustee, relations among trustees, and the rights and interests of a beneficiary.

UNIF. TRUST CODE (2000).

17. See, e.g., *Van Siclen v. Bartol*, 95 F. 793, 797–98 (E.D. Pa. 1899); *Warren v. Pazolt*, 89 N.E. 381, 388–89 (Mass. 1909).

18. See *infra* text accompanying notes 170–88.

19. See UNIF. TRUST CODE § 1008 (2000). The comments provide:

To overcome the presumption of abuse in subsection (b), the trustee must establish that the clause was fair and that its existence and contents were adequately communicated to the settlor. In determining whether the clause was fair, the court may wish to examine: (1) the extent of the prior relationship between the settlor and trustee; (2) whether the settlor received independent advice; (3) the sophistication of the settlor with respect to business and fiduciary matters; (4) the trustee's reasons for inserting the clause; and (5) the scope of the particular provision inserted. See Restatement (Second) of Trusts § 222 cmt. d (1959).

The requirements of subsection (b) are satisfied if the settlor was represented by independent counsel. If the settlor was represented by independent counsel, the settlor's attorney is considered the drafter of the instrument even if the attorney used the trustee's form. Because the settlor's attorney is an agent of the settlor, disclosure of an exculpatory term to the settlor's attorney is disclosure to the settlor.

UNIF. TRUST CODE § 1008 cmt. (2000) (emphasis added).

20. See *infra* text accompanying notes 171–82.

the duty of loyalty, and has opened the door to arguments that the duty of loyalty's default rules should be relaxed to benefit trustees. Consider the UTC's treatment of the duty of loyalty: one provision validates a troubling state legislative trend that permits trustees to engage in a limited class of profitable transactions without a settlor's knowledge or authorization,²¹ while another eliminates the centuries-old no-further-inquiry rule with respect to an entire category of formerly prohibited transactions.²²

And more is on the way. In a just-published article, John Langbein argues that the duty of loyalty's no-further-inquiry rule should be eliminated altogether and replaced with a standard that would allow trustees to profit from their positions as long as the transactions are in the trust's best interests.²³ This test, currently used in the corporate setting, would strike a fatal blow to the duty of loyalty as a moral norm, and would thus increase instances of trustee opportunism, at least at the margins.

This Article offers an analytical framework for limiting—but not eliminating—parties' power to modify fiduciary duties. It concludes that narrow, transaction-specific waivers are least likely to present asymmetrical information problems or norm erosion with its accompanying external effects, and that courts should generally enforce such narrow waivers. The analysis also shows that broad waivers, such as clauses that insulate institutional trustees from liability for breach of the duty of care or loyalty, are likely to implicate both information and externalities problems.

After Part I's brief examination of traditional trust theory, Part II chronicles the development of the default rule theory in corporate law, and explains why critical differences between the corporate and trust contexts (particularly the absence of markets for beneficial interests in trust and the asymmetry of information between the typical settlor and institutional trustee) mandate significant differences in the treatment of fiduciary duties. Part II also develops a normative framework for evaluating waivers of fiduciary duty, relying in large measure on the external benefits generated by maintaining a core of mandatory fiduciary duties. Part III applies these insights to the two most critical fiduciary duties—the duty of care and the duty of loyalty—and demonstrates that the traditional articulation of fiduciary duties in moral terms continues to serve an important social function, one that should not lightly be abandoned as mere “pulpit-thumping rhetoric.”²⁴

21. See UNIF. TRUST CODE § 802(f) (2000) and *infra* text accompanying notes 235–236.

22. See UNIF. TRUST CODE § 802(b)–(d) (2000).

23. John Langbein, *Questioning The Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929, 932 (2005). For a criticism of Langbein's proposal, see Melanie B. Leslie, *In Defense of the No Further Inquiry Rule: A Response to Professor Langbein*, 47 WM. & MARY L. REV. 541 (2005).

24. Langbein, *supra* note 6, at 629. Scholars who view fiduciary duties as freely waivable default rules insist, rather adamantly, that little significance should attach to courts' insistence on describing fiduciary duties in moral terms. They offer no compelling explanation for courts' insistent use of moralistic rhetoric and seem to explain away the phenomenon as a reflexive adherence to outdated language. See, e.g., *id.* at 629, 664–70 (urging courts to abandon their “pulpit-thumping” rhetoric);

I. TRUSTS AND FIDUCIARY DUTY: TRADITIONAL THEORY

Contract and trust law developed separately. Landowners arranged trust mechanisms (called "uses") as early as the thirteenth century.²⁵ Under these simple arrangements, landowners transferred title to "feoffees" with the understanding that the feoffee would later transfer the property to a beneficiary of the owner's choosing.²⁶ The landowner making the transfer trusted that the feoffee would not later turn disloyal and claim ownership of the property. Because uses were unenforceable at law, their effectiveness depended entirely on the trustee's behaving in a trustworthy manner.²⁷ As uses grew in popularity, disgruntled beneficiaries could not turn to the common-law courts for help when the feoffee proved faithless; rigid pleading requirements barred their claims,²⁸ and contract law, which required a written covenant as a basis for recovery and awarded only damages to the prevailing party,²⁹ proved useless. Beginning in the late fourteenth and early fifteenth centuries, beneficiaries increasingly turned for justice to the Chancellor,³⁰ who granted relief on the theory that he was "compelling the trustee to act upon the dictates of his conscience."³¹ In other words, the Chancellor's role was to force the trustee to abide by his pre-existing moral or ethical obligation. By mid-fifteenth century, the Chancellor routinely enforced uses.³²

Thus, the duty of loyalty developed as an equitable doctrine to support and enforce pre-existing moral norms. As the trust evolved from a device for holding real property to an asset-management mechanism, fiduciary duties became more complex.³³ Yet still, the trustee's pledge to place the beneficiaries' interests ahead of its own remained the essence of the relationship.³⁴ To honor

Easterbrook & Fischel, *Contract and Fiduciary Duty*, *supra* note 4, at 427 (stating that "[f]iduciary duties are not special duties; they have no moral footing" and that "[c]ourts may of course deny that fiduciary obligations are fundamentally contractual"). This Article argues that courts' characterization of trustee fiduciary duties as grounded in moral norms supports those pre-existing norms and thereby limits negative external effects that would result from the deterioration of those norms.

25. 1 AUSTIN WAKEMAN SCOTT, *THE LAW OF TRUSTS* § 1.3 (1939) [hereinafter SCOTT ON TRUSTS].

26. See R. H. Helmholz, *The Early Enforcement of Uses*, 79 COLUM. L. REV. 1503, 1503 (1979). Professor Scott cites Professor Maitland for the proposition that uses were first employed to benefit Franciscan friars, who were prohibited from owning property. See 1 SCOTT ON TRUSTS, *supra* note 25, § 1.3, at 11-12. Uses were also used to defeat creditor claims and taxes, and to avoid feudal incidences. *Id.* § 1.4, at 14-16.

27. See 1 SCOTT ON TRUSTS, *supra* note 25, § 1.3, at 12; Helmholz, *supra* note 26, at 1503. Helmholz questions why uses would increase in popularity despite the common-law courts' refusal to enforce them, and posits that ecclesiastical courts might have enforced uses in the years before courts of equity did. *Id.* at 1503-04.

28. 1 SCOTT ON TRUSTS, *supra* note 25, § 1.4, at 13.

29. See *id.* § 1.4, at 13; Langbein, *supra* note 6, at 634-35.

30. *Id.* § 1.4, at 13.

31. *Id.* § 1, at 5.

32. *Id.* § 1.4, at 13.

33. Langbein, *supra* note 6, at 637-38.

34. For example, Bogert defines a trust as "a fiduciary relationship," not as a relationship that may or may not have fiduciary characteristics depending upon the parties' preferences. See GEORGE T. BOGERT,

the “trust” that was the essence of the arrangement, fiduciary duties expanded to prohibit all forms of opportunistic behavior. From this, clear rules followed: trustees must use reasonable care, must abstain from self-dealing, and must not co-mingle funds.³⁵

Over the past one hundred years, scholars have clashed over whether the trust mechanism is grounded in property or contract law.³⁶ Although both camps acknowledged that settlors could authorize trustees to engage in particular acts that would otherwise be a breach of the trustee’s duty,³⁷ scholars differed on the significance of this fact. Those who viewed trusts as contracts emphasized that trust formation included voluntary bargaining³⁸ and cited settlors’ ability to modify trustee duties as evidence of their position.³⁹ Those in the “property” camp viewed fiduciary duties as the defining aspect of the trust,⁴⁰ and disapproved of trustees’ increasing attempts to waive or seriously modify essential duties.⁴¹ The majority of courts seemed to agree with this second camp: in cases where a professional trustee invoked a trust provision purporting to waive or modify its fiduciary duties as a defense to liability, courts generally took a hard line, enforcing exculpatory clauses by construing them strictly.⁴² Although some

TRUSTS 2 (6th ed. 1987); see also RESTATEMENT (SECOND) OF TRUSTS § 2 (1959) (defining a trust as “a fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it”); 1 SCOTT ON TRUSTS, *supra* note 25, §§ 2.3–2.6, at 40–48.

35. See RESTATEMENT (FIRST) OF TRUSTS § 170 (1935) (duty of loyalty); *id.* § 179 cmts. b–c (no commingling); 2 SCOTT ON TRUSTS, *supra* note 25, § 170, at 856; *id.* § 179, at 941.

36. See Langbein, *supra* note 6, at 644–50 (recounting the debates between Scott and Maitland).

37. See, e.g., 2 SCOTT ON TRUSTS, *supra* note 25, § 170.9 (reviewing instances where courts, on the ground that the trust instrument authorized self-dealing, upheld transactions that would otherwise be breaches of the duty of loyalty).

38. See MAITLAND, *supra* note 6, at 29.

39. See Langbein, *supra* note 6, at 657–61.

40. Bogert argued that because the trustee-beneficiary relationship is a “particularly intimate” one in which the trustee has great power over the beneficiaries’ affairs “[t]he relationship is not an ordinary business one.” BOGERT, *supra* note 34, at 2. Instead, the trustee is required to act solely in the beneficiaries’ interest, with “strict honesty and candor.” *Id.* Scott observed that the fiduciary relationship between trustee and beneficiary is “peculiarly intense,” SCOTT ON TRUSTS, *supra* note 25, §§ 2.5, 170, and noted that certain fiduciary obligations had a moral component. See, e.g., *id.* § 170.1, at 859 (discussing the precedential rationale against self-dealing).

41. For example, Bogert opined that:

The ethics of the demand by corporate trustees for the insertion of an exculpatory clause seems dubious, to say the least. After advertising great skill and ability, and impliedly promising to use all that care and capacity in any trust where it is chosen trustee, the bank or trust company should not insist that the [settlor] hold the trustee to a lower standard of performance.

BOGERT, *supra* note 34, at 340.

42. See First Ala. Bank of Huntsville v. Spragins, 515 So. 2d 962, 964 (Ala. 1987) (holding that “although a trustee’s duties and obligations are governed largely by the trust agreement, that agreement cannot be employed to vitiate ‘the duty imposed by the “prudent person” standard”); McNeil v. McNeil, 798 A.2d 503, 509 (Del. 2002) (considering a trust provision that protected the trustee from liability for negligence, and concluding that the trustee was liable for breach of trust, because “[a]

scholars insist that courts routinely enforced such clauses, a close analysis of the case law undermines the force of that conclusion. Even the cases cited by the Restatement (Second) as evidence that some courts routinely enforced exculpatory provisions show only that courts enforced waiver provisions in cases involving special circumstances that do not justify overbroad generalizations.⁴³

reasonable construction of these provisions . . . is that the Lois Trustees were exculpated for ordinary negligence, but not the duty to (i) inform beneficiaries or (ii) treat them impartially"); *In re Trusteeship of Williams*, 591 N.W.2d 743, 747-48 (Minn. Ct. App. 1999) (upholding the validity of an exculpatory clause shielding trustees from liability for errors in judgment, but finding that the trustee's failure to sell declining stock for over four years, even though the stock comprised the majority of the trust's assets, could constitute a breach of fiduciary duty, because the failure was possibly negligence rather than "an error in judgment"); *Semler v. CoreStates Bank*, 693 A.2d 1198, 1208 (N.J. Sup. Ct. App. Div. 1997) (holding the trustee liable for negligence on the ground that the trustee's negligent acts fell outside the scope of protection the exculpatory clause provided); *Behrman v. Egan*, 95 A.2d 599, 601 (N.J. Super. Ct. Ch. Div. 1953) (stating that an exculpatory clause cannot relieve a trustee from liability "where a loss results from negligence in the administration of a trust") (citing *Liberty Title & Trust Co. v. Plews*, 60 A.2d 630 (N.J. Ch. 1948)); *Dickerson v. Camden Trust Co.*, 53 A.2d 225 (N.J. Ch. 1947), *aff'd*, 64 A.2d 214 (N.J. 1949); *Villard v. Villard*, 114 N.E. 789, 794-95 (N.Y. 1916) (holding that a clause purporting to shield the trustee from liability for retaining investments originally held by the settlor did not shield the trustee from liability for failing to sell investments that it did not know were not part of the settlor's estate); *In re Rushmore's Estate*, 21 N.Y.S.2d 526, 529-30 (Sur. Ct. 1940) (holding that an exculpatory clause directing that the trustee would not be held liable "for any act done . . . in good faith hereunder" did not shield the trustee from liability for "non-legal" investments); *Bauer v. Bauernschmidt*, 589 N.Y.S.2d 582, 583 (App. Div. 1992) (holding that an exculpatory clause did not protect the trustee from liability for making certain negligent expenditures); *Jewett v. Capital Nat'l Bank*, 618 S.W.2d 109, 112 (Tex. Civ. App. 1981) (holding that an exculpatory clause relieving the trustee of liability for investing in speculative stocks did not shield the trustee from liability for negligence in failing to diversify the trust's assets).

43. As the Restatement (Second) of Trusts indicates, courts in the early part of the twentieth century did not take a consistent approach to the issue of whether trustees could escape liability by invoking exculpatory clauses. Courts often found trustees liable by construing exculpatory clauses narrowly. See RESTATEMENT (SECOND) OF TRUSTS § 222 reporter's notes. Although the Restatement (Second) also indicates that some courts routinely enforced exculpatory clauses, *see id.*, a close look at the cases cited in support of this proposition do not persuasively support it. In fact, most courts validated exculpatory clauses only (1) after finding that the trustee's conduct was not in fact negligent at all, *In re City Bank Farmers Trust Co.*, 61 N.Y.S.2d 484, 487 (App. Div. 1946); *In re Nuese's Estate*, 96 A.2d 298, 302 (Essex County Ct. 1953); (2) if the trustee had been a friend or relative of the settlor, *In re Mallon's Estate*, 89 N.Y.S. 554 (Sur. Ct. 1904); *Crabb v. Young*, 92 N.Y. 56, 67-68 (1883) (settlor named his children as trustees); (3) the settlor and/or beneficiaries expressly acquiesced in trustee's conduct and profited from it, *In re Leupp*, 153 A. 842 (N.J. Ch. 1931); (4) if the trust at issue was not the prototypical private express trust, but set up pursuant to an investment or business arrangement, *Gardner v. Squire*, 49 N.E.2d 587 (Ohio Ct. App. 1942); or (5) if the clause was not a broad grant of immunity from liability from negligence, but a narrowly tailored, transaction-specific waiver, and the conduct complained of fell squarely within the clause's protection, *Farr v. First Camden Nat'l Bank & Trust*, 66 A.2d 444, 446 (N.J. Super. Ct. App. Div. 1949). This Article offers a theoretical framework that explains why courts might uphold exculpatory clauses in those types of cases, but not in all cases. *See infra* text accompanying notes 165-170. In fairness, Massachusetts is a stark exception to this analysis. Cases in that state do stand as precedent that courts will routinely invoke exculpatory clauses to shield trustees from liability for negligent acts. *See, e.g., Warren v. Pazolt*, 89 N.E. 381, 390 (Mass. 1909).

II. FIDUCIARY DUTIES AS FREELY WAIVABLE DEFAULT RULES

Although the argument that trusts are a species of contract has existed for at least a century, the precise characterization of fiduciary duties as mere “default rules” crystallized only in the past fifteen years. In trust law, Professor John Langbein has argued that fiduciary duties are, in the main, default rules, freely waivable with the parties’ consent.⁴⁴ This development in trust law has paralleled, and perhaps been influenced by, the work of prominent corporate law scholars.⁴⁵ Professors Easterbrook and Fischel have argued that corporate fiduciary standards are, and should be, default rules—off-the-rack contract terms designed, in general, to maximize shareholder value.⁴⁶ The UTC embraces that premise in the trust context, but without sufficient attention to qualifications dictated by the special nature of the private trust relationship.⁴⁷ This Part explores why the argument that corporate fiduciary rules are, and should be,

44. Langbein does, however, recognize that there are some limits on the parties’ ability to contract around fiduciary protections. See Langbein, *supra* note 6, at 650–51; Langbein, *supra* note 13, at 1112, 1122–23. He explains trust law’s prohibitions on waivers of the duty of loyalty in its entirety, or the trustee’s duty to act in good faith, as “intent effectuating” rules. *Id.* at 1122–24. In other words, because no informed settlor would agree to those provisions, their inclusion in a trust document is evidence that the settlor did not understand the trust document. See *Id.* at 1124. He does not, however, explore whether the asymmetrical information problem would justify a court in striking less extreme exculpatory clauses, such as a clause that relieves the trustee of liability for gross negligence. Langbein also views freely bargained waivers of trust law rules with the purpose—or effect—of imposing onerous dead-hand control as unenforceable. See *id.* Finally, he states that while any of the core fiduciary duties are negotiable, the trust instrument must not waive all of them in their entirety. *Id.* at 1122–23. Sitkoff, accepting these limits, additionally argues that rules “that govern the trustee’s liability toward creditors of the trust property tend to be mandatory with respect to the settlor, but default with respect to the trustee and those with whom the trustee deals,” because such rules deal with the rights of outsiders to the trust organization. Sitkoff, *supra* note 3, at 641–42.

45. In support of his thesis that trusts are contracts, Langbein emphasizes Easterbrook and Fischel’s work, and characterizes fiduciary duties as default rules. See Langbein, *supra* note 6, at 657–69. Hansmann and Mattei, themselves corporate scholars, readily concede that the deal between settlor and trustee is contract-based. See Hansmann & Mattei, *supra* note 9, at 470. They further argue, however, that “it is precisely the property-like aspects of the trust that are the principal contribution of trust law.” See *id.* at 469. It is beyond the scope of their project to analyze whether and to what extent fiduciary duties should be mandatory, even within the contract paradigm. *Id.* at 449–50. Recently, Sitkoff has argued that the absence of market pressures distinguishes the trust from the public corporation, and that the resulting absence of effective monitoring controls justifies the imposition of greater fiduciary duties in the trust context. See generally Robert Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency*, 28 J. CORP. L. 565 (2003). He does not, however, consider the negative implications that waiver of these duties, which is permitted under the UTC, will have on beneficiaries and settlors.

46. See EASTERBROOK & FISCHEL, *supra* note 3, at 90–108; Easterbrook & Fischel, *Contract and Fiduciary Duty*, *supra* note 4, at 437; see also Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 29 (1990) (arguing that “[t]he critical point to understand under the contract theory is that fiduciary duties are not distinct from the contract but are simply one of many drafting alternatives”).

47. The UTC provides that the trust document may override all UTC provisions except certain specifically enumerated ones. See UNIF. TRUST CODE § 105(a) (2000) (providing that the trust document may modify or waive any of the UTC rules except those provided in subsection (b)); *id.* § 105(b) (listing mandatory trust rules, which include the duty of the trustee to act in good faith and in accordance with trust purposes, the requirement that the trust be for the benefit of the beneficiaries, and limiting the permissible scope of an exculpatory clause to prohibit clauses that shield the trustee from

fully and freely modifiable is considerably weaker in the trust context.⁴⁸

A. CORPORATE CONTRACT THEORY: FIDUCIARY DUTIES AS DEFAULT RULES

1. Fiduciary Duties and Agency Costs

The “nexus of contracts”⁴⁹ view of the firm has had a profound impact on the development of corporate doctrine.⁵⁰ The theory has at its core a notion of the corporation as a “nexus of contracts”—voluntary agreements between management and employees, management and creditors, management and investors.⁵¹

liability for conduct that is in bad faith or committed with reckless indifference to the beneficiaries’ interests).

48. Easterbrook & Fischel recognize that fiduciary rules vary in accordance with the context of each particular fiduciary relationship. See Easterbrook & Fischel, *Contract and Fiduciary Duty*, *supra* note 4, at 432 (stating “[t]hat fiduciary duties deviate substantially from one agency relation to another, no one could deny”); *id.* at 427 (stating that “[o]bligations implied to maximize value in high-transactions-costs cases may have some things in common, but differences in the underlying transactions will call for different ‘fiduciary’ obligations, just as actual contracts differ across markets”). They also recognize that differences in fiduciary rules across relationships are related to differences in the transaction costs of contracting and monitoring costs. *Id.* at 432. The authors acknowledge that fiduciary rules applicable to trustees are therefore more stringent. *Id.*

Yet, because Easterbrook and Fischel’s principal focus concerns the corporate firm, they have not engaged in a detailed exploration of trust law. Instead, they assume (without much analysis of trust law’s contextual backdrop) that trustees’ fiduciary duties are, and should be, freely and completely waivable. See, e.g., *id.* (noting that the trustee’s duties of care and loyalty are interpreted more stringently in the trust context, but stating that “[a]ll rules are freely variable by contract in advance”).

49. Ronald Coase developed the “nexus of contracts” approach to corporate law, see generally R.H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937). Multitudes of scholars have expanded on his work. See, e.g., EASTERBROOK & FISCHEL, *supra* note 3, at 12; Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 *AM. ECON. REV.* 777 (1972); Steven N.S. Cheung, *The Contractual Nature of the Firm*, 26 *J.L. & ECON.* 1 (1983); Michael C. Jensen, *Organization Theory and Methodology*, 58 *ACCT. REV.* 319, 326 (1983); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. FIN. ECON.* 305 (1976); William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 *YALE L.J.* 1521 (1982); Oliver Williamson, *Corporate Governance*, 93 *YALE L.J.* 1197 (1984); see generally Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 *J.L. & ECON.* 301 (1983).

50. See *infra* note 51 for a review of the literature arguing against the contractarian theory of the firm.

51. See Jensen & Meckling, *supra* note 49, at 310 (stating that firms are legal fictions that “serve as a nexus for a set of contracting relationships among individuals”). Although the parties do not always haggle over terms, see EASTERBROOK & FISCHEL, *supra* note 3, at 14, 16, the essential elements of contract arguably are present. See *id.* at 8–15. In exchange for management’s promise to abide by the terms of the corporate charter, shareholders voluntarily invest in the corporation. See *id.* at 14.

The contract theory of the corporation is controversial and has prominent detractors. See Lucian Arye Bebchuk, *Contractual Freedom in Corporate Law: Forward; The Debate on Contractual Freedom in Corporate Law*, 89 *COLUM. L. REV.* 1395, 1395 (1989) [hereinafter Bebchuk, *The Debate on Contractual Freedom in Corporate Law*]; Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 *HARV. L. REV.* 1820, 1825 (1989) [hereinafter Bebchuk, *Constraints on Charter Amendments*]; Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 *COLUM. L. REV.* 1403, 1403 (1985); John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 *COLUM. L. REV.* 1618, 1622–27, 1690–91 (1989) [hereinafter Coffee, *Mandatory/Enabling Balance*] (arguing that “the permissibility of deviations from the traditional standards of corporate law should be judged primarily

The corporate structure's separation of ownership and control creates agency costs that the "contract" must anticipate and control.⁵² Those costs are commensurate with the size of the manager's stake in the corporation; the less her interest is aligned with shareholders, the greater the potential agency costs.⁵³ When interests of managers and shareholders diverge, managers face incentives to benefit themselves at the expense of the shareholder, or to shirk when shirking is in management's self-interest.⁵⁴ Thus, if shareholders actually haggled over corporate contract "terms," they might insist on terms to minimize agency costs.⁵⁵

But the nature of the "contractual" relationship makes contracting to reduce agency costs difficult. The corporate "contract" is relational, not contemplating a one-shot performance by each party, but a continuing relationship that may stretch years into the future.⁵⁶ Parties cannot draft agreements that accurately anticipate and resolve all future conflicts.⁵⁷ Even if they could, transaction costs involved in contracting to meet every conceivable future event would be prohibitive.⁵⁸ Enter fiduciary duties, an efficient alternative to "elaborate prom-

in terms of the competence of courts or other agencies to monitor these departures and prevent opportunism" and calling for a "middle ground" which scrutinizes when courts can and should be so empowered); John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919, 924-25 (1988) [hereinafter Coffee, *No Exit*] (rejecting the "hypothetical bargaining" underpinnings of contractarian theory and arguing that optimal default rules do not maximize wealth, but rather disclose the discretionary power one party plans to exercise over another, thereby justifying some judicial paternalism as well as the consideration of external effects); Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1273-75 (1999) [hereinafter Eisenberg, *Social Norms*] (arguing that not all waivable rules are contractual in nature and that contractarian theory "ignores the expressive function of law"); Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989) [hereinafter Eisenberg, *The Structure of Corporation Law*]. Professor Tamar Frankel also argues more generally that "if we wish to create and maintain efficient markets, contract law—especially the freedom of contracting parties to customize their relationship—must yield to the mandatory rules of property law." Tamar Frankel, *The Legal Infrastructure of Markets: The Role of Contract and Property Law*, 73 B.U. L. REV. 389, 391 (1993).

52. Jensen & Meckling, *supra* note 49, at 308; see also EASTERBROOK & FISCHEL, *supra* note 3, at 8-11, 91-93; Easterbrook & Fischel, *Contract and Fiduciary Duty*, *supra* note 4, at 426; Eisenberg, *The Structure of Corporation Law*, *supra* note 51, at 1471 n.46; Fama & Jensen, *supra* note 49, at 304.

53. See EASTERBROOK & FISCHEL, *supra* note 3, at 91; Fama & Jensen, *supra* note 49, at 308.

54. See Eisenberg, *The Structure of Corporation Law*, *supra* note 51, at 1471-74.

55. EASTERBROOK & FISCHEL, *supra* note 3, at 90-93; Easterbrook & Fischel, *Contract and Fiduciary Duty*, *supra* note 4, at 426-27.

56. See, e.g., OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* 70-72 (1985); see also EASTERBROOK & FISCHEL, *supra* note 3, at 168 (noting that "[a]s firms evolve, the appropriate relation between residual risk bearers and the managers evolves too," positing that the minimization of agency costs requires a "combination of fiduciary principle with a mechanism to replace [. . .] managers," and concluding that such a mechanism is necessary despite running contrary to contractarian analysis); Coffee, *Mandatory/Enabling Balance*, *supra* note 51, at 1625 (stating that because a corporate charter "is the extreme example of a relational contract, it does not attempt to specify all the parties' expectations").

57. See EASTERBROOK & FISCHEL, *supra* note 3, at 92; Easterbrook & Fischel, *Contract and Fiduciary Duty*, *supra* note 4, at 426.

58. EASTERBROOK & FISCHEL, *supra* note 3, at 92.

ises and extra monitoring.”⁵⁹ Fiduciary duties are best understood as the terms that the parties would have agreed to *ex ante* if they had anticipated the future conflict, and bargaining was costless.⁶⁰ Fiduciary duties “preserve the gains resulting from the separation of management from risk bearing while limiting the ability of managers to give priority to their own interests over those of investors.”⁶¹ Because fiduciary duties are default terms, the parties should generally be free to contract around them, or to authorize transactions that would otherwise constitute a breach of duty.⁶²

2. The Market as a Policing Device

A number of corporate scholars argue that a regime of freely waivable fiduciary duties will not hurt investors, because market mechanisms are sufficient to control most forms of opportunistic behavior, including the insertion of inefficient provisions in corporate charters.⁶³ First, assuming full information, the stock price of the initial offering will reflect the value of any terms that are disadvantageous to shareholders, which will force management to internalize costs of opportunistic terms.⁶⁴ As a result, management will attempt to ease

59. *Id.*

60. *Id.*; see also Sitkoff, *supra* note 45, at 577 (positing that “[i]nstead 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”); Sitkoff, *supra* note 3, at 636–38.

61. EASTERBROOK & FISCHEL, *supra* note 3, at 92.

62. Even corporate scholars argue that a scheme that includes some mandatory rules is not inconsistent with the contractual view of the corporation. See Coffee, *Mandatory/Enabling Balance*, *supra* note 51, at 1619–20 (pointing out that “courts have invariably played an active and indispensable role” in interpreting relational contracts, and therefore “analogizing the corporation to a long-term contract may suggest not that the mandatory features of American corporate law are vestigial remnants of an earlier era that was hostile to private ordering, but rather that these provisions are analogous to similar legal rules that restrict opportunism in other areas of complex, long-term contracting”); Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, *supra* note 51, at 1408–09 (1989) (arguing, with respect to the corporate context, that “one may accept the contractual view of the corporation and at the same time reject the freedom-to-opt-out position and support a substantial number of mandatory rules”).

63. See, e.g., EASTERBROOK & FISCHEL, *supra* note 3, at 17–22; Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1557–66 (1989); see also Butler & Ribstein, *supra* note 46, at 33–45.

Tamar Frankel, who generally objects to contractarian characterization of fiduciary duties, argues that benefits produced by market incentives are outweighed by the costs market forces create by entrenching those in power. Specifically, Frankel notes that corporate fiduciaries keep the entrusted property when disgruntled shareholders exit and sell it to others, which insulates those fiduciaries from judicial oversight. Frankel, *Fiduciary Duties*, *supra* note 5, at 1257–58.

64. See EASTERBROOK & FISCHEL, *supra* note 3, at 21 (stating that if corporate charters contain disadvantageous terms, investors will go elsewhere); Butler & Ribstein, *supra* note 46, at 33–45 (arguing that markets are efficient and that corporate terms are fully reflected in stock prices, and concluding that “the presence of play in the corporate contract suggests, rather than a failure of contracting, a recognition that the least costly way of dealing with agency costs may be to allow them to be checked by incentive or monitoring devices instead of by liability rules”); Gordon, *supra* note 63, at 1562–63 (arguing that stock prices do telegraph information about charter terms). *But see* Frankel,

fiduciary duties only when doing so will maximize value.⁶⁵ Second, the market creates significant pressures that minimize agency costs regardless of whether management is bound by fiduciary duties. For example, managers' compensation might be linked to performance.⁶⁶ The threat of a takeover of corporate control, the need to succeed in product markets, and the job market provide additional incentives for managers to perform in shareholders' best interests.⁶⁷ Moreover, a well-developed information market helps shareholders monitor management's performance.⁶⁸ If shareholders learn of management's opportunistic behavior, they will exit, causing stock prices to fall. Thus, although market forces may be inadequate to curb one-shot breaches of the "take the money and run" sort,⁶⁹ for the most part fiduciaries will tend to minimize agency costs even if the corporate charter does not require them to do so.

The above account assumes that investors have full information about the meaning and effect of the corporate charter's terms. Corporate contractarians argue that the assumption is justified. Even though a rational investor, who is heavily diversified, might choose to remain ignorant of charter terms, market forces minimize the impact of the information problem.⁷⁰ First, underwriters will push management to offer optimal terms.⁷¹ Second, even if some rational investors fail to read the corporate charter, some significant number of investors will study it—institutional investors in particular have a strong incentive to possess full information regarding the details of the charter terms.⁷² Moreover, a powerful secondary information market exists that helps shareholders who seek

supra note 5, at 1221 (doubting that stock prices can communicate significant information about the quality of the fiduciary, because those prices reflect large quantities of information).

65. See, e.g., Bebchuk, *Constraints on Charter Amendments*, *supra* note 51, at 1826–27.

66. EASTERBROOK & FISCHER, *supra* note 3, at 5; see Butler & Ribstein, *supra* note 46, at 27.

67. See EASTERBROOK & FISCHER, *supra* note 3, at 68, 91, 95–97; Butler & Ribstein, *supra* note 46, at 27.

68. EASTERBROOK & FISCHER, *supra* note 3, at 96–97.

69. *Id.* at 103.

70. See *id.* at 17–22; Gordon, *The Mandatory Structure of Corporate Law*, *supra* note 63, at 1565–68 (concluding that concern for protecting investors does not justify the imposition of mandatory corporate rules, because uninformed investors can free-ride on informed investors efforts; in equilibrium, there will be a sufficient number of informed investors, because there is an information market, and underwriters push for optimal terms).

71. Gordon, *supra* note 63, at 1559.

72. EASTERBROOK & FISCHER, *supra* note 3, at 18–22 (stating that "[t]he price of stocks traded in public markets is established by professional investors, not by amateurs" and, drawing on other academic literature, arguing that stock price reflects the value of charter terms, which protects uninformed investors); see also Gordon, *supra* note 63, at 1557–58.

Melvin Eisenberg is not persuaded on this point. He argues that "many investors in IPO stock are relatively uninformed," and posits that situations exist where institutional investors, upon whom smaller investors might normally free-ride, lack the incentive to adequately price, or the foresight to accurately forecast, "variations in core fiduciary and structural rules." Eisenberg, *The Structure of Corporation Law*, *supra* note 51, at 1517. He argues further that underwriters may agree to "inappropriate" terms in order to obtain the issue, or might be unaware of the underlying market value of the security, due to preliminary investors' ignorance of the "corporation's constitutive rules." See *id.* at 1517–20.

information find it.⁷³ Because there will be a sufficient number of well-informed investors, the stock will be adequately priced, allowing uninformed investors to free ride on informed investors' efforts.⁷⁴

Contractarians assume that the contract model applies equally well to the close corporation.⁷⁵ Though they acknowledge the absence of market forces, they argue that sufficient substitutes exist. They emphasize that close corporate fiduciaries usually own a large chunk of the corporation. Because they will have to absorb the cost of their own bad behavior, "what is good for [the fiduciary] is also good for the firm (and for the other participants)."⁷⁶ Easterbrook and Fischel note that close corporations are often founded on pre-existing trust-based relationships which, in their view, minimize agency costs.⁷⁷ Finally, contractarians argue that close corporation shareholders have more incentive and a greater opportunity to monitor fiduciary behavior.⁷⁸

Although some scholars acknowledge that close corporation shareholders have strictly limited exit options, they do not view this as a sufficient justification for imposing mandatory fiduciary terms. Instead, they argue that the inability to exit will cause most close corporate shareholders to incorporate standard fiduciary protections into their agreement.⁷⁹ The contractarian analysis assumes that the parties to the deal have full information and equal bargaining power.⁸⁰

73. EASTERBROOK & FISCHEL, *supra* note 3, at 96–97.

74. See Gordon, *supra* note 63, at 1557–65 (positing that "the investor protection hypothesis," which holds that mandatory rules are necessary to protect both informed and uninformed investors from opportunistic charter provisions, does not explain the existence of mandatory corporate law, and arguing that evidence exists to demonstrate that charter provisions provide adequate price signals). *But see* Coffee, *Mandatory/Enabling Balance*, *supra* note 51, at 1624 (arguing that "given the informational asymmetries and collective action problems that are inherent to the corporate context, there is reason to doubt the market's ability to price accurately the impact of innovative charter provisions that confer potential power on managers to behave opportunistically").

75. See Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 *STAN. L. REV.* 271 (1986); Butler & Ribstein, *supra* note 46.

76. Easterbrook & Fischel, *supra* note 75, at 274.

77. *Id.*

78. *Id.*; see also Butler & Ribstein, *supra* note 46, at 20.

79. Butler & Ribstein, *supra* note 46, at 10–11.

80. The case for freely waivable fiduciary duties arguably is weaker in the close corporation context. That many close corporations are built on pre-existing relationships of trust can cut the other way: it may induce parties to be less vigilant monitors than they would be otherwise. It may also indicate that the parties do not have equal bargaining power. Perhaps it is for these reasons that the Model Business Corporation Act expressly prohibits complete waiver of the duty of care or loyalty and invalidates exculpatory clauses that purport to insulate directors from liability more broadly than the act permits. See *MODEL BUS. CORP. ACT* § 7.32(a) cmt. at 7-76 (2002). The Florida legislature describes as against public policy agreements that lessen the directors' duties of care or loyalty, or exculpate the directors from liability for duties imposed by the Florida statute. See *FLA. STAT. ANN.* § 607.0732(h) (West 2001). Many state courts refuse to enforce blanket waivers of fiduciary duties in close corporation charters, and California caselaw explicitly suggests that such waivers violate public policy. See *Neubauer v. Goldfarb*, 133 Cal. Rptr. 2d 218, 223–25 (Cal. Ct. App. 2003) (construing *CAL. CIV. CODE* § 1668 (West 1985)).

Because the contract model works best when applied to general partnerships, Larry Ribstein argues

B. FIDUCIARY DUTIES AND THE TRUSTEE

As in the corporate context, agency costs are a central problem with the private express trust, and fiduciary duties may be conceptualized as mechanisms that control agency costs.⁸¹ But trust scholarship has yet to develop an analytical framework for evaluating the degree to which parties to the trust should be free to modify fiduciary duties. As we have seen, market monitoring is crucial to the view of fiduciary rules as freely waivable default provisions in the corporate context; market forces induce behavior consistent with fiduciary standards by disciplining departures from fiduciary norms that decrease value. Who, then, will monitor opportunistic behavior by the private trustee? Does the market perform that function here? If not, are settlors or beneficiaries adequate monitors?

1. The Market as a Monitor of Trustee's Misbehavior

Almost none of the market forces that pressure corporate fiduciaries to forgo opportunistic behavior are at play in the trust context. There is no "share price" or secondary information market that informs other potential customers of a trust term that reduces fiduciary duties or communicates trustees' opportunistic behavior to potential customers. Even if a particular beneficiary discovers that her trustee is performing poorly, she will be unlikely to communicate this to the trustee's other clients, of whom she is unaware.⁸² Moreover, that beneficiary

that there should be no mandatory partnership rules. See Larry E. Ribstein, *A Mid-Term Assessment of the Project to Revise the Uniform Partnership Act*, 46 BUS. LAW. 111, 138 (1990) (stating that "waivers in the partnership context are normally negotiated by knowledgeable parties at arms' length. This is hardly a situation in which mandatory rules are necessary to protect unwary parties"). Because general partners make equal financial and management contributions, face equal liability, and have equal access to records and other facts, they have both the incentive and the ability to monitor other partners' performance.

The Uniform Partnership Act ("U.P.A.") warmly embraces the contractarian approach. Limits on waiving fiduciary duties are constrained to those situations where the waiver is so unreasonable as to indicate the presence of significant asymmetries in bargaining power, information or business sophistication. See UNIF. P'SHIP ACT § 21(b)-(c) (2005).

For criticisms of the U.P.A.'s contractarian approach to partnership law, see Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 B.U. L. REV. 523 (1993); Lawrence E. Mitchell, *The Naked Emperor: A Corporate Lawyer Looks at RUPA's Fiduciary Provisions*, 54 WASH. & LEE L. REV. 465 (1997). For an analysis of whether the contractarian approach should apply to LLPs, see Sandra K. Miller, *The Role of the Court in Balancing Contractual Freedom with the Need for Mandatory Constraints on Opportunistic and Abusive Conduct in the LLC*, 152 U. PA. L. REV. 1609 (2004).

81. See Easterbrook & Fischel, *Contract and Fiduciary Duty*, *supra* note 4, at 426-27; Langbein, *supra* note 6, at 658 (concluding that "[l]oyalty and prudence, the norms of trust fiduciary law, embody the default regime that the parties to the trust deal would choose as the criteria for regulating the trustee's behavior in these settings in which it is impractical to foresee precise circumstances and to specify more exact terms"); Sitkoff, *supra* note 3, at 652 (noting that the trustee's duty of impartiality, unique to trust law, controls agency costs not present in other organizational relationships that are subjected to fiduciary duties).

82. Further, she cannot easily replace the trustee. See Sitkoff, *supra* note 45, at 571.

cannot exit if she is dissatisfied.⁸³

In addition, trustees need not worry about raising money, maintaining or increasing stock prices, or responding to the threat of hostile takeovers. Although employees of trust companies may be concerned about the labor market, it pressures them less than it does their corporate counterparts. Because there is no information market that reveals their poor performance, employees of trust companies may be less concerned about finding a new job if they are terminated. Thus, “*ex post* settling up in markets”⁸⁴ will too infrequently occur when a trustee acts opportunistically with respect to any particular trust account. When the trustee is an individual professional, the problem is compounded.⁸⁵

John Langbein points out that professional trustees often obtain business from trust attorneys who recommend trustees to their clients, and this creates an incentive for trustees to behave in accordance with fiduciary standards.⁸⁶ But this pressure, to the extent it exists, is insufficient to substitute for the market pressures the corporate fiduciary faces. First, trust attorneys draft trust agreements, but do not generally monitor trustee behavior after the trust is up and running. The attorney has little incentive to monitor trustee behavior, unless she is later retained by the beneficiaries. Even if the attorney wanted to monitor the trustee, the attorney is not a party to the trust arrangement and (absent retention by trust beneficiaries) has no right to receive accountings or other information

83. Sitkoff notes that aftermarkets for beneficiaries’ interests are weak; moreover, in many trusts, spendthrift clauses prevent beneficiaries from alienating their interest even involuntarily. *See* Sitkoff, *supra* note 45, at 570. Her only recourse is to mount a suit for breach of fiduciary duty. Because lawsuits are expensive, beneficiaries are likely to bring them only in those relatively rare instances where opportunism can be clearly proven and recovery is likely to be large. This knowledge of the beneficiaries’ relative lack of options may cause less than honorable trustees to push the envelope toward opportunistic behavior.

84. *See* EASTERBROOK & FISCHEL, *supra* note 3, at 104 (noting that directors have reputational concerns and face “*ex post* settling up in labor and capital markets”). Easterbrook and Fischel argue that due to the presence of information markets, *ex post* settling up is a more efficient tool than judicial intervention. *See id.* at 99.

85. Perhaps because of the lack of market constraints, federal and state governments bring regulatory pressure to bear on institutional trustees. *Cf.* Roberta Romano, *Comment on Easterbrook and Fischel, “Contract and Fiduciary Duty,”* 36 J.L. & ECON. 447, 449 (1993) (positing that difficulties in monitoring and contract specification for certain commercial relationships may be severe enough to warrant that statutory regulation trump contract flexibility). A significant number of institutions may strive to comply scrupulously with applicable regulations, which goes a long way toward curbing trustees’ opportunistic behavior. Yet these regulations are not a sufficient substitute for market pressure. Stringency and enforcement vary from state to state, and focus only on regulating specific aspects of trustee behavior. Fear of regulators is also unlikely to curb spectacular, one-shot instances of self-dealing by an individual trustee employee. The result is that institutions that confine their business to extraordinarily high net worth clients are those most likely to comply with federal or state regulations, while those which are newer to the business, or less scrupulous, are the least likely to be influenced by fear of regulators. Moreover, regulations do not act as a check on forms of opportunistic behavior that they do not cover. This goes double for individual professional trustees, who escape regulation altogether. Although professional rules might require lawyers or accountants to conform to fiduciary standards, there is no regulatory body to enforce those standards in advance of a breach of duty. And when regulation fails to curb opportunism, there is no market to fill the void.

86. Langbein, *Questioning the Duty of Loyalty*, *supra* note 23, at 937.

about trust investments. At most, the desire for recommendations may induce trustees to behave honorably during contract negotiation.

Second, Langbein's model of the trust attorney who recommends trustees to clients is increasingly less apt. With increasing frequency, it is the trustee who works with, and has authority over, the settlor's attorney. The client may consult an investment adviser, who recommends a revocable living trust and an attorney to look over the documents. When attorneys are the ones seeking the recommendations, trustees face little pressure to impress them.⁸⁷

2. The Parties as Monitors

Of course, if the parties to the trust deal can adequately monitor trustee behavior, then the absence of market controls is less problematic for those who advocate the default rule characterization of fiduciary duties. Because the settlor typically will die before the expiration of the trust, monitoring generally falls to the trust's beneficiaries.

Beneficiaries, however, are in a poor position to monitor the trustee's behavior. Often, the beneficiary received the gift in trust, as opposed to outright, because the settlor had doubts about the beneficiary's financial sophistication. Beneficiaries who are minors, incapacitated, or who lack financial sophistication will be unable to determine whether a trustee is behaving opportunistically. Because of this imbalance of capacity and information, beneficiaries are likely to place substantial trust in the trustee. The trustee's advertised reputation of trustworthiness encourages beneficiaries' reliance on its judgment. Or, if the trustee is an individual, chosen by the settlor for her honesty, competence and knowledge of family relationships, the beneficiary trusts that the trustee will continue to act consistently with past behavior. In either case, the beneficiary is predisposed to believe that the trustee acts at all times in the beneficiary's best interests. Thus, beneficiaries are not likely to be adequate monitors of trustee performance, which gives a less-than-trustworthy trustee incentive to behave opportunistically.

Of course, one might argue that the settlor is in the best position to determine whether modifying the trustee's fiduciary duties might maximize beneficiary wealth. If the settlor prefers to modify the trustee's common-law duties, she is

87. See, e.g., *State v. Laden*, 893 P.2d 771, 772 (Colo. 1995) (publicly censuring an attorney for aiding a trust marketer in the unauthorized practice of law by issuing standard form advice letters in response to the trust marketer's clients' requests for legal advice); *Comm. on Prof'l Ethics v. Matias*, 521 N.W.2d 704, 706-07 (Iowa 1994) (lawyer's license suspended for accepting referrals from a company that marketed living trusts); *Comm. on Prof'l Ethics & Conduct v. Baker*, 492 N.W.2d 695, 702-04 (Iowa 1992) (reprimanding an attorney for accepting over 100 referrals from a financial services company establishing living trusts and failing to advise clients in a disinterested fashion); *In re Mid-America Living Trust Assocs.*, 927 S.W.2d 855, 871 (Mo. 1996) (enjoining a living trust company, which sold living trust kits to clients and recommended attorneys to those clients, from doing business in Missouri); *Cincinnati Bar Ass'n v. Kathman*, 748 N.E.2d 1091, 1097 (Ohio 2001) (suspending an attorney from practicing law for aiding a trust marketer in the unauthorized practice of law and failing to render meaningful legal advice to the trust marketer's customers).

indicating that she thinks that the beneficiaries will be better off if the trustee is not constrained by rigid duties.

That the trust document contains terms that purport to modify or waive fiduciary duties is not always evidence that the settlor made a knowing determination that the waiver would maximize value. Notwithstanding the settlor's large investment, the settlor may lack information that is critical to understanding and pricing a waiver.⁸⁸ For various reasons, the settlor may be unaware of the waiver provision, or may fail to understand its meaning. Even when the settlor purports to understand the waiver, the settlor's lack of foresight inhibits her ability to understand how the waiver will be construed in light of events that will occur long after the settlor's death. The information problem is an asymmetrical one, because professional trustees have economies of scale in understanding the nature and effect of trust provisions.⁸⁹ As the following discussion suggests, information deficits may induce the settlor to agree to waive fiduciary duties even when a waiver would decrease, rather than maximize, trust value.⁹⁰

First, the unrepresented settlor may not know that the trust document, which is provided by the trustee, includes a provision waiving or reducing fiduciary standards. Even if the settlor spots the language, she may not understand the legal rights that she is waiving. In choosing a professional trustee, the settlor relies on the professional's reputation and representations about its loyalty and skill in managing trust assets. The unrepresented settlor may not spot or belabor the waiver language, because it might not occur to her that the trustee would attempt to escape or diminish the duties that are the essence of the deal.⁹¹ The settlor is even less likely to look for a waiver term when she has chosen a professional with whom she has had a long-term relationship based on trust, such as an attorney or accountant.⁹²

88. Hansmann, Mattei, and Langbein recognize that settlors may lack sufficient information to evaluate certain waivers, and they offer that fact as a justification for trust law's prohibition on waiver of the duty of loyalty in its entirety. Yet none of these authors expand on this insight to consider whether the asymmetrical information problem might justify more rigid fiduciary terms. See Hansmann & Mattei, *supra* note 9, at 448-49; Langbein, *supra* note 13, at 1124.

89. Cf. Gordon, *supra* note 63, at 1565 (arguing that "uncertainty about operation of the customized term is likely to run against the prospective shareholder and in favor of the firm," because the firm has a greater incentive than the shareholder to understand how a particular customized charter term will operate).

90. Cf. Romano, *supra* note 85, at 449-50 (positing that higher fiduciary duties may be necessary in certain commercial relationships due to the absence of market pressures); see generally Sitkoff, *supra* note 45.

91. Similarly, John Coffee notes that the asymmetrical information problem is a critical one when a shareholder is faced with a broad waiver of a fiduciary duty, because most shareholders will assume that directors will abide by moral constraints for their own sake and out of concern for reputation: "when legal rules are suspended but nonlegal constraints remain, the result is to create unproductive uncertainty." Coffee, *Mandatory/Enabling Balance*, *supra* note 51, at 1669. Here, he argues, a mandatory rule prohibiting a waiver that would allow departure from moral norms is efficient. *Id.* at 1669-70.

92. Indeed the UTC acknowledges as much, imposing on the trustee the burden of proof that the exculpatory clause inserted by the drafter/trustee be "fair under the circumstances" and that "its existence and content" be "adequately communicated to the settlor." UNIF. TRUST CODE § 1008(b)(2)

Even the settlor who is represented by counsel may be ignorant of the waiver's existence or meaning. Of course, the vast majority of attorneys will ably represent their clients, and will not agree to an exculpatory clause that runs counter to their clients' best interests or neglect to explain the clause to their clients in full. In the traditional model, a wealthy client selects a family lawyer whose primary motive is to protect the settlor by choosing a reputable trustee and drafting a trust instrument thoroughly protective of the beneficiaries' interests. However, the traditional model has become less prevalent in recent years, as commercial banks and traditional trust companies lose market share to brokerage firms and other non-traditional trust providers.⁹³ When these institutions, which aggressively market trusts to their customers, suggest potential lawyers to their clients, the lawyers have an incentive to protect their referral source.⁹⁴ In recent years, the overly close relationship between lawyers and trust

(2000). However, the UTC guts the protection that this standard ostensibly provides by directing that such a provision is presumed to be fair if the settlor was represented by counsel. *See infra* text accompanying notes 191–94.

93. *See* Comizio & Hare, *supra* note 1, at 1300. The authors establish that “banks have traditionally dominated the trust market, but personal trust services are now being marketed by a variety of new competitors; as a result, banks have lost market share.” *Id.* They note that, since the passage of the Gramm-Leach-Bliley Act, financial service companies of all types are increasingly offering trust services. *Id.*; *see also* Diversified Servs. Group, Inc., *Prospectus: Trust Distribution 2002: Business & Distribution Models & Tactics in the Non-Traditional Trust Market*, http://www.dsg-candr.com/rmreports/trust_2002_dist.html (stating that “the number of depository institutions with trust powers and assets under management decreased by 20.1%” over the three years ending in 1999); LoBue Associates, *Non-Bank Competition Continues to Erode Bank Trust Marketshare* (1998), http://www.lobue.com/about_us/about_connections.html (stating that banks are experiencing an “alarming” drop in trust business, and that since 1990, “banks have lost more than half of the 65% market share they once enjoyed”).

94. *See* Gerald P. Johnston, *An Ethical Analysis of Common Estate Planning Practices—Is Good Business Bad Ethics?*, 45 OHIO ST. L.J. 57, 115–25 (1984). Professor Johnston explains,

It is a widespread practice among corporate fiduciaries to retain the services of the lawyer who drafted a will or trust in which a bank is named as executor or trustee to perform any legal work that may be necessary in estate or trust administration. In probating a testator's estate, legal services are virtually always needed because of the strict application of laws relating to unauthorized practice of law, which preclude corporate fiduciaries from handling matters processed through the probate court system. The policy of retaining the draftsman to provide legal services has been described as a “gentlemen's agreement” between financial institutions and the bar, as “reciprocal back scratching,” as a “symbiotic relationship,” and, less generously, as a “conspiracy” between corporate executors and lawyers to exploit the client by recommending that the testator name a bank as executor in exchange for assurance that the executor, once appointed, will retain the attorney to assist in the probate of the testator's estate.

Id. at 115 (footnotes omitted).

Although this arrangement appears to give the attorney power over the trustee (because the trustee wants to induce the attorney to bring it business), it does not seem beyond the pale to suppose that some attorneys engaged in this type of symbiotic relationship might agree to trust terms simply to keep the relationship on an even keel. *See also* Sitkoff, *supra* note 3, at 644–45 (arguing that “information-forcing default rule[s]” are justified to remedy informational asymmetries between inexperienced settlors and repeat player trust attorneys); *see, e.g.*, *Comm. on Prof'l Ethics & Conduct v. Baker*, 492 N.W.2d 695, 702–04 (Iowa 1992) (reprimanding an attorney for accepting over 100 referrals from a

providers has provoked disciplinary sanctions against a number of lawyers.⁹⁵

This type of asymmetrical information problem has more serious ramifications in the trust context than it does in the corporate context because there are no market mechanisms to remedy the problem. Unlike the uninformed investor, who can free-ride on the efforts of institutional investors, the settlor with inadequate information is on her own. The investor who is eventually disappointed about how the waiver turned out can cut her losses by selling her shares on the open market. Yet the beneficiary has no such exit option. If the waiver proves harmful down the road, beneficiaries have no recourse because there is no market for their interests. Moreover, beneficiaries may generally be more dependent on the trust fund than diversified investors are on a particular corporation. The harm the beneficiary suffers is significant, because the trust comprises the bulk of his or her wealth.

The asymmetrical information problem is less likely to exist when the settlor chooses as trustee a non-professional associate or family member. In this situation, the settlor chooses the trustee, not necessarily for her financial expertise, but because the trustee has a relationship with the settlor and the objects of the settlor's bounty, and she can be trusted to make discretionary decisions about the beneficiary's respective needs. Individual trustees of this sort are unlikely to be trustees of other trusts, are less likely to participate in drafting the trust's terms, and are likely to be on a level playing field in terms of sophistication.

The second type of information deficit that may cause even the represented settlor to agree to a value-decreasing provision involves the settlor's imperfect foresight. A waiver's effects may be felt far in the future, generations past the settlor's death. Given the long duration of many trusts, a settlor cannot anticipate the circumstances that might lead a trustee to depart from ordinary fiduciary duties.⁹⁶ Moreover, in agreeing to a waiver, a settlor may assume that the fiduciary will act in accordance with its past practice and reputation, failing to

financial services company establishing living trusts and failing to advise clients in a disinterested fashion).

95. See, e.g., *State v. Laden*, 893 P.2d 771, 772 (Colo. 1995) (publicly censuring an attorney for aiding a trust marketer in the unauthorized practice of law by issuing standard form advice letters in response to the trust marketer's clients' requests for legal advice); *Comm. on Prof'l Ethics v. Matias*, 521 N.W.2d 704, 706-07 (Iowa 1994) (lawyer's license suspended for accepting referrals from a company that marketed living trusts); *In re Mid-America Living Trust Assocs.*, 927 S.W.2d 855, 871 (Mo. 1996) (enjoining a living trust company, which sold living trust kits to clients and recommended attorneys to those clients, from doing business in Missouri); *Cincinnati Bar Ass'n v. Kathman*, 748 N.E.2d 1091, 1097 (Ohio 2001) (suspending an attorney from practicing law for aiding a trust marketer in the unauthorized practice of law and failing to render meaningful legal advice to the trust marketer's customers).

96. See Eisenberg, *The Structure of Corporation Law*, *supra* note 51, at 1464-65 (elaborating on John Stuart Mill's argument that long-term contracts should be subject to judicial intervention by citing evidence that parties tend routinely to underestimate future risk and fail to see distant contingencies).

consider how the waiver will change the trustee's future behavior.⁹⁷

Although the foresight problem exists in the corporate context as well, it is much more troubling in the trust context. Unlike the investor, who must speculate only about events that will occur during her lifetime, the settlor has a much longer time horizon; thus her estimations are even less likely to be accurate.

In the corporate context, some scholars have suggested that courts should not enforce broad waivers of basic duties because they provide strong evidence that the parties possessed asymmetrical information about the existence and meaning of the waiver provision.⁹⁸ In particular, John Coffee argues that the specificity of the waiver is critical to determining the severity of the foresight problem. An investor is likely to understand a specific and narrowly tailored waiver, because it will be able to predict with some certainty how that waiver will be interpreted in the future.⁹⁹ Thus, the waiver provision is more likely to be reflected in the stock price, which goes a long way toward curing the information problem faced by uninformed investors.¹⁰⁰ Broad waivers, on the other hand, are not likely to be priced accurately, in part because investors cannot determine how the waiver will play out, and in part because investors may mistakenly rely on the fiduciary's past behavior in calculating the waiver's likely future effects (a mistake, because the waiver itself may change the fiduciary's behavior).¹⁰¹ Coffee's insight is even more pertinent to the trust arrangement, where the settlor has only his own estimation on which to rely.

C. FIDUCIARY DUTY WAIVERS, SOCIAL NORMS, AND EXTERNAL COSTS

So far, the analysis has assumed that fiduciary duty waivers affect only the parties to the trust document. If that were true, then parties should be able to waive or modify trustees' fiduciary duties so long as both parties have full information about the waiver's existence, meaning, and potential future effects.

97. See Coffee, *Mandatory/Enabling Balance*, *supra* note 51, at 1677 (citing Thompson and others) ("[T]he process of contracting about a long-term business relationship in which one party must place trust and confidence in another makes it difficult to explore the 'downside' possibilities that such party will be defrauded."); see also Eisenberg, *The Structure of Corporation Law*, *supra* note 51, at 1465-66 & n.16 (noting that, in the context of the close corporation, "[i]t is almost impossible to deal adequately with this potential for *ex post* opportunism by *ex ante* contracting").

98. See Coffee, *Mandatory/Enabling Balance*, *supra* note 51, at 1668-72 (arguing that only those waivers that are "transaction specific" are likely to be adequately priced); Frankel, *supra* note 5, at 1237 (stating that "a broad waiver of duties is bound to be uninformed and speculative").

99. See Coffee, *supra* note 51, at 1623, 1668 (arguing that "transaction specificity" is an answer to the pricing problem).

100. *Id.* at 1665-66.

101. *Id.* at 1668; see also *id.* at 1624 (arguing that "waivers that give broad powers to management to deviate from ways that market forces or moral standards would usually constrain" will not be accurately priced); Eisenberg, *Limits of Cognition*, *supra* note 5, at 249-50 (arguing that the duty of loyalty should not be waivable because beneficiaries of that duty lack the cognition to anticipate the circumstances in which and degree to which managers might gain the incentive to take advantage of the waiver).

But in fact, introducing variation into fiduciary duty law can create external costs that reduce value for all trusts.¹⁰² Interference with freedom of contract may be justified when necessary to limit external costs. Professors Merrill and Smith argue that property law severely limits the variety of property interests that parties may create in order to minimize costs to third parties.¹⁰³ Professors Hansmann and Mattei show how certain mandatory trust rules minimize costs for creditors and third parties who must deal with the trustee.¹⁰⁴

Viewing trustees' fiduciary duties simply as optional default rules would produce two distinct types of external effects. First, fiduciary duty law supports and reinforces social norms that require trustees to act with care and to refrain from self-dealing. Characterizing fiduciary duties as optional strips fiduciary duties of moral force and would, over time, weaken the social norms embodied in those duties. The end result would be a decline in the value of the trust mechanism, not merely for settlors and beneficiaries whose trusts include waiver provisions, but also for settlors and beneficiaries who seek to retain traditional fiduciary protections.

Second, if parties increasingly vary fiduciary terms, there will, over time, be less consensus about the meaning and content of fiduciary terms. Parties that cannot anticipate all potential agency cost problems rely on fiduciary duties as a substitute for express contract provisions. Fiduciary duties reduce the cost of contracting precisely because there is a common consensus about the meaning and scope of the core fiduciary principles. Professors Jeffrey Gordon and Melvin Eisenberg, coming at the issue from radically different perspectives, both conclude that law is a public good, and erosion of fiduciary standards would reduce the value of that public good.¹⁰⁵ Treating fiduciary duties as freely modifiable will, by introducing uncertainty into fiduciary law, increase the costs of contracting and litigation for all, and will consequently devalue beneficiaries' interests by increasing agency costs. After the dust clears, settlors who want to provide their beneficiaries with fiduciary protections will have to contract with greater specificity to anticipate future conflict (the very problem that fiduciary duties currently solve). Fiduciary duties will lose value as mechanisms for minimizing agency costs.

102. *But see* EASTERBROOK & FISCHER, *supra* note 3, at 22–25 (arguing that corporate contracts do not produce externalities that justify the imposition of mandatory terms).

103. *See* Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The Numerus Clausus Principle*, 110 *YALE L.J.* 1, 25–34 (2000) [hereinafter Merrill & Smith, *The Numerus Clausus Principle*]; Thomas W. Merrill & Henry E. Smith, *The Property/Contract Interface*, 101 *COLUM. L. REV.* 773 (2001); *see also* Gordon, *supra* note 63, at 1568–70 (exploring the extent to which concerns for negative externalities justify having mandatory legal rules in the corporate context).

104. *See* Hansmann & Mattei, *supra* note 9, at 451–67 (arguing that mandatory trust laws are justifiable, because they define property rights between the parties to the trust and third parties whose rights cannot be protected by contract).

105. *See* Eisenberg, *Social Norms*, *supra* note 51, at 1278; Gordon, *supra* note 63, at 1555.

1. Fiduciary Duties and Efficient Social Norms

To the extent that fiduciary standards embody social or moral norms, deterioration in a common understanding of their meaning will cause a corresponding loss in their proscriptive force. This point, advanced by corporate scholars, has been largely ignored in the trust literature and bears emphasis. Erosion of fiduciary terms would dilute the stigma attached to behavior that transgresses fiduciary standards, and it would therefore increase opportunistic behavior by even those fiduciaries who have not obtained waivers of particular duties.¹⁰⁶ Melvin Eisenberg and Robert Hillman both have argued that fiduciary duties are social norms that are more effective in shaping behavior than simple legal rules would be.¹⁰⁷ Although Eisenberg casts his point as part of a larger counterattack on the contractarian account of fiduciary duties,¹⁰⁸ his insights are particularly useful for exploring the extent to which fiduciary terms ought to be waivable.

Eisenberg's argument draws on the work of Robert Cooter and economist Kaushik Basu to posit that fiduciary duties are more than simply legal rules.¹⁰⁹ They are "obligational norms"—that is, norms of behavior that are sufficiently ingrained in the culture that violation of the norm will incite self-censure or the

106. See Cass R. Sunstein, *On the Expressive Function of the Law*, 144 U. PA. L. REV. 2021, 2029–30 (1996) (explaining that "[n]orms solve . . . problems by imposing social sanctions on defectors. When defection violates norms, defectors will probably feel shame, an important motivational force").

107. Eisenberg, *Social Norms*, *supra* note 51, at 1265–79; Robert W. Hillman, *Business Partners As Fiduciaries: Reflections on the Limits of the Doctrine*, 22 CARDOZO L. REV. 51, 72–73 (2000) (recognizing that fiduciary standards embody business norms, and that "[s]ome business partners may be restrained only by a fear of penalties imposed for misconduct, but a greater number of partners operate under self-imposed standards of behavior grounded in a broader ethic than legal duties").

108. Eisenberg is one of the leading scholars who argues against a conception of fiduciary duties as contractual. See Eisenberg, *The Structure of Corporation Law*, *supra* note 51, at 1487 ("The corporation is not a nexus of contracts but an enterprise organized by rules."). According to Eisenberg, because of the large number of managerial and non-managerial agents in a public corporation, "most of the constitutive rules of . . . corporations are determined not by contract, but by law or by private bureaucratic rulemaking." *Id.* at 1471. He further notes that while many constitutive rules are subject to private ordering, the most important ones are mandatory. While contractarians generally view private ordering as contractual, and hence mandatory rules as anticontractarian, Eisenberg argues that not all modifiable duties are contractual in nature. He explains:

[T]hat a right or duty may be limited by agreement does not make the right or duty contractual. For example, a general duty to exercise reasonable care can be contracted around, within certain limits, but that does not make the law of negligence contractual. Similarly, a right to a jury trial can be waived, but that does not make the Sixth Amendment contractual. Nor is a right or duty contractual because it is imposed on the basis of what courts or legislatures believe the parties would want to do if they had addressed the issue. Since it is impossible to determine what terms actors with unknown preferences and potentially different bargaining power would actually agree upon, rules that purport to be based on hypothetical bargains are actually based on collective action.

Eisenberg, *Social Norms*, *supra* note 51, at 1274–75.

109. Eisenberg, *Social Norms*, *supra* note 51, at 1258–63. Robert Cooter's work focuses on an actor's internal beliefs causing adherence to social norms. Kaushik Basu theorizes that "obligational norms" prevent us from violating social norms regardless of any personal utility that might result. See *infra* note 112.

judgment of others.¹¹⁰ Eisenberg argues that many obligational norms are internalized. Internalized norms comprise an aspect of individual character, and individuals will honor it reflexively, even if doing so causes them to forgo material gain.¹¹¹ Norms can change, however. If at some point a sufficient number of people believe that others are violating the norm, the norm reaches a “tipping point” and loses its obligational force.¹¹²

It follows that if fiduciary duties were entirely optional, the normative proscriptions against slacking and self-dealing would begin to unravel.¹¹³ If fiduciaries come to believe that other fiduciaries routinely violate the social norm, fewer fiduciaries will internalize those norms, and instead will engage in a cost-benefit analysis when considering whether to behave opportunistically.¹¹⁴ If the meaning of the standard term has eroded sufficiently to decrease a shareholder’s incentive to bring lawsuits, this may tip the balance toward

110. Eisenberg, *Social Norms*, *supra* note 51, at 1257 (explaining obligational norms); *id.* at 1265–66 (explaining that fiduciary duties are obligational norms). Eisenberg divides social norms into three categories: (1) behavioral patterns “that neither entail a sense of obligation nor are self-consciously adhered to or engaged in”; (2) practices that are “self-consciously engaged in but do not involve a sense of obligation”; and (3) obligational norms, which are “rules or practices that actors not only self-consciously adhere to or engage in, but feel obliged in some sense to adhere to or engage in.” *Id.* at 1256–57. Eisenberg explains that moral norms are one type of obligational norm. *Id.* at 1257.

111. *Id.*

112. Eisenberg explains that:

Tipping occurs when the success of a social activity depends on the formation of a critical mass, and enough actors sign on or off that the activity succeeds or fails A consequence of critical-mass and tipping phenomena is that the behavior of a relatively small number of actors can cause an activity to succeed or fail, because a tipping-point may be crossed as a result of the addition or subtraction of a small number of actors.

Id. at 1264.

When an obligational norm is not internalized, individuals considering whether to violate the norm engage in a cost-benefit analysis weighing the benefits of violation against the possible sanctions. *Id.* at 1257–58. Eisenberg quotes economist Kaushik Basu:

Certain norms stop us from doing certain things or choosing certain options, irrespective of how much utility that thing or option gives us. Thus most individuals would not consider picking another person’s wallet in a crowded bus. This they would do not by speculating about the amount the wallet is likely to contain, the chances of getting caught, the severity of the law and so on, but because they consider stealing wallets as something that is simply not done.

Id. at 1258 (quoting Kaushik Basu, *Social Norms and the Law*, in 3 NEW PALGRAVE ENCYCLOPEDIA OF LAW AND ECONOMICS 476, 477 (1998)).

113. See Cass R. Sunstein, *supra* note 106, at 2025–26 (arguing that the way in which a legal rule is framed can influence social norms). Eisenberg argues that corporate directors’ compliance with the duty of care is driven by a desire to comply with social norms, and not by fear of liability. Eisenberg, *Social Norms*, *supra* note 51, at 1265. Acknowledging that social norms can be inefficient, Eisenberg does not argue the law should blindly support all social norms. *Id.* at 1271. He does, however, make the case that fiduciary duties, particularly the duty of loyalty, are efficient norms, and argues that the law does and should support those norms. *Id.* at 1271–76. As for the duty of loyalty, he argues that compliance is induced both by the desire to comply with norms and by fear of liability. *Id.* at 1265–66.

114. Because the norms are efficient, the law serves an important expressive function in supporting and enforcing these norms, which ultimately encourages future compliance. See Eisenberg, *Social Norms*, *supra* note 51, at 1265–77.

opportunistic behavior.¹¹⁵

In the corporate context, the problem will be mitigated by market forces. In particular, a powerful information market exerts pressure on the corporate manager to exercise care and loyalty. The system is backed up by a rigorous regulatory scheme that threatens prosecution and jail time to corporate fiduciaries who commit egregious breaches of the duty of loyalty.

The insight that the deterioration of a fiduciary standard may create external costs by diluting social norms is, for two reasons, more powerful in the trust context. First, trustees are not subject to the same market discipline and government enforcement mechanisms as corporate officers and directors.¹¹⁶ Second, trust beneficiaries are typically less diversified than corporate shareholders.

Because trustees are not subject to market discipline (in particular, information markets and share price), they are more likely to include waivers of fiduciary duties. Because of information asymmetries, settlors and beneficiaries are unlikely to understand the meaning and future impact of these waivers.¹¹⁷ As a result, deviation will be more frequent, and deterioration of standards will be faster, than in the corporate context. At the same time, the absence of market discipline and rigorous enforcement of regulations makes it more likely that trustees, unfettered by strict fiduciary duties, will engage in behavior that is not value-enhancing. Because the trustee does not face a powerful information market that monitors managerial negligence and disloyalty,¹¹⁸ the only forces that keep the trustee from pushing the limits of appropriate behavior are conscience and the prospect of litigation by beneficiaries (who are poorly positioned to detect opportunistic behavior).

Compounding the problem is the beneficiaries' lack of diversification and inability to exit.¹¹⁹ If the proscriptive force of the fiduciary norm erodes and opportunistic behavior by trustees increases, the resulting harm to beneficiaries will generally be greater than the harm to shareholders.

2. Fiduciary Duties as a Public Good

If law is a public good, then cases that define the scope of standard terms, such as fiduciary duties, produce public benefits.¹²⁰ Yet if standard terms are freely modifiable, then contracting parties might increasingly attempt to deviate from them. As Gordon points out, market constraints limit the incentive for

115. Robert W. Hillman argues that indeterminate standards may motivate some fiduciaries to engage in opportunistic behavior. See Hillman, *supra* note 107, at 59–60.

116. See *supra* text accompanying notes 63–80.

117. See *supra* text accompanying notes 88–101.

118. See *supra* text accompanying notes 102–15.

119. Sitkoff, *supra* note 3, at 657 (pointing out that trust law “assumes that the beneficiaries are not diversified, so the trustee’s default duty of care is set at the more restrictive reasonable person standard”).

120. See Eisenberg, *Social Norms*, *supra* note 51, at 1278 (arguing that “shareholder suits [for breach of the duty of loyalty], whatever their short-term purpose and result, have the long-term result of creating an extremely valuable public good”).

corporations to deviate from standard terms to the extent that deviations reduce share price.¹²¹ Yet some corporations will find that deviation adds value, and over time significant numbers of corporations may deviate from standard terms.¹²² If so, those standard terms will less often be the subject of litigation, and their meaning will erode.¹²³ Litigation will become more costly and settlement less likely.¹²⁴ The end result will be an increase in transaction costs because contractors will be unable to rely on a common understanding of the standard term and will instead have to articulate more terms with precision.¹²⁵

The concern that deterioration of a standard term will result in increased transaction costs for all should be, for two reasons, especially intense when that standard term is a fiduciary duty. First, if fiduciary duties exist precisely because the parties cannot adequately anticipate future agency costs, erosion of the common understanding of the meaning and scope of fiduciary duties will be costly indeed. Settlers may simply be unable to contract with any degree of certainty.

This point has considerable force in the trust context. Fiduciary duties draw brighter lines here as compared to corporate or partnership law, and these brighter lines help parties contract with efficiency. For example, until quite recently it was widely understood that the duty of loyalty prohibited trustees from using their position to profit personally.¹²⁶ The rule was clear: if the trustee transacts business with the trust in its personal capacity, the trustee has breached its duty of loyalty to the trust, even if the beneficiaries could prove no damage as the result of the trustee's decision to sit on both sides of the table.¹²⁷ Did the trustee buy trust property? Breach.¹²⁸ Did the trustee sell assets to the trust? Breach.¹²⁹ Did the trustee learn of an opportunity because of its role as trustee

121. Gordon, *supra* note 63, at 1567–68.

122. *Id.*

123. *Id.* at 1566–71 (describing how deviation from standard terms may lead “to disintegration of the standard form”).

124. *Id.* at 1566–67. Robert Hillman has argued that vague standards—considered together with the costs of bringing litigation to enforce fiduciary duties (the costs may include the irreparable fracturing of the fiduciary relationship) and the inability to recoup litigation costs unless damages are substantial—will deter many lawsuits. See Hillman, *supra* note 107, at 60–61.

125. See Gordon, *supra* note 63, at 1565–70; see also Coffee, *Mandatory/Enabling Balance*, *supra* note 51, at 1677 (noting that deviation from standard terms “can impose costs on third parties, which ultimately will be spread throughout society”).

126. RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. a (1959). The most recent preliminary draft of the Restatement (Third) affirms the Restatement (Second)'s approach to the duty of loyalty in the main, but recognizes (and thus seems to validate) a troubling new loophole for institutional trustees that threatens to undermine the duty of loyalty. See RESTATEMENT (THIRD) OF TRUSTS § 78(1) cmt. d (Tentative Draft No. 4, 2005) (affirming the duty of loyalty generally); *id.* cmt. c(8) (noting that state statutes allow institutional trustees to invest trust assets in proprietary mutual funds).

127. See RESTATEMENT (THIRD) OF TRUSTS § 78(1) cmt. d (Tentative Draft No. 4, 2005); RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. c (1959).

128. See RESTATEMENT (THIRD) OF TRUSTS § 78(1) cmts. b & d (Tentative Draft No. 4, 2005); RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmts. b, e & j (1959).

129. See RESTATEMENT (THIRD) OF TRUSTS § 78(1) cmt. d (Tentative Draft No. 4, 2005); RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. h (1959).

and take personal advantage of that opportunity? Breach.¹³⁰ The settlor, in entering into a trust arrangement, did not need to envision every possible way in which the trustee could profit from its position as trustee and negotiate for contract provisions to preclude every instance of self-dealing. Instead, the settlor could rely on the well-established understanding of the meaning and scope of the duty. A settled understanding of the term reduced transaction costs.

Now, conceptualize fiduciary duties as optional. If professional trustees begin to deviate from standard fiduciary duties by inserting waivers in trust documents, this deviation will reduce the number of cases articulating the scope of fiduciary duty. At the same time, deviation increases the number of cases approving fiduciary conduct that would previously have constituted breach. Taken together, these factors increase the uncertainty facing a beneficiary whose trustee has violated traditional fiduciary standards. This increased uncertainty continues the downward spiral; the value of potential litigation declines, resulting in still fewer lawsuits and further degradation of the fiduciary standard. The result is that future settlors who wish to control trustees' future behavior must take greater care to specify duties by contract. No longer can they rely on off-the-rack fiduciary standards. Thus, in trust law, clearly defined, plainly understood duties play an important role in minimizing transaction costs.

In sum, when fiduciary standards embody commonly accepted and understood social norms, transaction costs are minimized. Viewing fiduciary standards as freely waivable default terms will increase the cost of contracting and increase litigation uncertainty.

III. DOCTRINAL IMPLICATIONS

Even if waivers maximize value for the immediate parties to the trust agreement, they increase costs for other settlors and beneficiaries, present and potential. The significant external costs that freely mutable fiduciary rules would impose provide justification for limiting parties' ability to modify them.

None of this is to suggest that all customization of trust terms should be prohibited. As Professors Merrill and Smith observe of property rules more generally, trust law should reach a balance between the efficiency gains generated by free contract and the losses that result from external costs associated with free contract.¹³¹ In particular, limited modifications that enhance trust value but are unlikely to significantly erode the force of the social norm or the general understanding about the meaning and effect of the broader duty might be justifiable. For example, the law might sanction a limited waiver of the duty of care, offered by the settlor to induce the trustee to accept risky investments as trust property, if that waiver is limited to liability for a decrease in value of those risky investments.¹³² This small exception to the duty of care is unlikely

130. RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. k (1959).

131. See Merrill & Smith, *The Numerus Clausus Principle*, *supra* note 103, at 25-34.

132. See *infra* text accompanying notes 167-68

to create uncertainty about the meaning of the duty of care, nor is it likely to dilute the social norm of trust. On the other hand, broad exculpatory clauses that insulate an institutional trustee from liability for all breaches of the duty of care could be viewed as too likely to create significant external effects to be justified. To take another example, a carefully drawn limited waiver absolving the trustee from liability for purchasing close corporation stock on behalf of the close corporation of which he is a director would be unlikely to induce confusion about the scope of the duty of loyalty as a whole, nor would it erode the general prohibition on self-dealing.¹³³ Wholesale authorization of the trustee's purchase of assets from which it receives a commission would, however, blur the common understanding of the duty, introduce uncertainty, and weaken the social norm's proscriptive force.

Thus, consideration of both the asymmetrical information problem and the externalities problem leads to the conclusion that courts should generally enforce narrowly drawn waivers that seek to limit only one aspect of a particular duty. On the other hand, courts should not routinely enforce broad waivers, particularly when the trustee is an institution.¹³⁴ Parts III.A and III.B explore these themes with respect to the two most basic duties of trust law: the duty of care and the duty of loyalty.

A. THE DUTY OF CARE

Across many kinds of agency relationships, the fiduciary duty of care requires the agent to exercise reasonable care in carrying out the principal's business.¹³⁵ In the corporate arena, duty is tempered by the notion that corporate managers should not generally be vulnerable to allegations of negligent behavior. The business judgment rule, which can be found in the case law as early as the mid-nineteenth century,¹³⁶ redefines the corporate duty of care, creating a presumption that management's decisions are informed and motivated by a good faith belief that the decision serves the corporation's best interests.¹³⁷ That presumption can be overcome only by a showing that management's behavior rose to a level of gross negligence.¹³⁸ There is a clear sense in corporate law that holding management or directors liable for actions that can

133. See *infra* text accompanying notes 217–18.

134. Cf. Coffee, *Mandatory/Enabling Balance*, *supra* note 51, at 1668–69 (noting in the corporate context the distinction between general and transaction-specific waivers, and arguing that parties are better able to account in advance for the impact of transaction-specific waivers).

135. See Easterbrook & Fischel, *Contract and Fiduciary Duty*, *supra* note 4, at 432–34, for a catalogue of agency relationships and their associated fiduciary duties.

136. See *Smith v. Prattville Mfg.*, 29 Ala. 503 (1857); *Hodges v. New Eng. Screw Co.*, 1 R.I. 312 (1850); *Godbold v. Branch Bank*, 11 Ala. 191 (1847); *Percy v. Millaudon*, 6 Mart. (n.s.) 616 (La. 1828).

137. See *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (“The rule itself ‘is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.’”) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

138. *Id.* at 873.

be construed as simply negligent is a troubling policy.¹³⁹

There is no comparable sense in trust law. Courts adjudicating cases alleging breach of the duty of care never developed a doctrine analogous to the business judgment rule.¹⁴⁰ In fact, they tended to construe exculpatory clauses strictly; cases finding a trustee liable notwithstanding the trust document's exculpatory clause were the rule rather than the exception.¹⁴¹ In the last twenty years, as corporate literature has popularized the characterization of the duty of care as a mere default term, legislatures have enacted provisions expressly authorizing exculpatory clauses in trust instruments.¹⁴² Uniform Trust Code section 1008 follows the lead of those legislatures by authorizing parties to insert exculpatory clauses in trust documents, subject to certain limitations.¹⁴³

139. Indeed, the idea that management should be insulated from liability for breach of the duty of care is so strong that legislators have reinforced it when they perceived the judiciary weakening it. In *Smith v. Van Gorkom*, decided in 1985, the court held that management could be found liable for breaching its duty of care, because its decisionmaking process was shoddy. *Id.* at 892-93. The *Smith* court viewed management's decisionmaking behavior as rising to the level of gross negligence and determined that its actions did not earn the protection of the business judgment rule. *Id.* at 881. Notwithstanding the court's characterization of management's actions as grossly negligent, the decision created widespread alarm, because it seemed to weaken the business judgment rule. In no time, the Delaware legislature passed a statute authorizing corporations to offer charter terms to limit liability for breach of the duty of care. See DEL. CODE ANN. tit. 8, § 102(b)(7) (2004).

140. See, e.g., *In re Newhoff*, 486 N.Y.S.2d 956, 958, 963 (App. Div. 1985) (stating that "the primary objective of a trustee should be preservation of the trust rather than enrichment of the beneficiary" and holding the trustee liable for risky investments); see also Sitkoff, *supra* note 45, at 574-76 (arguing that a trustee's stricter duty of care effectuates the aversion to risk that settlors and beneficiaries generally prefer, whereas the business judgment rule encourages greater levels of risk-taking that most shareholders seek).

141. See *supra* note 42.

142. Such jurisdictions include, but are not limited to: ALASKA STAT. § 13.36.192 (2004) (provision enacted 1985); COLO. REV. STAT. § 15-1-305 (2003) (provision enacted 1997); DEL. CODE ANN. tit. 12, § 3586 (2001) (provision enacted 2000); GA. CODE ANN. § 53-12-194 (1997) (provision enacted 1991); HAW. REV. STAT. § 554C-1 (Supp. 2004) (provision enacted 1997); IDAHO CODE ANN. § 68-501 (1999) (provision enacted 1997); IND. CODE ANN. § 30-4-3.5-1 (West Supp. 2005) (provision enacted 1999); IOWA CODE § 633.4505 (2001) (provision enacted 1999); KAN. STAT. ANN. § 58-24a01 (Supp. 2004) (provision enacted 2000); KY. REV. STAT. ANN. § 386.710 (West 2004) (provision enacted 1995); ME. REV. STAT. ANN. tit. 18-A, § 7-302 (1998 & Supp. 2004) (provision enacted 1995); MASS. GEN. LAWS ANN. ch. 203C, § 2 (West 2004 & Supp. 2005) (provision enacted 1998); MO. REV. STAT. § 469.901 (2000 & Supp. 2004) (provision enacted 1996); MONT. CODE ANN. § 72-34-512 (2004) (enacted 1989); NEB. REV. STAT. § 30-3883 (1997 & Supp. 2004) (provision enacted 1997); N.C. GEN. STAT. § 36A-161 (2003) (provision enacted 2001); OKLA. STAT. ANN. tit. 60, § 175.61 (West Supp. 2005) (provision enacted 1995); OR. REV. STAT. § 128.194 (2003) (provision enacted 1995); R.I. GEN. LAWS § 18-15-1 (2003) (provision enacted 1996); S.C. CODE ANN. § 62-7-302 (1987 & Supp. 2004) (provision enacted 1986); TENN. CODE ANN. § 35-14-103 (Supp. 2004) (provision enacted 2002); UTAH CODE ANN. § 75-7-302 (1993 & Supp. 2005) (provision enacted 1995); VT. STAT. ANN. tit. 9, § 4651 (Supp. 2004) (provision enacted 1997); VA. CODE ANN. § 26-45.3 (2004) (provision enacted 2000); WASH. REV. CODE ANN. § 11.100.010 (West 1998 & Supp. 2005) (provision enacted 1995); W. VA. CODE § 44-6C-1 (2004) (provision enacted 1996); WIS. STAT. ANN. § 881.02 (West 2002 & Supp. 2004) (provision enacted 2002); WYO. STAT. ANN. § 4-10-901 (2005) (provision enacted 2003).

143. Specifically, UTC section 1008(a)(1) does not validate trust provisions that shield trustees from liability for acts "committed in bad faith or with reckless indifference to the purposes of the trust or the interests of the beneficiaries." Section 1008(a)(2) authorizes courts to invalidate clauses that were inserted as a result of an abuse of a confidential relationship between the trustee and settlor.

Although there is an extensive literature exploring the issue of limiting liability for corporate management, relatively little scholarship has addressed whether and to what extent trustees ought to receive comparable protection. After analyzing the justifications for immunizing corporate management from liability for negligent acts, this section then considers the appropriate treatment of trust provisions purporting to exculpate trustees from liability for negligent behavior.

1. The Duty of Care and Corporate Directors

Professors Fischel and Easterbrook argue that protecting directors from liability from breach of the duty of care maximizes shareholder value, because the costs of the duty of care outweigh its benefits, and because liability rules are an ineffective mechanism for adjudicating shareholder-management disputes on this issue.

First, they argue that because management faces strong market pressures to exercise reasonable care, a legal rule requiring management to do so is superfluous.¹⁴⁴ Managers are repeat players; they continuously need to raise capital.¹⁴⁵ Moreover, management's wealth is tied to its performance, and its performance is judged by share price and its success in the capital markets.¹⁴⁶ Poor managers will have a hard time obtaining other comparable management positions if they are fired.¹⁴⁷ Finally, corporate investments in human capital create pressure.¹⁴⁸ In sum, because the market will discipline poor managers, management will perform reasonably regardless of whether failure to do so will result in liability.

On the other hand, they argue, management gains little from breaching the duty of care.¹⁴⁹ Consequently, "[a]s the present value of forgone compensation in future periods increases relative to the current gains from poor performance, liability rules become less important."¹⁵⁰ Moreover, they argue, courts are in a poor position to evaluate management's performance because business decisions involve a multitude of factors, including knowledge of the particular business, market, and institution.¹⁵¹ Managers must often act quickly in the face of market pressures, without time to deliberate.¹⁵² A decision that turned out

144. EASTERBROOK & FISCHEL, *supra* note 3, at 94–102.

145. *Id.* at 95.

146. *Id.* at 96–97.

147. *Id.* at 95.

148. To wit, "[c]orporate managers frequently possess expertise and skills specialized to a firm. Changing managers is costly because the replacements lack equivalent firm-specific expertise—costly to managers, too, because they must acquire specific capital to be useful elsewhere. Both sides try to avoid these costs, the threat of which induces both to perform well in the first place." *Id.* at 97.

149. *See id.* at 95.

150. *Id.* at 95–96.

151. "What looks like a hasty decision by corporate managers may simply reflect experience or an effort to avoid the expense of hiring outside experts." *Id.* at 102; *see also* Joy v. North, 692 F.2d 880, 898 (2d Cir. 1982) (Cardamone, J., dissenting).

152. "Businesses rarely encounter 'sure things.' Often managers must act now and learn later; delay for more study may be the *worst* decision . . ." EASTERBROOK & FISCHEL, *supra* note 3, at 98–99.

poorly might have been the right decision nonetheless. As Fischel and Easterbrook put it, the “[c]osts of decision *ex post* will be highest precisely when it was also most difficult to contract *ex ante*.”¹⁵³ Furthermore, most agency costs are attributable to a “lack of gumption,”¹⁵⁴ but in a situation where decisions are usually made by committee, it is difficult, if not impossible, for a court to determine the extent and character of each parties’ contribution, or lack thereof. In the rare case where those forces prove inadequate to induce management to behave reasonably, “*ex post* settling up in markets” is a disciplinary tool superior to judicial intervention.¹⁵⁵

While a rule requiring management to exercise reasonable care adds little value, it creates significant costs. First, it makes management unduly vulnerable to derivative suits, which consume significant corporate resources.¹⁵⁶ Yet plaintiffs and their attorneys may have little reason to consider the corporation’s costs when determining whether to sue. The smaller the shareholder’s interest, the greater her incentive to sue, because the cost of the suit to the plaintiff/shareholder may be small in comparison to the potential reward. Shareholders with small stakes will bear little of the cost of the litigation, and they have no incentive to consider the cost the litigation will create for other shareholders.¹⁵⁷ Attorneys considering whether to pursue a derivative suit will consider only the likely compensation, but not the cost to the corporation.¹⁵⁸ A rule limiting management’s liability to acts that are at least grossly negligent arguably minimizes frivolous derivative suits.

A second cost of a rule that requires exercise of reasonable care is that it reinforces management’s risk-averse nature. Shareholders who are diversified might wish to increase management’s tolerance for risk. Easterbrook and Fischel argue that a rule that absolves management from liability for risks taken in good faith might enhance shareholder wealth by increasing profit while allowing shareholders to pay less in compensation and insurance.¹⁵⁹

From the business judgment rule, it is a small step to conclude that statutes authorizing management to offer charter terms that shield them from liability for breach of the duty of care make some sense. To the extent that an exculpatory clause simply reaffirms the standard business judgment rule, there is little need to worry that shareholders may be disadvantaged by the clause, even if they are unaware of its existence. If the clause affords management greater protection than the business judgment rule would (because it could be construed to protect even actions that could be characterized as grossly negligent), share

153. *Id.* at 99.

154. *Id.*

155. *Id.*

156. *Id.*

157. “A dominating characteristic of the derivative action is the lack of any link between stake and reward—not only on the judge’s part but also on the plaintiff’s.” *Id.*

158. *Id.* at 101.

159. *Id.* at 99–100.

price—which reflects the cost of disadvantageous terms—arguably protects the uninformed investor.¹⁶⁰

2. The Duty of Care and the Trustee

a. The Absence of a Business Judgment Rule. Why has trust law not developed a version of the business judgment rule? First, there are relatively fewer market pressures to induce trustees to exercise reasonable care. Trustees need not worry about raising money, maintaining or increasing stock prices, or responding to hostile takeovers. There is no “share price” or secondary information market that informs other potential customers of a trustee’s negligent acts. In fact, negligence is often hard for a beneficiary to detect. Beneficiaries who discover that a trustee is performing poorly will be unlikely to communicate this to the trustee’s other clients, who remain unknown to them. Although employees of trust companies may be concerned about the labor market, it influences them less than it does their corporate counterparts. Because there is no information market that reveals their poor performance, employees may be less concerned about finding a new job if they are terminated. Thus, there is little “*ex post* settling up in markets”¹⁶¹ when a trustee acts negligently with respect to any particular trust account; as long as trustees do not run afoul of regulators, there are few market pressures that encourage them to exercise reasonable care. When the trustee is an individual professional, the problem is compounded.

Second, there is no reason to encourage trustees to take risks.¹⁶² The duty of care does not hamstring trustees the way it arguably does corporate management.¹⁶³ The exercise of reasonable, cautious judgment is the very essence of the trustee’s job.

Moreover, if a beneficiary does allege that the trustee breached the duty of care, judges or juries are better equipped to determine whether a trustee’s action, or lack of action, amounts to negligence. Unlike the corporate environment, where management must deal daily with a multitude of variables, and

160. The foresight problem is not significant, because the shareholder makes predictions about events that will occur during her lifetime, and because losses suffered as a result of inadequate foresight are small. Contractarians have failed to take seriously arguments about the external costs created by norm erosion. See, e.g., Butler & Ribstein, *supra* note 46, at 37–39. Butler and Ribstein dismiss externality arguments made by Coffee. See Coffee, *No Exit*, *supra* note 51, at 948–49.

161. EASTERBROOK & FISCHER, *supra* note 3, at 99.

162. Sitkoff, *supra* note 45, at 574 (noting that “beneficiaries cannot easily diversify, and when one cannot diversify the standard economic assumption is that of risk-averseness”). Sitkoff argues that relative tolerance for risk explains the difference in the duty of care standard in the corporate and trust contexts. *Id.* at 574–76.

163. Robert Cooter and Bradley Freedman have argued that:

The duty of care imposes an obligation on the fiduciary to avoid unnecessary risk. However, different levels of risk are appropriate in different fiduciary relationships. For example, a trustee often is required to be prudent and conservative in managing an asset, whereas a director of a start-up company may be encouraged to take risks.

See Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1062 (1991).

quick action on less than full information may be necessary, the business of trust management is comparatively straightforward.¹⁶⁴ Trustees ordinarily need not make decisions under time pressure, and investment decisions involve relatively clear considerations. The trust terms create guidelines to assist the trustee (and later, the court) to evaluate whether a particular type of investment is sound for a particular trust. Additionally, because there are usually only one or two trustees, determining which trustee made the mistake is unlikely to be difficult for the factfinder. As a general matter, a liability rule requiring the exercise of due care appears well calibrated to constrain trustee misbehavior.

But will the costs of litigation offset the benefits the rule generates? The litigation cost problem is less significant in the trust context compared to the corporate context because fewer incentives to frivolous litigation exist. The corporate problem of the litigious shareholder who bears little of the cost of litigation, and thus has an incentive to bring an action that imposes costs on other stakeholders, should be much less pronounced. Because each trust has only a few beneficiaries, a litigious beneficiary will bear a significant portion of the litigation costs, because if the trustee prevails, litigation expenses will be paid out of the trust property.¹⁶⁵ This creates a disincentive to bring a lawsuit, unless the case for trustee breach seems strong. Thus the corporate problem of frequent litigation of questionable merit is mitigated by the circumstances of the trust mechanism.

In sum, close analysis vindicates the history of trust law, in which trustees are held to a high standard of performance. Because the duty of care generates value, there has been no judicial trend toward abolishing it or reducing the protections it affords. In contrast, in the corporate context the legislative sanction of exculpatory provisions is an understandable reaction to judicial determinations that make the limits of the duty uncertain.

b. Exculpatory Clauses. Although the duty of care generally maximizes trust value, there are instances in which the settlor would benefit from a provision modifying the trustee's common-law duty. Whether these modifications should be enforced, however, depends on the existence and scope of information

164. See Sitkoff, *supra* note 45, at 577 (noting that "managerial decisions regarding financial assets are easier to monitor than decisions regarding operating assets" and that this relative ease justifies legal oversight of the trustee).

165. See, e.g., *Snook v. Trust Co. of Ga. Bank*, 909 F.2d 480, 485 (11th Cir. 1990).

asymmetries, and on the external costs generated by modifying the common-law duty.

When the settlor chooses a non-professional trustee, information problems are unlikely to be significant. A settlor who chooses a non-professional does so because the settlor places a high value on qualities other than professional trust management, such as the trustee's knowledge of family dynamics or the beneficiaries' peculiarities. The parties' interests are fairly aligned, and neither is likely to possess superior legal knowledge. In such a case, the trustee might lack financial expertise. The settlor might not want to see the trustee sued for errors in investment decisions, and the fear of potential liability might make the potential trustee reluctant to serve, depriving the settlor of the family expertise that she seeks. Both settlor and trustee might want an exculpatory clause to give the trustee some room to maneuver without fear of liability. Because serious information problems are unlikely to exist, and because the waiver enhances value for both parties, there is no justification for prohibiting a waiver that raises the threshold for liability to gross negligence or recklessness.

When the settlor chooses a professional trustee, however, the analysis is different. Although most settlors (especially those with very high net worth) will be well represented by skilled and honest attorneys, the occasional settlor may be unrepresented or ill-served by his attorney. In such a case, the parties' access to information about the existence, meaning, and future effect of an exculpatory clause may be asymmetrical.¹⁶⁶ If there were a need to allow professional trustees to insert broad clauses exculpating them from the effects of their own negligence, then one might ask whether concerns for those marginally few poorly or unrepresented settlors justifies a rule prohibiting broad waivers. But, as the following paragraphs develop, there is little justification for allowing professional trustees to protect themselves with broad exculpatory clauses; in fact, most well-established institutional trustees do not feel the need for broad clauses and do not insist on them. Given this circumstance, a rule prohibiting professional trustees from hiding behind broad exculpation clauses might be justified as necessary to protect those settlors at the margins who lack full information. On the other hand, narrowly drawn, transaction-specific waivers are unlikely to be the result of information deficits, and courts should generally enforce them.

The externalities concern leads to the same conclusion. Broad unspecific waivers have the greatest potential to erode fiduciary norms. Narrowly tailored, transaction-specific waivers, however, pose relatively little threat to the vitality of fiduciary norms.

At least three reasons might lead a settlor with full information to consider exculpating a professional trustee from liability for breach of the duty of care. First, the settlor might fear frivolous litigation by disappointed beneficiaries, litigation that will ultimately reduce the value of the trust for all beneficiaries.

166. See *supra* text accompanying notes 90–101.

Second, the settlor may believe that trustee compensation will be less expensive if the trustee is not bound by common-law fiduciary duties and their attendant risk of litigation. Third, the settlor may face a particular problem or set of problems for which fiduciary duties present a sub-optimal solution. For instance, the settlor may desire that the trustee hold assets in trust that the trustee is reluctant to accept.

Consider first the settlor who fears nuisance suits by a particular beneficiary (or beneficiaries) with a tendency to behave irrationally. The settlor can easily solve this problem with the equivalent of "no contest" clauses commonly drafted in wills. A beneficiary who unsuccessfully challenges the trustee's exercise of care loses all or part of her beneficial interest in the trust. While even this solution might be criticized for its potential to deter meritorious suits, at least a no-contest clause preserves some incentive for a trustee to exercise reasonable care: the settlor need not saddle all beneficiaries with no-contest provisions (so that some of the beneficiaries could enforce the duty without risking their interests), and, in at least some cases of clear breach, beneficiaries might be willing to take some personal risk to recover from a careless trustee. By contrast, a broad exculpatory clause fails completely to separate nuisance suits from those involving breach of the duty of care.

Next, consider the settlor who is willing to include an exculpatory clause to lower trustee compensation. The trustee may represent to the settlor that the exculpatory clause will reduce its litigation costs, and the trustee's representations of, and reputation for, trustworthiness may reassure the settlor that the trustee will act prudently without threat of litigation. Here, a primary difficulty is one of asymmetric information: the settlor may have little understanding of the rights she is forfeiting by including an exculpatory clause, nor may she understand how much she is saving by forfeiting those rights. One solution would be to enforce broad exculpatory clauses, but only if the professional trustee formally offers the settlor two prices for two different services: one commission for full-service trusteeship, and a lower commission for an agreement that includes an exculpatory clause.¹⁶⁷ At least in this instance a large price differential is likely to induce the settlor to obtain independent advice about the rights she gives up when she agrees to the exculpatory clause. Moreover, requiring the trustee to price the exculpatory clause would discourage trustees from routinely insisting on such clauses.

Finally, consider a settlor who wants to induce the trustee to accept and maintain as trust property investments that the trustee would not ordinarily consider appropriate trust investments—stock in a closely held corporation or some other concern in which the settlor has a personal interest. If a trustee

167. See Coffee, *Mandatory/Enabling Balance*, *supra* note 51, at 1623 (stating that "courts should uphold opt-out provisions that deviate from traditional fiduciary standards only when they can find that the term has been accurately priced"); see also *id.* at 1667-68 (discussing difficulties with accurate pricing).

deems the investment too risky, or if the investment falls outside the scope of the trustee's investment guidelines for trust investments, the trustee may condition receipt of the problematic assets on the inclusion of an exculpatory clause in the trust document. If the clause is drawn narrowly, so that it relieves the trustee from liability only if the problematic assets later decline in value, there is no reason to prohibit the waiver. Because the waiver is specific and requested or offered as a condition to taking on problematic assets, both sides are likely to possess equal information about the clause's existence, scope, and future effects.

Suppose now that the settlor and the trustee attempt to solve the same problem with a boilerplate exculpatory clause that reads, "the trustee named in this instrument shall not be liable for the trustee's acts or failure to act, except for willful misconduct or gross neglect."¹⁶⁸ Although the professional trustee understands fully the meaning of this provision, the settlor may believe that the clause is intended solely to protect the trustee from liability stemming from the risky investment. Given the settlor's limited foresight, he may not understand that the trustee may later raise the clause as a defense against a beneficiary's claim of breach with respect to other actions taken by the trustee. Because of asymmetrical information about the meaning of the broadly worded exculpatory clause, the fact that the clause exists is not evidence that it is actually wealth-enhancing.

Moreover, authorizing broadly worded exculpatory clauses may, in the aggregate, cause significant harmful external effects. As explained previously, broad waivers tend to erode the legal understanding of the fiduciary standard, which, over time, will increase transaction costs by reducing the parties' ability to rely on the standard as a backdrop to the contract. In addition, the erosion of the fiduciary norm will weaken its proscriptive force, which may encourage some trustees to behave opportunistically, further reducing the value of the trust form.

In short, none of the reasons that might lead a settlor to include an exculpatory provision in a trust instrument provides a sufficient justification for routinely enforcing broad exculpatory clauses against institutional trustees. Typically, when the settlor faces a problem for which off-the-rack fiduciary duties provide a sub-optimal solution, the settlor can resolve the problem with a trust provision that is narrowly tailored to achieve the settlor's objective; a broad exculpatory clause is not necessary. Only the trustee's representations that a broad exculpatory clause will reduce its litigation costs, and hence the settlor's commissions, provide some basis for enforcing broad clauses. But trust provisions drafted based on those representations are rife with asymmetric information problems. And, beyond those problems, enforcement of exculpatory clauses would generate external costs not present to the same degree with narrowly tailored provisions.

168. Drafting California Revocable Living Trusts, CAL. C.E.B. § 16.22 (J. Cohan ed., 4th ed. 2003).

The external-costs problem suggests that courts should not enforce broadly drafted exculpatory clauses against institutional trustees (allowing non-professional trustees to invoke them is unlikely to seriously erode the norm). But even if courts are willing to ignore those external costs, the analysis suggests that they should enforce exculpatory clauses only where there is clear evidence that the clause advances some identifiable objective of the settlor, and that the settlor possessed full information about the cost and potential impact of the clause.

Statutes that authorize parties to insert broad exculpatory clauses that shield professional trustees from liability for failure to exercise reasonable care are partially misguided, because they water down the judiciary's role. As John Coffee has emphasized, American courts "have invariably played an active and indispensable role" in monitoring long-term relational contracts;¹⁶⁹ the American tolerance for contractual freedom has typically been counterbalanced by judicial activism in monitoring for opportunism.¹⁷⁰ To the extent that statutes propose to weaken this *ex post* judicial review as a check on opportunistic behavior, they pose a danger beyond the one generated by occasional judicial enforcement of a broad exculpatory clause.

c. The Law. The preceding analysis provides a theoretical explanation for the approach that many states have taken. For example, New York by statute expressly prohibits exculpatory clauses in testamentary trusts.¹⁷¹ Surrogate Court judges (not all of whom are known for being overly sensitive to ethical dilemmas) drafted and advocated for the statute,¹⁷² which was enacted in 1936 over the strong objections of the city and county bar associations.¹⁷³ The impetus for the statute was the surrogates' urgent sense that exculpatory clauses

169. Coffee, *Mandatory/Enabling Balance*, *supra* note 51, at 1619.

170. *Id.* at 1620-21.

171. N.Y. EST. POWERS & TRUSTS LAW § 11-1.7 (McKinney 1967). That section provides:

- (a) The attempted grant to an executor or testamentary trustee, or the successor of either of any of the following enumerated powers or immunities is contrary to public policy:
 - (1) The exoneration of such fiduciary from liability for failure to exercise reasonable care, diligence and prudence.

172. According to a letter written by Surrogate Wingate to Governor Lehman, the bill was drafted by Surrogates Wingate, Foley and Delehanty. The Surrogate's Association of New York State approved the bill. *See* Letter from Surrogate Wingate to Governor Lehman (Apr. 1, 1936) (on file with the library of the Association of the Bar of the City of New York).

173. The New York County Lawyer's Association recommended that the legislature disapprove the bill. *See* Report of the New York County Lawyers' Association, Committee on State Legislation (Report No. 442, Mar. 31, 1936) (on file with the library of the Association of the Bar of the City of New York). The Committee on State Legislation of the Association of the Bar of the City of New York also recommended that the bill be rejected. *See* Report of the Committee on State Legislation of the Association of the Bar of the City of New York 595-97 (Report No. 257, n.d.) (on file with the library of the Association of the Bar of the City of New York). The New York State Bar Association seems to have approved the bill. *See* Letter from Surrogate Wingate to Governor Lehman (Apr. 21, 1936) (on file with the library of the Association of the Bar of the City of New York).

were becoming standard in trust forms used by institutional trustees (while non-professional trustees never insisted on them),¹⁷⁴ and that settlors who signed these trust agreements were insufficiently informed about the existence, meaning and likely future consequences of these provisions.¹⁷⁵ One drafter also emphasized the failure of settlors' lawyers to cure the information asymmetries:

[T]he drawing of wills . . . has to perhaps a preponderant extent fallen into the hands of lawyers who are either actively engaged in work for these financial institutions or hopefully anticipate such retainers. As a result, men who are more and more coming to do the work of testamentary draftsmanship, have come to view the wills they are called upon to draw from the standpoint of the corporate fiduciaries whom they expect to represent, rather than from that of the testator and the persons, whether dependents or otherwise, whom he desires to benefit.¹⁷⁶

Although the New York statute does not apply to inter vivos trusts, New York

174. In a second letter from Surrogate Wingate to Governor Lehman in support of the legislation, which Surrogate Wingate drafted, Surrogate Wingate blasted the New York Bar Association for contending that exculpatory clauses were principally necessary to enable testators to give freedom to non-professional, family-member trustees:

The fact of the matter, as demonstrated by my almost twenty years of experience on the bench in the county, which by reason of the fact that it has the largest population in the state, does the greatest volume of probate business, is that the argument advanced is wholly specious and misleading. In all my experience, I cannot recall a single instance in which a testator has given such authority (to deviate from the standard of care) to an executor or trustee who was an object of his bounty. On the other hand, such clauses are of almost daily occurrence in wills in which corporate fiduciaries are named.

The following clause . . . has appeared, in substance, on so many occasions as to lead to the conclusion that it has been adopted as a standard form by the corporate and other professional fiduciaries: 'My executor and Trustee shall not be liable for any act of omission or loss in the performance of its duties except for willful neglect or misconduct.'

Letter from Surrogate Wingate to Governor Lehman 3-4 (Apr. 21, 1936) (on file with the library of the Association of the Bar of the City of New York).

175. Surrogate Wingate argued that "the chief vice [with exculpatory clauses] arises from the fact that the average testator neither sees nor understands these clauses nor the effect that they may produce among his dependents. He is primarily concerned with the fact that certain dependents are to receive, as he believes, certain portions of his property, and is content to leave to the attorney drawing the will the administrative portions thereof." Letter from Surrogate Wingate to Governor Lehman 2 (Apr. 1, 1936) (on file with the library of the Association of the Bar of the City of New York). In another letter, Surrogate Wingate argued that testators in the vast majority of cases had not "any remote realization of the fact that he was subjecting the property upon which his dependents must look for support, to potentially serious jeopardy." Letter from Surrogate Wingate to Governor Lehman 4 (Apr. 21, 1936) (on file with the library of the Association of the Bar of the City of New York).

176. Letter from Surrogate Wingate to Governor Lehman 1 (Apr. 1, 1936) (on file with the library of the Association of the Bar of the City of New York). Surrogate Wingate further argued that "[t]hese corporate fiduciaries in too many instances view the entire matter [of drafting a will with a testamentary trust provision] not so much as a sacred trust upon which the welfare of the beneficiaries, and indeed, at times, their very existence depends, as just another piece of business to be handled in a routine way, frequently by underpaid clerks, lacking both experience and sound judgment." *Id.*

courts have continued to resist exculpatory clauses in those trusts.¹⁷⁷ New York cases deciding the issue fall into three categories: either the court holds the trustee liable on the ground that the acts complained of are outside the scope of the protection the exculpatory clause affords;¹⁷⁸ the court finds that the exculpatory clause precludes the beneficiaries' action, because the trustee is still accountable to the living settlor;¹⁷⁹ or the court holds that the trustee is not liable, because it was not negligent.¹⁸⁰

Other state courts share New York's reluctance to shield trustees from liability for breach of the duty of care. For example, New Jersey courts have determined that, as a general matter, an exculpatory clause cannot relieve a trustee from liability "where a loss results from negligence in the administration of a trust."¹⁸¹ And the Alabama Supreme Court has held that "although a trustee's duties and obligations are governed largely by the trust agreement, that agreement cannot be employed to vitiate 'the duty imposed by the "prudent person" standard.'"¹⁸²

Although the vast majority of state courts routinely announce that exculpatory clauses are enforceable,¹⁸³ in reality, courts tend to shield the trustee from

177. It is not clear why the drafters of the New York statute did not expressly extend the exculpatory clause prohibition to inter vivos trusts. Perhaps the explanation lies in the fact that the vast majority of trusts during this period were testamentary trusts, or because surrogates were less sure that the legislature had authority to interfere with the terms of inter vivos instruments, which were not subject to judicial supervision. In the first cases to consider whether the statute's prohibition should extend to inter vivos trusts, courts held that it should not. *See, e.g., In re Cent. Hannover Bank & Trust Co.*, 26 N.Y.S.2d 924 (Sup. Ct. 1941). Early cases holding that exculpatory clauses are enforceable if contained in inter vivos trust are better understood as consistent with the rule, which is well established in several states, that "while a trust is revocable, the trustee owes duties to the person holding the power to revoke and not to the named beneficiaries." CAL. PROB. CODE § 16400 cmt. (West 2004).

178. *See Villard v. Villard*, 114 N.E. 789, 794-95 (N.Y. 1916) (holding that a clause purporting to shield a trustee from liability for retaining investments originally held by the settlor did not shield the trustee from liability for failing to sell investments that it did not know were not part of the settlor's estate); *In re Rushmore's Estate*, 21 N.Y.S.2d 526, 529-30 (Sur. Ct. 1940) (holding that an exculpatory clause directing that a trustee would not be held liable "for any act done . . . in good faith hereunder" did not shield the trustee from liability for "non-legal" investments).

179. *See Bauer v. Bauernschmidt*, 589 N.Y.S.2d 582 (App. Div. 1992).

180. *See In re Clark's Will*, 177 N.E. 397 (N.Y. 1931).

181. *See Behrman v. Egan*, 95 A.2d 599, 601 (N.J. Super. Ct. Ch. Div. 1953) (citing *Liberty Title & Trust Co. v. Plews*, 60 A.2d 630 (N.J. Ch. 1948)); *Dickerson v. Camden Trust Co.*, 53 A.2d 225 (N.J. Ch. 1947), *aff'd*, 64 A.2d 214 (N.J. 1949); *see also Semler v. CoreStates Bank*, 693 A.2d 1198, 1208 (N.J. Super. Ct. App. Div. 1997) (holding a trustee liable for negligence on the ground that the trustee's negligent acts fell outside the scope of protection the exculpatory clause provided).

182. *See First Ala. Bank of Hunstville v. Spragins*, 515 So. 2d 962, 964 (Ala. 1987) (holding that a trust provision cannot alter the trustee's duty to use reasonable care in making and managing investments).

183. *See Kimball v. New Eng. Trust Co.*, 14 Conn. Supp. 432, 440 (1947) (stating that "[a]lthough courts should not encourage efforts to impair the stringency of the time-honored safeguards with which the law has encompassed the fiduciary relation, nevertheless, the acts of this executor-trustee must be examined in the light of the 'exculpatory clauses' of this will. This testator has excused, in each instance, any loss not due to bad faith or willful default. The court does not understand the appellants to claim any bad faith in this case"); *In re Trusteeship of Williams*, 591 N.W.2d 743, 746-48 (Minn. App. 1999) (rejecting the beneficiary's argument that enforcement of an exculpatory clause in favor of a

liability in only four situations: (1) the trustee exercised reasonable care notwithstanding the exculpatory clause;¹⁸⁴ (2) the trustee is a non-professional or uncompensated;¹⁸⁵ (3) the exculpatory provision relates directly to the settlor's direction that the trustee retain specific, relatively risky investments, and the beneficiaries seek to hold the trustee liable for their handling of those investments;¹⁸⁶ or (4) there is other evidence that the settlor possesses full information.¹⁸⁷ In cases where the trustee's negligence is apparent, courts often find the trustee liable on the ground that the exculpatory clause does not protect the trustee from the negligent acts.¹⁸⁸

3. The Duty of Care and the Uniform Trust Code

Following the Restatement, Uniform Trust Code section 1008 deems enforceable an exculpatory clause relieving the trustee from liability for breach of the duty of care.¹⁸⁹ On its face, there is nothing controversial about section 1008. In allowing waivers for even those trustee acts that amount to gross negligence, the

professional trustee was against public policy, but finding that the exculpatory clause did not shield the trustee from liability for negligent acts).

184. See *Kimball*, 14 Conn. Supp. at 440; *Powell v. Cocowitch*, 94 So. 2d 589, 591-92 (Fla. 1957); *Blauvelt v. Citizens Trust Co.*, 71 A.2d 184 (N.J. 1950); *Bauer v. Bauernschmidt*, 589 N.Y.S.2d 582, 583 (App. Div. 1992) (finding that the trustee acted with the requisite degree of care in taking some of the actions that led to the complaint); *In re Cowles' Will*, 255 N.Y.S.2d 160, 173 (App. Div. 1965); *Spring v. Hawkes*, 41 A.2d 538 (Pa. 1945).

185. See *Pearson v. Barr*, No. D037414, 2002 WL 1970144 (Cal. Ct. App. Aug. 27, 2002).

186. See *Bartlett v. Dumaine*, 523 A.2d 1, 11 (N.H. 1986) (upholding exculpatory clause). The *Bartlett* court noted that "[i]n this case, the master found that Dumaines 'is a unique trust, having features of both a trust and a corporation,' and that [settlor's] general intent . . . was to authorize his Trustees 'in their associated capacity to carry on business' 'so far as convenient and practicable' under the name of 'Dumaines.' It was the settlor's general intent to give the trustees 'absolute control of trust property and trust business.' The master also found that '[s]ince the Dumaines Trustees are to establish and carry on businesses, the settlor clearly intended that the 'prudent [person] rule' of investment would not be applicable.'" *Id.* at 8; see also *Hoffman v. First Va. Bank*, 263 S.E.2d 402 (Va. 1980); *Perling v. Citizens & S. Nat'l Bank*, 300 S.E.2d 649 (Ga. 1983); *In re Cowles' Will*, 255 N.Y.S.2d 160, 173-74 (App. Div. 1965).

187. *Farr v. First Camden Nat'l Bank & Trust Co.*, 66 A.2d 444, 446 (N.J. App. Div. 1949).

188. See *McNeil v. McNeil*, 798 A.2d 503, 509 (Del. 2002) (considering a trust provision that protected a trustee from liability for negligence, and concluding that the trustee was liable for breach of trust, because "[a] reasonable construction of these provisions . . . is that the Lois Trustees were exculpated for ordinary negligence, but not the duty to (i) inform beneficiaries or (ii) treat them impartially"); *In re Trusteeship of Williams*, 591 N.W.2d 743, 747-48 (Minn. Ct. App. 1999) (upholding the validity of an exculpatory clause shielding a trustee from liability for errors in judgment, but finding that the trustee's failure to sell declining stock for over four years, even though the stock comprised the majority of the trust's assets, could constitute a breach of fiduciary duty, because the failure was possibly negligent rather than "an error in judgment"); *Behrman v. Egan*, 95 A.2d 599, 601 (N.J. Super. Ct. Ch. Div. 1953) (citing *Liberty Title & Trust Co. v. Plews*, 60 A.2d 630 (N.J. Ch. 1948)); *Bauer v. Bauernschmidt*, 589 N.Y.S.2d 582, 583 (App. Div. 1992) (holding that an exculpatory clause did not protect a trustee from liability for making certain negligent expenditures); *Jewett v. Capital Nat'l Bank*, 618 S.W.2d 109, 112 (Tex. Ct. App. 1981) (holding that an exculpatory clause relieving a trustee of liability for investing in speculative stocks did not shield the trustee from liability for negligence in failing to diversify the trust's assets).

189. UTC § 1008 provides:

model statute echoes the Restatement.¹⁹⁰ The drafters seem to have been cognizant of asymmetrical information problems, and the model statute includes several attempts to remedy those potential problems. First, by providing for limits, albeit minimal, on the permissible scope of the waiver, the drafters tacitly acknowledge that some settlors will not be aware of or understand an exculpatory clause; otherwise, there would be no reason to flatly prohibit waivers of trustee actions that are reckless or in bad faith, because no informed settlor would ever agree to such provisions.¹⁹¹ Second, the model statute places the burden of proving that the settlor was informed of the exculpatory clause squarely on the trustee who inserts it. If the trustee cannot prove both that the clause was "fair" and that the clause's "existence and contents were adequately communicated to the settlor," the clause will not be enforced.¹⁹²

The comments to the section, however, threaten to gut the protections the statutory language provides. First, there is no indication of what proof would be sufficient to show that the settlor received adequate disclosure. Do the drafters anticipate that the trustee should require the settlor to sign a separate writing acknowledging the exculpatory clause? If so, what reason is there to think that a settlor would understand the acknowledgment any better than she would understand the clause in the document? It will be the trustee's word against that of a

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- (a) A term of a trust relieving a trustee of liability for breach of trust is unenforceable to the extent that it:
 - (1) relieves the trustee of liability for breach of trust committed in bad faith or with reckless indifference to the purposes of the trust or the interests of the beneficiaries; or
 - (2) was inserted as the result of an abuse by the trustee of a fiduciary or confidential relationship to the settlor.
 - (b) An exculpatory term drafted or caused to be drafted by the trustee is invalid as an abuse of a fiduciary or confidential relationship unless the trustee proves that the exculpatory term is fair under the circumstances and that its existence and contents were adequately communicated to the settlor.

UNIF. TRUST CODE § 1008 (2000).

190. RESTATEMENT (SECOND) OF TRUSTS § 222(2) cmt. a (1959) (stating that although strictly construed, exculpatory provisions, absent an abuse in insertion into the trust instrument, relieve the trustee of liability for breach of trust unless the breach was committed in "bad faith, intentionally, or with reckless indifference to the interests of the beneficiary"). Yet the fact is that most states do not have a rule in place that actually results in shielding trustees from liability for gross negligence. California and states that have followed its lead have expressly rejected the Restatement's formulation, prohibiting by statute exculpatory clauses that purport to relieve the trustee for liability from gross negligence. *See, e.g., CAL. PROB. CODE* § 16461(b) (West 2004) (providing that "[a] provision in the trust instrument is not effective to relieve the trustee of liability (1) for breach of trust committed intentionally, with gross negligence, in bad faith, or with reckless indifference to the interest of the beneficiary, or (2) for any profit that the trustee derives from a breach of trust"); *MONT. CODE ANN.* § 72-34-512 (2003) (same as California). The official comments to section 16461(b) of the California code state that "[t]his section is the same in substance as part of Section 222 of the Restatement (Second) of Trusts (1957), except that the reference to gross negligence does not appear in the Restatement."

191. *See* Langbein, *supra* note 13, at 1124 (acknowledging that a waiver of a trustee's duty to act in good faith "must have been improperly concealed from the settlor or otherwise misunderstood by the settlor when propounded").

192. UNIF. TRUST CODE § 1008(b) (2000).

dead client; the risk is that courts might accept such a writing in satisfaction of the trustee's burden of proof.

The well-advised trustee, of course, would ensure that the settlor was represented by counsel. However, it is with respect to this issue that the comments are even more troubling: they provide that if the settlor was represented by counsel, the settlor's attorney shall be presumed to be the trust instrument's drafter, even if the trustee supplied the trust document form!¹⁹³ Further, the comments create a conclusive presumption that the represented settlor had full information regarding the existence and meaning of the exculpatory provision.¹⁹⁴ The comments also provide that the settlor's lawyer's knowledge of the clause shall be imputed to the settlor, regardless of whether the attorney actually informed the client.¹⁹⁵

These directives are a marked departure from the traditional judicial approach. Institutional trustees would no doubt argue that the automatic protection that the provision creates is necessary to enable them to rely on the clause. Even if the settlor had full information and expressly agreed to the clause, the trustee might later find itself under attack from the beneficiaries. Yet the UTC's automatic protection rule goes much further than is necessary to respond to this concern. A better rule would require trustees to prove that settlor expressly agreed to the clause. This would force trustees and attorneys to be candid during negotiations.

Although the UTC drafters recognize that attorneys might overreach when motivated by the prospect of financial gain,¹⁹⁶ section 1008 (read together with the comments) ultimately fails to protect settlors with unethical or less than vigilant attorneys. Although the provision may negatively affect only a small fraction of settlors, one wonders why the provision and its comments are necessary at all. Responsible trustees and attorneys do not need the benefit of a statute that imputes knowledge to their clients, because they will ensure that clients have actual knowledge and a fair understanding of any non-standard trust terms. Thus, this provision benefits only those attorneys who violate ethical obligations to curry favor with institutional trustees.

193. The comments to section 1008 state that "[t]he requirements of subsection (b) are satisfied if the settlor was represented by independent counsel. If the settlor was represented by independent counsel, the settlor's attorney is considered the drafter of the instrument even if the attorney used the trustee's form. Because the settlor's attorney is an agent of the settlor, disclosure of an exculpatory term to the settlor's attorney is disclosure to the settlor." UNIF. TRUST CODE § 1008 cmt. (2000); see *supra* note 19.

194. UNIF. TRUST CODE § 1008 cmt. (2000).

195. *Id.*

196. Subsection (b) provides that "An exculpatory term drafted or caused to be drafted by the trustee is invalid as an abuse of a fiduciary or confidential relationship unless the trustee proves that the exculpatory term is fair under the circumstances and that its existence and contents were adequately communicated to the settlor." *Id.* § 1008(b). The comments to subsection (b) indicate that it was intended to disapprove of *Marsman v. Nasca*, 573 N.E.2d 1025 (Mass. App. Ct. 1991), which validated an exculpatory clause that was drafted by the settlor's attorney, who was also named as trustee. § 1008(b).

As this Article has shown, a broad waiver of the duty of care is against the best interests of most settlors who choose professional trustees. Moreover, those settlors who would obtain value by reducing the professional trustee's standard of care can accomplish their objectives by drafting narrow clauses precisely tailored to their objectives.

The UTC could do a better job of addressing the problem of information asymmetries. One possible approach would be to sharply distinguish between professional and non-professional trustees, and to allow exculpatory clauses for the latter and forbid them for the former (unless the settlor desired a limited clause designed to encourage the trustee to take on a risky investment). Or the UTC could recommend that professional trustees be held to a higher standard than non-professionals. To the extent that section 1008 directs courts to enforce most broad exculpatory clauses that protect institutional trustees, it lacks persuasive justification. That similar provisions are already in force in many states is not in itself a sufficient reason to recommend that other states take the same approach.

Section 1008 is troubling for other reasons: if, in states where the approach to exculpatory clauses traditionally has been more grudging, state legislatures adopt it, some courts might reasonably construe the act of adoption as a directive to depart from the traditional judicial approach to exculpatory clause issues.¹⁹⁷ This would work a quiet revolution in a majority of states. If courts increasingly uphold broad exculpatory clauses, the fiduciary standard will become fuzzier, reducing its value and weakening the social norm that guides fiduciary behavior. The likely result is an increase in transaction costs, not to mention the disappointment of expectations held by settlors and beneficiaries.

B. THE DUTY OF LOYALTY

1. The Duty of Loyalty and the Corporation

Even those who view fiduciary duties as freely waivable default rules do not argue that a corporation should be free to insert a blanket waiver of the duty of loyalty in the corporate charter.¹⁹⁸ The duty of loyalty, as it is currently applied, does not prevent management from functioning efficiently or from benefiting shareholders in some other way. In fact, the duty might increase the stability of the board or management by discouraging individual actors from breaching trust.¹⁹⁹ Insulating directors from liability for all breaches of that duty, therefore, would not be expected to generate efficiency gains. Moreover, the potential gains from breach of the loyalty obligation are significantly greater than the gains from breach of the duty of care; thus, the individual director or manager

197. See Coffee, *Mandatory/Enabling Balance*, *supra* note 51, at 1621.

198. See, e.g., EASTERBROOK & FISCHER, *supra* note 3, at 103-05 (showing how corporate law allows transaction-specific departures from the duty of loyalty, but failing to argue that a blanket duty-of-loyalty waiver in a corporate charter should be valid).

199. Eisenberg, *Social Norms*, *supra* note 51, at 1273-75.

faces greater incentives to engage in opportunistic behavior than in negligent behavior.²⁰⁰ Finally, the market would be relatively less effective at discouraging breach of the duty of loyalty; defalcations are harder to detect, in part because those who behave opportunistically take greater care to cover up their behavior, which is therefore less likely to be reflected in the stock price.²⁰¹ Individual managers or directors might calculate that the reward justifies the risk of getting caught—even if the market threatened to punish some breaches, it is a risk worth taking if the payoff is great enough.²⁰²

Because blanket duty-of-loyalty waivers are unlikely to be wealth enhancing, only a sorely unsophisticated and uninformed shareholder would agree to one.²⁰³ The asymmetrical information problem thus justifies the mandatory character of the duty.²⁰⁴ At the same time, particular transactions that could be characterized as opportunistic would benefit the corporation, and so corporate law has developed mechanisms for authorizing or validating those particular deals.²⁰⁵ Although the law varies considerably from state to state, some general principles are more or less uniform: a director or manager who wishes to engage in a self-interested transaction may do so if, after giving full disclosure, she obtains the approval of some number of the directors or shareholders (usually a majority).²⁰⁶ In theory, at least, this eliminates the information problem and allows the corporation to engage in specific transactions that increase share-

200. EASTERBROOK & FISCHER, *supra* note 3, at 103.

201. *Id.*

202. *Id.*

203. Melvin Eisenberg argues that research exploring human cognitive abilities suggests that the duty of loyalty should never be completely waivable. See Eisenberg, *Limits of Cognition*, *supra* note 5, at 249. He explains:

To begin with, because of bounded rationality the beneficiaries could not possibly identify all the varying circumstances to which a general waiver of the duty of loyalty would apply. Furthermore, the beneficiaries would likely be unduly optimistic about the extent to which the manager would deal fairly despite the lack of fiduciary restraints. The availability and representativeness heuristics would enhance such undue optimism: Beneficiaries would tend to give undue weight to their good relationship with the manager at the time of contract formation, because that relationship is vivid, concrete, and instantiated, as compared with the possibility that the manager would exploit the bargain at some point in the future, which is abstract, general, and pallid, and would tend to overestimate the extent to which the present relationship with the manager is a reliable index of the future relationship.

Id. at 249.

204. This helps explain why, at early common law, self-interested transactions were voidable by shareholders. See Deborah A. DeMott, *The Figure in the Landscape: A Comparative Sketch of Directors' Self-Interested Transactions*, LAW & CONTEMP. PROBS., Summer 1999, at 243, 252–53 (noting that “any contract between a director and the corporation [was] voidable at the corporation’s insistence” and noting that later, “courts may have believed that substantive judicial review [was] more likely to detect problematic transactions than [was] submission to shareholders”).

205. EASTERBROOK & FISCHER, *supra* note 3, at 104.

206. See 18B AM. JUR. 2D *Corporations* §§ 1737–38 (2003) (providing a description of relevant statutory provisions and stating the rule under section 41 of the Model Business Corporation Act).

holder wealth.²⁰⁷ The law of most states also insulates an interested director from liability even if he has failed to obtain *ex post* authorization, provided he can show that the transaction was “fair” and/or in the corporation’s best interests.²⁰⁸ In other words, a director is not liable for engaging in a transaction that fully informed shareholders would have agreed to *ex ante*.

2. The Trustee’s Duty of Loyalty

a. Broad Waivers. Unlike corporate law, trust law allows a beneficiary to void a transaction when the trustee profits from engaging in a conflicted transaction with the trust without obtaining prior approval.²⁰⁹ The trustee is held *per se* liable simply upon the beneficiary’s showing that the trustee had a personal interest in the transaction (the no-further-inquiry rule), even if the self-interested transaction caused the trust no damage.²¹⁰ The trustee must disgorge all profits realized as a result of the transaction and return them to the trust.

The rule sends a clear message to trustees: trustees must subordinate their interests to the trust’s. If a trustee believes that a self-dealing transaction will benefit the trustee, it must obtain advance authorization from a court or the trust’s beneficiaries.²¹¹

The duty of loyalty cannot be described purely as a default rule.²¹² Although parties may authorize particular acts that would otherwise be a breach of duty, they cannot agree to dispense with the duty of loyalty entirely.²¹³ As in the

207. Melvin Eisenberg argues that a fairness test alone is insufficient to protect shareholder interests. Specifically, he argues that a “fairness” test should require that a transaction be both “fair” and “in the corporation’s best interest.” See Eisenberg, *Divergence of Standards*, *supra* note 5, at 450–51 (citing Am. Law Inst., *Principles of Corporate Governance: Analysis and Recommendations* § 5.02(a) (Proposed Final Draft, 1992)).

208. See MODEL BUS. CORP. ACT § 41 (Martindale-Hubbell Law Digest 1981) (providing that an interested transaction can be validated if it is “fair and reasonable to the corporation”); see also 18B AM. JUR. 2D *Corporations* § 1737 (2003) (noting that although some statutes recognize the validity of a board resolution approving a self-interested transaction, such transactions may be avoided if they are “unfair and unreasonable to the corporation”); 18B AM. JUR. 2D *Corporations* § 1738 (2003) (citing the MODEL BUS. CORP. ACT § 41).

209. See RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. a (Tentative Draft No. 4, 2005) (stating that the “duty of loyalty is, for trustees, particularly strict even by comparison to the standards of other fiduciary relationships”).

210. See RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. b (Tentative Draft No. 4, 2005) (stating that under the no-further-inquiry rule “it is immaterial that the trustee may be able to show that the action in question was taken in good faith, that the terms of the transaction were fair, and that no profit resulted to the trustee”).

211. As Cooter and Freedman note, “[t]he duty of loyalty must be understood as the law’s attempt to create an incentive structure in which the fiduciary’s self-interest directs her to act in the best interest of the beneficiary.” Cooter & Freedman, *supra* note 163, at 1074.

212. As the Restatement puts it, “to some extent the duty of loyalty involves (as do other duties) more than default law—that is, there are limits to the settlor’s freedom, thereby protecting the fundamental fiduciary character of trust relationships recognized by law.” RESTATEMENT (THIRD) OF TRUSTS § 78 illus. c(2) (Tentative Draft No. 4, 2005).

213. Even the Uniform Trust Code does not permit an entire waiver of the duty of loyalty. Section 105 provides that the only fiduciary provisions that are not waivable by the parties are the trustee’s duty “to act in good faith and in accordance with the purposes of the trust,” and “the requirement that the

corporate context, no state authorizes, nor will any state court enforce, a trust term that insulates the trustee from liability for all self-dealing behavior. Given the almost total absence of market constraints (such as secondary information markets and institutional investors) on the trustee's opportunistic behavior, and the lack of unity between ownership and control (in contrast to the close corporation) the case for a mandatory rule is even stronger than in corporate law. And as difficult as the corporate director's opportunistic activity is to detect, the trustee's is often less visible to beneficiaries, who are relatively poor monitors.²¹⁴ In addition, the trustee's breach has greater implications than in the corporate context: unlike the shareholder, who can sell her stock and cut her losses, the beneficiary (who often is dependent on the trust income for her livelihood) has no means of exit. These important differences between the corporate and trust contexts justify different decision rules. Unlike corporate law, a trustee who has engaged in a self-interested transaction with the trust cannot escape liability on a showing that the transaction was "fair." Instead, the trustee is strictly liable for breach of the duty of loyalty, and most trustees deliver all profits realized from the opportunistic transaction to the trust.²¹⁵ This no-further-inquiry rule protects the beneficiary who cannot protect his or her self.²¹⁶ It also sends a strong and unambiguous message to trustees: refrain from engaging in business with the trust.

Broad provisions exculpating trustees for breach of the duty of loyalty are entirely inconsistent with the trust relationship the settlor has created. A broadly drafted exculpatory clause, if enforced, essentially gives the trustee the power to use the trust assets as her own. A fully informed settlor who wished to confer that power on a professional trustee would create no trust at all.²¹⁷

b. Limited, Specific Initial Waivers. As does corporate law, trust law recognizes that occasional departures from the loyalty norm may be in the beneficia-

trust and its terms be for the benefit of its beneficiaries." UNIF. TRUST CODE § 105(b)(2)–(3) (2000). The exception to the rule that the parties cannot completely eliminate the duty of loyalty occurs when a settlor creates a revocable living trust to avoid probate. The settlor often names herself trustee and gives herself unlimited rights to the trust assets. Because revocable living trusts function only as substitutes for wills, they deserve different treatment and are not a subject of this Article.

214. Beneficiaries often lack financial expertise or business savvy, and they may be minors. As a result, they sometimes place a high degree of trust in the trustee's superior knowledge. Beneficiaries, then, will often be unable to detect trustees' opportunistic behavior.

215. See RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. b (Tentative Draft No. 4, 2005) (stating that under the no-further-inquiry rule "it is immaterial that the trustee may be able to show that the action in question was taken in good faith, that the terms of the transaction were fair, and that no profit resulted to the trustee").

216. As Robert Cooter and Bradley Freedman have put it, "[t]o overcome difficulties in proof, the law infers disloyalty from its appearance, presuming that a fiduciary will appropriate the principal's asset when it is in her self-interest to do so." Cooter & Freedman, *supra* note 163, at 1055.

217. See Langbein, *supra* note 13, at 1121–22. For tax purposes, a settlor who wants to give a spouse full power to treat property as his own might nevertheless create a trust to take advantage of the settlor's unified credit under the federal estate tax, while naming the spouse—the person the settlor most trusts—as trustee. The same incentive would not exist, however, for a professional trustee.

ry's best interest.²¹⁸ If so, then a court should uphold a trustee's interested transaction if the trust document specifically authorizes it, evidence shows that the settlor possessed complete information regarding the nature and future effect of the limited waiver, and the transaction at issue was one in which the settlor contemplated that the trustee would engage.

Consider two examples of partial waivers. The first example involves a settlor who owns stock in the trust company that will serve as trustee. The settlor may wish to place the stock in trust, and if so will authorize the trustee to retain that investment. Or the settlor may create a credit shelter trust naming her husband both income beneficiary and trustee, with a limited right to invade the principal for his own benefit (and without regard for the remainder beneficiaries' preferences). Both waivers should be enforceable. In neither situation does the asymmetrical information problem exist. The purpose of the authorization is clear, and allowing the trustee to make choices that benefit her is consistent with the settlor's purpose.

When the settlor does not derive such a clear-cut benefit from an authorization of trustee self-dealing, courts have been extraordinarily reluctant to shield institutional trustees from liability. Courts' grudging approach may reveal both an inherent understanding of the asymmetrical information and foresight problems, and a desire to prevent the erosion of normative force of the loyalty standard.

Consider *In re Anneke*,²¹⁹ in which the settlor, who was represented by counsel, executed a trust document to benefit his daughter. The document, drafted by the trustee's counsel, contained a number of provisions arguably designed to allow the institutional trustee to purchase for the trust bonds and other securities offered by its bond department.²²⁰ The relevant trust provisions gave the trustees "absolute and uncontrolled discretion" to choose investments,²²¹ authorized the trustee to make illegal investments as long as the trustee judged those investments to be in the trust's best interests, and in a paragraph titled, "Transactions With Bond Department of Trustee," provided that the trustee "in the case of an investment . . . in securities held by it, shall be entitled to the regular commission or underwriting profits of its Bond Department on the sale of such securities, in addition to the [trustee's fee] herein provided"²²² The trust document also exculpated the trustee from liability

218. See RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. c(2) (Tentative Draft No. 4, 2005) (stating that "a trustee may be authorized by the terms of the trust, expressly or by implication, to engage in transactions that would otherwise be prohibited by the rules of undivided loyalty," but emphasizing that even when the settlor has authorized such transactions, "no matter how broad the provisions of a trust may be in conferring power to engage in self-dealing or other transactions involving a conflict of fiduciary and personal interests, a trustee violates the duty of loyalty to the beneficiaries by acting in bad faith or unfairly").

219. 38 N.W.2d 177 (Minn. 1949).

220. *Id.* at 178.

221. *Id.*

222. *Id.*

for loss incurred by reason of the trustee's good faith mistakes or errors in judgment and for loss incurred as a result of any action taken at the settlor's direction.²²³ In following years, the trustee purchased many investments from its own bond department, often with the settlor's agent's approval. The trustee purchased bonds at slightly below par and sold them to the trust at par, and it furnished the settlor with semi-annual reports revealing the nature of the trust investments. This pattern continued after the settlor's death—for more than twenty years. In 1948, some twenty-two years after the trust was created, the beneficiaries objected to the trustee's yearly accounting on the grounds of self-dealing.²²⁴ The trial court surcharged the trustee for losses incurred on the investments,²²⁵ and the Minnesota Supreme Court sustained the trial court.²²⁶

In upholding the trustee's liability, the court focused on the prohibition against a trustee purchasing its own investment vehicles for the trust. The court then stated,

applying this rule to the facts and circumstances presented here will not permit us to read into the instrument, by implication, a waiver of a rule of law so well-established and so strictly applied as that against self-dealing by a fiduciary. . . . [H]ad [trustee's counsel] intended to grant to the trustee authority to deal in securities owned by it for the trust in contravention of the well established and strict rule against self-dealing, it would have been a simple matter for him to say so in clear and unmistakable language.²²⁷

The court also rejected the trustee's argument that the settlor had acquiesced in the investments on the ground that none of the trustee's communications clearly revealed that the investments, while offered by a separate corporation with a different name, were essentially owned by the trustee.²²⁸

Anneke involved clear information asymmetries. The trustee's counsel drafted the language. One could infer that the settlor's attorney failed to negotiate or challenge the trust company over those terms. Moreover, the trust company failed to explain clearly to the settlor that the differently named corporation from which it was purchasing investments was affiliated with the trustee.

The *Anneke* court also took the opportunity to reinforce the norms of fiduciary behavior. The court emphasized the importance of the traditional duty-of-loyalty rules.²²⁹ In insisting that the trustee's breach amounted to a moral

223. *Id.*

224. *Id.* at 179.

225. *Id.*

226. *Id.* at 183.

227. *Id.*

228. *Id.*

229. *Id.* at 179 (declaring that "the rule against self-dealing by a trustee, which prohibits both sale of the trustee's own property to the trust and purchase by the trustee of property of the trust, is so firmly established and universally accepted that it seems useless to again restate the rule here"); *id.* at 181 (quoting SCOTT, *supra* note 25, at 538, the *Anneke* court emphasized that, "[t]he principle that a trustee

failing, the court reinforced the norm to ensure that fewer trustees would err on the side of self-dealing.

3. The Duty of Loyalty Under Assault

Terminology matters. Characterizing fiduciary duties as default rules ignores their important norm-enforcing function. If the view of fiduciary duties as optional default terms becomes entrenched, then the default terms themselves are vulnerable to attack by banks and others who seek to limit trustee liability. If fiduciary duties have no moral or normative content, then why not change the default rules? After all, the parties to the trust document can always draft around them.

In fact, default rule rhetoric has exposed the duty of loyalty to this type of attack. As a result, the past fifteen years has seen the duty weakened in significant ways. The attack has come not from the judiciary, but on the legislative front. First, over the past fifteen years, the majority of states have enacted statutes providing that trustee investments in vehicles owned by the trustee or a related company do not give rise to a breach of the duty of loyalty. The justification for these statutes is that they are necessary to enable trustees to invest trust assets in mutual funds, and that allowing self-interested investing will create economies of scale that will benefit all trusts. The justification, however, does not explain why it is necessary to allow the trustee's related or parent company to collect both trustee commissions *and* fees in its capacity as an investment bank. Recognizing this, some state legislatures require trustees who invest in their own investment vehicles to choose between earning trustee commissions or investment commissions.²³⁰ Other states, while allowing trustees to earn double commissions, at least require trustees to notify the beneficiaries that they are profiting from their trustee position, which mitigates the monitoring problem somewhat.²³¹ The majority of states, however, provide no protections for beneficiaries, and simply authorize institutional trustees to profit

cannot [properly] sell his individual property to the trust is applicable to corporate trustees. A trust company violates its duty to the beneficiaries of a trust under which it is trustee if it purchases property from itself").

230. ME. REV. STAT. ANN. tit. 18-A, § 7-408 (West 1998); N.Y. EST. POWERS & TRUSTS LAW § 11-2.2 (Consol. 2005); OKLA. STAT. ANN. tit. 60, § 175.55 (West 2004). Nebraska goes further, requiring the trustee to obtain the beneficiary's consent to self-dealing in writing. *See* NEB. REV. STAT. § 30-3205 (2004).

231. ALA. CODE § 19-3-120.1 (1997); ARIZ. REV. STAT. ANN. § 6-246 (Supp. 2004); CONN. GEN. STAT. § 45a-209 (2003); DEL. CODE ANN. tit. 12, § 3312 (2004); FLA. STAT. § 660.417 (1993); LA. REV. STAT. ANN. § 9:2127 (West 2004); MASS. GEN. LAWS ANN. ch. 167G, § 3 (West 2003 & Supp. 2005); MINN. STAT. § 501B.151 (2002); MISS. CODE ANN. § 81-5-33 (2003); MONT. CODE ANN. § 32-1-420 (2003); NEB. REV. STAT. § 30-3205 (2001); NEV. REV. STAT. §§ 662.097, 669.225 (2003); N.M. STAT. § 46-2A-1 (2003); N.C. GEN. STAT. § 36A-66.2 (2003); N.D. CENT. CODE § 6-03-02 (1987 & Supp. 2003); OHIO REV. CODE ANN. § 1109.10 (West 2003); 20 PA. CONS. STAT. ANN. § 7314.1 (1999); S.D. CODIFIED LAWS § 55-1A-9 (2001); TEX. PROP. CODE ANN. § 113.053 (Vernon 2004); VA. CODE ANN. § 26-44.1 (2004); WYO. STAT. ANN. § 2-3-301 (2005).

from their position as trustees,²³² a result once clearly prohibited by the duty of loyalty.²³³ As a result, settlors who wish to prohibit certain types of trustee self-dealing must expressly contract for that protection.²³⁴

Although one might not expect legislators to appreciate the negative externalities that such a move might generate, it is quite troubling that academics have failed to spot the problem. Instead, some have joined in the effort to weaken the constraints that the duty places on trustees. The Uniform Trust Code, which freely uses “default rule” rhetoric, not only follows the ill-advised state law trend toward authorizing an entire class of self-dealing investments,²³⁵ but does

232. The following statutes authorize trustees to invest in mutual funds or other investments from which they will earn additional commissions or fees: ALASKA STAT. § 13.90.010 (2004); ARK. CODE ANN. § 28-71-104 (2004); CAL. PROB. CODE § 16015 (West 2002); GA. CODE ANN. § 53-8-2 (1997); HAW. REV. STAT. § 412:8-400 (2004); IDAHO CODE ANN. § 68-404A (2004); 760 ILL. COMP. STAT. § 5/5.2 (2004); IND. CODE § 28-1-12-3 (1998); IOWA CODE 633.123A (2004); KY. REV. STAT. ANN. § 386.020 (West 2004); MD. CODE ANN., EST. & TRUSTS § 15-106 (LexisNexis 2001); MICH. COMP. LAWS ANN. § 487.485 (West 1998); MO. REV. STAT. § 362.550 (2000); OR. REV. STAT. § 709.175 (2003); S.C. CODE ANN. § 62-7-302 (West Supp. 2004); TENN. CODE ANN. § 35-3-117 (2001); UTAH CODE ANN. § 75-7-402 (1993); WASH. REV. CODE § 11.100.035 (2004); W. VA. CODE ANN. § 44-6-9 (LexisNexis 2004); WIS. STAT. § 881.01 (2003–2004).

233. Although paper trails are few, the available evidence (not to mention common sense) suggests that the banking lobby pushed for this legislation. For example, the history of the New York legislation that authorizes trustees to invest in proprietary mutual funds reveals that the New York State Bankers Association lobbied for the legislation, arguing that the measure was necessary to enable them to compete for business with banks in other states. See Letter to The Honorable Elizabeth D. Moore, Counsel to the Governor, from the New York State Bankers Association (July 16, 1992) (on file at the Association of the Bar of the City of New York). Although government actors responding to the governor’s request for advice concluded that the bill was “inadvisable” because it could “erode the historic rules in New York which prohibit a trustee from engaging in self-dealing or from taking other positions where his personal interest might be in conflict with his duty as a trustee,” the bill passed. See Letter to Governor Mario Cuomo from James W. Wetzler, Commissioner of Taxation and Finance, dated July 17, 1992 (on file with the library of the Association of the Bar of the City of New York). The Assembly Rules Committee Memorandum argues that the legislation was necessary to compete with other states. See Memorandum of the Assembly Rules Committee: Fiduciary/Investment Mutual Funds (New York State Assembly, Assembly Bill No. 11971, June 10, 1992).

234. In the most recent draft of the Restatement (Third), the drafters take note of this state statutory development and characterize it as an “exception” to the duty of loyalty. They do not appear to endorse these statutes, however. See RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. c(8) (Tentative Draft No. 4, 2005) (noting that the UTC comments purporting to justify the exception merely describe the advantages of mutual funds, but do not explain why investments in *proprietary* mutual funds are necessary); *id.* cmt. c (describing the proprietary mutual fund exception as “an exception that has been adopted by (*and is dependent upon*) legislation enacted in most American jurisdictions” (emphasis added)).

235. UTC § 802(f) provides:

An investment by a trustee in securities of an investment company or investment trust to which the trustee, or its affiliate, provides services in a capacity other than as trustee is not presumed to be affected by a conflict between personal and fiduciary interests if the investment complies with the prudent investor rule of [Article] 9. In addition to its compensation for acting as trustee, the trustee may be compensated by the investment company or investment trust for providing those services out of fees charged to the trust if the trustee at least annually notifies the persons entitled under section 813 to receive a copy of the trustee’s annual report of the rate and method by which the compensation was determined.

UNIF. TRUST CODE § 802(f) (2000).

so without requiring trustees to choose between trustee or investment commissions.²³⁶ It also authorizes a second broad classification of transactions that the law formerly prohibited. Section 802(c)(4) transforms from self-dealing to indirect self-dealing *all* transactions between institutional and professional trustees and companies related to them or in which they have an interest.²³⁷ If adopted, this change will free institutional trustees from the constraints of the no-further-inquiry rule and allow them to profit from a wide variety of formerly prohibited transactions as long as trustees can argue that "the transaction was not affected by a conflict between personal and fiduciary interests."²³⁸ This marked departure from trust law's no-further-inquiry rule requires a settlor who wishes to prevent this type of self-dealing to bargain for the protection that the law historically has provided.

The movement to dilute the duty of loyalty has reached an apex with a newly published article by John Langbein, who now advocates replacing the no-further-inquiry rule with a default rule that would allow trustees to engage in self-interested transactions.²³⁹ Professor Langbein argues that the time has come to replace the duty of loyalty's no-further-inquiry rule, which flatly prohibits the trustee from gaining personal advantage from its position, with a "fairness" test that would allow a trustee to profit from a transaction with the trust so long as the trustee could prove, if challenged, that the transaction was in the trust's best

236. The Reporter for the Restatement (Third) of Trusts does *not* seem to embrace the state law trend toward allowing trustee double-dipping. In the most recent draft of the Restatement (Third), the drafters take note of these state statutes and characterize them as "exceptions" to the duty of loyalty. The Reporter fails to endorse them, however. *See supra* note 234.

237. Section 802(c) provides:

- (c) A sale, encumbrance, or other transaction involving the investment or management of trust property is *presumed to be affected* by a conflict between personal and fiduciary interests if it is entered into by the trustee with:
- (1) the trustee's spouse;
 - (2) the trustee's descendants, siblings, parents, or their spouses;
 - (3) an agent or attorney of the trustee; or
 - (4) *a corporation or other person or enterprise in which the trustee, or a person that owns a significant interest in the trustee, has an interest that might affect the trustee's best judgment.*

UNIF. TRUST CODE § 802(c) (2000) (emphasis added).

238. The relevant comments in full provide:

The rule is less severe with respect to transactions involving trust property entered into with persons who have close business or personal ties with the trustee. Under subsection (c), a transaction between a trustee and certain relatives and business associates is presumptively voidable, not void. Also presumptively voidable are transactions with corporations or other enterprises in which the trustee, or a person who owns a significant interest in the trustee, has an interest that might affect the trustee's best judgment. The presumption is rebutted if the trustee establishes that the transaction was not affected by a conflict between personal and fiduciary interests. Among the factors tending to rebut the presumption are whether the consideration was fair and whether the other terms of the transaction are similar to those that would be transacted with an independent party.

UNIF. TRUST CODE § 802 cmt. (2000).

239. Langbein, *supra* note 23, at 932.

interests.²⁴⁰ Characterizing the trust as a “contract” and the duty of loyalty as a “default rule” causes Langbein to give inadequate consideration to the trust’s unique features, including information asymmetries, foresight problems, and, most importantly, the law’s function of enforcing loyalty norms.²⁴¹ As a result, his proposal threatens to erode the duty of loyalty’s proscriptive power—to the detriment of all trust beneficiaries.

CONCLUSION

The move to reconceptualize fiduciary duties as simple default rules, divorced of any normative content, is likely to have serious consequences for many trust settlors and beneficiaries. Courts should enforce waivers of fiduciary duties only when there is clear evidence (such as pricing or transaction-specificity) that the settlor possessed full information. This approach will support and strengthen the social norm of trust that facilitates efficient transacting in the trust setting.

To the extent the UTC encourages courts to enforce all exculpatory clauses absent evidence of coercion, it threatens to erode the important role that the judiciary has played in effectuating settlors’ intentions and minimizing transaction costs. This Article suggests that the UTC is seriously flawed, because it overlooks monitoring problems that are unique to the trust context when it allows institutional trustees largely to escape the no-further-inquiry rule. States that are considering adopting the UTC would do well to pay careful attention to its duty-of-loyalty provisions.

240. *Id.*

241. Professor Langbein’s principal objection to the no-further-inquiry rule is that it overdeters trustees and discourages them from making investments that would benefit the trust beneficiaries. Professor Langbein’s argument fails to persuade, because he minimizes the importance of the advance-approval doctrine, which allows trustees to profit, provided that they obtain advance approval from the court or the trust beneficiaries. He does not and cannot establish that the no-further-inquiry rule overdeters to any significant degree. Professor Langbein fails to examine the significant costs that his own proposal would create by underdetering trustee opportunism. A comparison of the no-further-inquiry rule with Professor Langbein’s best-interest defense shows that his proposal would be more harmful to trust beneficiaries as a class. *See* Leslie, *supra* note 23.