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# In Defense of the No Further Inquiry Rule: A Response to Professor John Langbein

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# IN DEFENSE OF THE NO FURTHER INQUIRY RULE: A RESPONSE TO PROFESSOR JOHN LANGBEIN

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## INTRODUCTION

In an article recently published in the *Yale Law Journal*, Professor John Langbein of the Yale Law School advocates a radical change in trust law.[1] Professor Langbein targets the "no further inquiry" rule, a centuries-old rule that unequivocally prohibits a trustee from profiting from transactions with the trust without advance approval from a court or trust beneficiaries.[2] The rule also imposes harsh consequences for unauthorized trustee self-dealing.[3] Langbein argues that the rule should be replaced with a regime that allows trustees to profit from conflicts of interest as long as they can prove, if challenged in court, that the conflicted transaction was in the trust's best interests.[4] In essence, Langbein would like to see trust law mirror the duty of loyalty rules that currently apply to corporate fiduciaries.

Professor Langbein is one of the most influential trust scholars of our time. In fact, Professor Langbein is a member of the committee responsible for drafting the Uniform Trust Code (UTC) and the UTC's duty of loyalty provisions are consistent with his views. Two such provisions, taken together, effectively release institutional trustees from the constraints of the no further inquiry rule for many, if not most, of the conflicted transactions in which they might engage,[5] and allow trustees to rebut a charge of self-dealing with proof that the transaction was fair to the trust.[6] This is a radical

1. John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929 (2005).

2. *See id.* at 931-32.

3. *See id.* ("Remedies include rescission, disgorgement of gain, and consequential damages.").

4. *See id.* at 980-87.

5. UTC section 802(c)(4) eliminates the no further inquiry rule when a trustee transacts business with "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)(4) (amended 2003). Section 802(f) allows trustees to earn profits by investing trust assets in investment vehicles in which the trustee has a proprietary interest. *Id.* § 802(f). It is hard to imagine a conflicted transaction in which an institutional trustee might engage that would not fall under one of these two provisions. In essence, then, the UTC largely exempts institutional trustees from the no further inquiry rule.

6. *Id.* § 802 cmt.

change in trust law,[7] and one that seems to have occurred with little critical analysis or fanfare. Professor Langbein now argues that we should take this trend to its logical conclusion and eliminate the no further inquiry rule entirely.[8]

In the past few years, fourteen states and the District of Columbia have enacted the UTC.[9] Most other states are considering whether to adopt it.[10] The UTC loyalty provisions that eliminate the no further inquiry rule clearly will make life easier and more profitable for institutional trustees. But it is critical to examine whether they will generate comparable benefits for trust beneficiaries.

This Article argues that Professor Langbein fails to prove that the no further inquiry rule is problematic, or that his proposed "best-interest" defense would make trust beneficiaries better off. In fact, a best-interest defense would generate serious harm to future beneficiaries.

## I. HOW THE NO FURTHER INQUIRY RULE ADVANCES BENEFICIARY INTERESTS

For centuries, trust law has stubbornly insisted that when a trustee profits from engaging in a conflicted transaction with the trust, the beneficiary may void the transaction unless the trustee

7. Currently, several states have in force statutes that require a trustee to obtain court approval prior to engaging in a conflicted transaction. *See, e.g.*, ARIZ. REV. STAT. ANN. § 14-7235 (2004); FLA. STAT. ANN. § 737.403 (West 2005); HAW. REV. STAT. § 554A-5 (2004); IDAHO CODE ANN. § 68-108 (2004); MICH. COMP. LAWS ANN. § 700.7403 (West Supp. 2004); MISS. CODE ANN. § 91-9-111 (2004). Enactment of the UTC would repeal these statutes, as it repealed similar statutes in Kansas, KAN. STAT. ANN. §§ 58-1201 to 58-1211 (repealed 2002); Maine, ME. REV. STAT. ANN. tit. 18, § 7-404 (repealed 2005); Nebraska, NEB. REV. STAT. §§ 30-2819 to 30-2826 (repealed 2003); New Hampshire, N.H. REV. STAT. ANN. §§ 564-A:1 to A:11 (amended 2004); New Mexico, N.M. STAT. ANN. § 45-7-401 (repealed 2003); Oregon, OR. REV. STAT. §§ 128.003-128.051 (repealed 2005); South Carolina, S.C. CODE ANN. § 62-7-706 (amended 2005); and Utah, UTAH CODE ANN. §§ 75-7-401 to 409 (repealed 2004).

8. Langbein, *supra* note 1, at 980-87.

9. Those states are Arkansas, Kansas, Maine, Missouri, Nebraska, New Hampshire, New Mexico, North Carolina, Oregon, South Carolina, Tennessee, Utah, Virginia, and Wyoming. *See* National Conference of Commissioners on Uniform State Laws, A Few Facts About the Uniform Trust Code, http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-utc2000.asp (last visited Oct. 11, 2005).

10. *See* Michelle W. Clayton, *Enacting the Uniform Trust Code*, 3 E-STATE 2003, http://www.abanet.org/rppt/publications/estate/2003/3/clayton.pdf.

obtained prior approval.[11] The trustee is held per se liable simply upon a 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.[12] The trustee must disgorge all profits realized as a result of the transaction and return them to the trust.[13]

Consider an example: *X* is trustee of a testamentary trust that holds as an asset a twenty-acre plot of land. *X* determines that the time is right to sell the land for development. In addition to being trustee, *X* also happens to be a developer, and she would like to purchase the land from the trust herself. After obtaining several appraisals, *X* purchases the land from the trust for a sum that she reasonably believes represents the land's fair market value. If the trust's beneficiaries sue the trustee for breach of the duty of loyalty, should they prevail even though the trustee seemed to have paid a fair price? The law answers "yes."[14]

If *X* had sold the land on the open market, she would have used her best efforts to obtain the highest possible price for the land, which might have resulted in a higher sale price. If so, the beneficiaries were harmed by the trustee's purchase of the trust assets, even if the trustee paid a price within the range of the property's fair market value, because the trustee did not, and could not expect to, advocate for the trust beneficiaries seeking to obtain the highest

11. *See* GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 543, at 217-20, 264 (rev. 2d ed. 1993); *see also* 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").

12. *See* 2 GEORGE T. BOGERT, TRUSTS § 543 (6th ed. 1987); *see also* 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").

13. *See* Langbein, *supra* note 1, at 932.

14. *See, e.g.*, Marshall v. Carson, 38 N.J. Eq. 250, 256 (1884) (finding that trustee who purchased land from the trust breached the duty of loyalty because there is an inherent conflict of interest in a situation in which a purchaser wants to pay the lowest possible price for land, while a trustee wants to sell the land for the best possible price); Staats v. Bergen, 17 N.J. Eq. 554, 559 (1867) (finding trustee liable for breach of the duty of loyalty for purchasing trust property at a foreclosure sale because "the interest of the [trustee] was directly antagonistic to that of the complainant. A low price was the gain of the defendant, but it was, in the same ratio, a loss to the complainant.").

price.[15] Instead, the trustee, not the trust, captured some of the value generated by the deal. Moreover, beneficiaries and a court would have difficulty determining after the fact whether *X* in fact paid top dollar for the property; the market is a better indicator of fair market value than is an ex post judgment by the court.[16] The no further inquiry rule supports trust settlors' objectives. The trustee earns compensation for acting as the beneficiaries' advocate. The trustee's duty is to subordinate its own interest to the beneficiaries' interests. The trustee's role is to advocate zealously for trust beneficiaries at all times, without regard for the trustee's personal interests. The trustee's promise to subordinate its interests to those of the beneficiaries reassures the settlor that her loved ones will be well cared for after her death.

The rule sends a clear message to trustees: absent unusual circumstances, you may not profit from your position (aside from trustee commissions). If you want to transact business with the trust, you must obtain advance authorization from a court or the trust beneficiaries.[17]

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15. *See* RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. b (Tentative Draft No. 4, 2005) (stating that "a trustee ... commits a breach of trust by purchasing trust property, even as the highest bidder at a public auction"). Section 170 of the Second Restatement of Trusts suggests that a trustee should obtain court approval for the purchase of trust property, and that a court should grant that approval only when the purchase is in the beneficiary's best interests. Comment f to section 170 states:

> The trustee can properly purchase trust property for himself with the approval of the court. The court will permit a trustee to purchase trust property only if in its opinion such purchase is for the best interest of the beneficiary. Ordinarily the court will not permit a trustee to purchase trust property if there are other available purchasers willing to pay the same price that the trustee is willing to pay.

RESTATEMENT (SECOND) OF TRUSTS § 170 cmt. f (1959).

16. *See* BOGERT & BOGERT, *supra* note at 11, § 543, at 217-20. 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." Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1055 (1991).

17. 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." *Id.* at 1074.

## II. PROFESSOR LANGBEIN'S ARGUMENT

Professor Langbein observes that our lives consist of a web of conflicted relationships.[18] Both in our personal lives and in business, we consistently surrender power to those who are in a position to abuse our trust by furthering their own self-interest at our expense.[19] The mother is conflicted about how much time to spend with her son, how much on herself.[20] The surgeon examines the patient, and then recommends costly surgery from which the surgeon will profit.[21] The adult child holds her parent's durable power of attorney, which allows her to determine how much money to spend on her incapacitated parent and how much to save to receive as an inheritance.[22] Yet the law allows the participants in such relationships to manage the conflict themselves.[23] Most of the time, people handle conflicts fairly. Only in trust law is there a rule that flatly prohibits one with a conflict from profiting from the relationship, even if a trustee could handle the conflict fairly.[24]

Why, then, did trust law develop the no further inquiry rule as a response to trustee conflicts of interest? Professor Langbein argues that the rule is a relic, left over from a time when beneficiaries were unable to prove a trustee's misappropriation.[25] The rule was developed in the late eighteenth and early nineteenth centuries, when the English Court of Chancery lacked the mechanisms to discover and adjudicate facts,[26] and before regulatory and business pressures created a norm of stringent record-keeping practices.[27] Because beneficiaries were unable to prove self-dealing, a rule developed that imposed liability upon a showing that the trustee

18. Langbein, *supra* note 1, at 934-44.
19. *Id.*
20. *See id.* at 935.
21. *See id.* at 936.
22. *See id.* at 938.
23. *See, e.g., id.* at 943-44.
24. *Id.* at 934-45.
25. *Id.* at 944.
26. *See id.* at 945-47. Langbein states that several factors contributed to this difficulty: discovery rules were severely restricted, witnesses did not testify at trial, and court officials were corrupt and overworked. *Id.*
27. *See id.* at 948.

engaged in a conflicted transaction.[28] In today's environment, Professor Langbein argues, the rule is no longer necessary.[29]

To justify abolishing a rule as entrenched as the no further inquiry rule, Professor Langbein must establish that the rule causes actual harm. The principal harm he identifies is that the rule overdeters: the rule sometimes prevents trustees from engaging in transactions that will benefit both the beneficiary and the trustee.[30] Although he acknowledges that the rule allows trustees to profit from a transaction with the trust as long as they seek advance approval from the court or the beneficiaries, he argues that the expense and delay of the advance approval process discourages trustees from engaging in the transaction.[31] He also fears that trustee concerns for settlor's privacy prevent trustees from seeking advance approval and, therefore, from completing beneficial transactions.[32]

Finally, Professor Langbein offers an explanation for the judiciary's failure to abandon the no further inquiry rule. He argues that it survives only because exceptions and exclusions have developed to mitigate the rule's dire effects.[33] He cites the advance approval doctrine and courts' willingness to uphold trust provisions authorizing particularly described conflicted transactions as examples of judicially crafted exceptions.[34] He cites particular state statutes and Uniform Trust Code provisions that categorically exempt a broad swath of transactions from the reach of the no further inquiry rule as further evidence that the no further inquiry rule retains no persuasive modern-day justification.[35] These statutes (and proposed statutes) direct that certain types of self-dealing

28. *See id.* at 944-45.

29. *Id.* at 948.

30. *Id.* at 951-57.

31. *Id.* at 967.

32. *Id.* He also criticizes the no further inquiry rule on grounds that it underdeters; that is, a trustee who wants to self-deal will do so if the payoff from self-dealing outweighs the losses trustee will bear if and when he is caught. *Id.* at 951-52. This is not a real criticism because his proposed rule would underdeter to an even greater degree. *See infra* Part IV.

33. Langbein, *supra* note 1, at 963-80.

34. *Id.* at 963-67.

35. *Id.* at 968-80.

transactions shall be valid if the trustee can show that the transaction was fair and in the beneficiaries' best interests.[36]

Professor Langbein argues that this approach should be extended to all transactions between the trustee and the trust.[37] He contends that the corporate law standard, which shields a corporate fiduciary from liability for self-dealing if the fiduciary can prove that the transaction was fair to the corporation, provides an apt model for trust law.[38] Under his proposal, a trustee could escape liability for self-dealing if it could prove that the trustee engaged in the conflicted transaction to promote the beneficiaries' best interests.[39] It bears emphasis that Professor Langbein would judge the trustee's conduct in light of the circumstances existing at the time of the transaction.[40] Thus, a trustee whose self-dealing act *benefited the trustee* and *actually harmed the trust beneficiaries* would not be held liable as long as the trustee could establish that it *reasonably believed,* at the time of the transaction, that the deal would prove to be in the beneficiaries' best interests.[41] He contends that this approach would create more value for trust beneficiaries than the no further inquiry rule currently does.[42]

Professor Langbein's argument fails because he does not and cannot establish that the no further inquiry overdeters to any significant degree. More important, he fails to explore the costs of his own proposal, which would significantly underdeter trustee opportunism. A comparison of the no further inquiry rule with Professor Langbein's best-interest defense reveals that his proposal would be more harmful to trust beneficiaries as a class. Finally, present exceptions to the no further inquiry rule do not stand as evidence against the rule's vitality. Judicially crafted exceptions are consistent with the rule's objectives. Newly created legislative exceptions are without solid theoretical foundation, and simply establish that banking institutions are effective lobbyists.

36. *See, e.g., id.* at 979.
37. *Id.* at 980-81.
38. *Id.* at 989-90.
39. *Id.* at 980-82.
40. *Id.* at 982-83.
41. *Id.*
42. *Id.* at 989-90.

## III. PROFESSOR LANGBEIN OVERSTATES THE NO FURTHER INQUIRY RULE'S POTENTIAL FOR OVERDETERRENCE

No rule perfectly calibrates deterrence. Every legal rule overdeters or underdeters. Some rules do both. The fact that a rule may overdeter does not establish its inefficiency. Before invoking the prospect of overdeterrence as a basis for attacking a legal rule as inefficient, one must consider two questions: first, to what extent does the rule overdeter, and second, does the rule generate other benefits that outweigh the costs of overdeterrence.

Professor Langbein's principal argument against the no further inquiry rule is that the rule may dissuade trustees from engaging in transactions from which the trustee will profit, even when the transaction would further the trust's best interests.[43] He argues that allowing trustees to obtain advance authorization for such transactions does not solve the overdeterrence problem because the approval process is sometimes too costly.[44] The trustee will choose to forego the profitable transaction rather than expend trust assets obtaining advance approval.

Professor Langbein's argument simply does not make the case that this scenario is common enough to create a serious problem for beneficiaries. When the gains from a self-dealing transaction outweigh the costs of obtaining beneficiary consent, trustees will seek beneficiary authorization. Only when the costs of obtaining consent outweigh the benefits of the transaction will the trustee be deterred. Because those costs typically are not significant, only those transactions that would have been minimally profitable to the trust will be deterred; therefore, it is hard to believe that the advance approval doctrine significantly and routinely harms beneficiaries.

To support his argument that the no further inquiry rule overdeters, Professor Langbein conjures up a worst-case scenario: a trustee who has hired Sotheby's to auction off trust property and is interested in bidding on the property in his personal capacity.[45] If the trustee were the highest bidder, the trust beneficiaries could sue

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43. *Id.* at 951-57.
44. *Id.* at 967.
45. *Id.* at 952-53.

the trustee for return of the trust property, or to capture any profit the trustee realized on resale.[46] This is the case despite the fact that there is little or no chance the trustee took unfair advantage of its position as trustee, and trustee's participation only helped the beneficiaries by driving the price higher.[47] The no further inquiry rule, Professor Langbein argues, would discourage the trustee from bidding, which would render the trust beneficiaries worse off.[48]

Professor Langbein's hypothetical, however, does little to prove that the advance approval doctrine significantly overdeters. First, even in Professor Langbein's public auction hypothetical, most trustees would not be deterred from participating, but would responsibly seek advance authorization to bid. In public auctions, the cost of obtaining beneficiary authorization is low. The question is a simple one that beneficiaries—or a court, if necessary—can evaluate easily. Giving approval is clearly in the beneficiaries' interest because an independent party will ensure that the property is awarded only to the highest bidder; a beneficiary, therefore, would likely authorize the trustee to bid on the trustee's own behalf. Second, few examples of trustee self-dealing do involve trustee participation in an independent auction held by a neutral third party. Most sales of trust property are conducted by the trustee itself. In this context, Professor Langbein himself acknowledges that the "auction rule" does prevent a fair amount of serious self-dealing. In his own words,

> [i]n estate administration it has been reasonably common for fiduciaries to have to sell real estate at auction, when there is a need to raise proceeds to pay creditors, taxes, and monetary bequests. The danger of self-dealing in such cases can be serious. An executor bidding on rural property for his or her own account has a material disincentive to hustle around the county to drum up competing bids .... Moreover, in selecting which property to sell when there is a choice, or in engaging the auctioneer and setting any discretionary terms of sale, the conflicted trustee has

46. *See id.* at 952.
47. *See id.*
48. *Id.* at 952-53.

> other potential opportunities to prefer his or her own interest over that of the beneficiaries.[49]

Therefore, even if the no further inquiry rule did deter trustees from participating in public auctions conducted by neutral third parties, these transactions represent a small fraction of cases where the trustee purchases trust property. The Sotheby's example does not advance Professor Langbein's claim that the no further inquiry rule significantly overdeters.

Putting aside the Sotheby's example, Professor Langbein makes the more general claim that the advance approval doctrine is sufficiently costly to prevent other types of transactions that would benefit the trust.[50] Here, he makes three points. First, he argues that the process of obtaining approval may unduly infringe on the settlor's privacy interests.[51] Second, he states that the process of getting approval is so sufficiently time consuming that it may cause trustees to miss important opportunities.[52] Third, he contends that the process of obtaining beneficiary or court approval is overly expensive.[53] All three points are exaggerated.

First, Professor Langbein points out that settlors are often motivated to create living trusts because living trusts afford settlors more privacy than do wills, which become public documents at the testator's death.[54] Professor Langbein suggests that the trustee's reluctance to violate a settlor's privacy might cause the trustee to refrain from seeking advance approval for a transaction in which the trustee will profit.[55] Professor Langbein's argument, however, applies to a small subset of trusts to which the no further inquiry rule applies. First, a significant number of trusts are testamentary, and privacy concerns are not implicated at all because the will is a matter of public record.[56] Second, even settlors who create inter

49. *Id.* at 953-54.
50. *Id.* at 965-67.
51. *Id.* at 967.
52. *Id.*
53. *Id.*
54. *Id.*
55. *Id.* (arguing that family, commercial, and regulatory privacy concerns can hinder the trustee's objections).
56. *See* A. James Casner, *Estate Planning—Avoidance of Probate*, 60 COLUM. L. REV. 108, 123 (1960).

vivos trusts may not be motivated by privacy concerns.[57] As Professor Langbein himself has recognized, settlors typically create living trusts to avoid a probate system laden with "expense, delay, clumsiness, makework, and worse."[58] To justify abandoning an otherwise serviceable rule to protect an occasional intrusion on privacy interests would be to throw out the proverbial baby with the bathwater.

Next, Professor Langbein argues that the expense and delay of obtaining advance approval may encourage the trustee to forego beneficial opportunities.[59] He envisions a full-blown litigation process, complete with discovery, pretrial submissions, and, potentially, appellate review.[60] Professor Langbein forgets that the trustee may obtain approval directly from trust beneficiaries.[61] Only if beneficiaries are unrepresented minors whose interests diverge from the interests of all represented beneficiaries,[62] or if beneficiaries withhold consent, will a judicial proceeding be necessary.[63] In these cases, the judicial process is unlikely to amount to a full-blown trial and appeal. Of course, when judicial proceedings do take on the characteristics of a full-blown trial, the costs of approval may outweigh the benefits of the transaction to the trust.[64] In those cases, it is hard to believe that the cost of a missed opportunity constitutes serious harm to the trust. The more opposition the proposal raises, the less likely the beneficiaries will be harmed if the opportunity is missed.

The remaining evidence that Professor Langbein cites in support of his argument that the no further inquiry rule overdeters consists of three cases in which courts imposed liability on trustees whose transactions with the trust appear to have been in good faith and motivated by a sincere desire to advance the beneficiaries'

57. *See id.*

58. John H. Langbein, *The Nonprobate Revolution and the Future of the Law of Succession*, 97 HARV. L. REV. 1108, 1116 (1984).

59. Langbein, *supra* note 1, at 967.

60. *Id.*

61. *Id.* at 964.

62. See, for example, UTC § 304, providing that "a minor, incapacitated, or unborn individual" may be "represented by and bound by another having a substantially identical interest with respect to the particular question or dispute." UNIF. TRUST CODE § 304 (amended 2003).

63. *See* RESTATEMENT (SECOND) OF TRUSTS § 216 cmt. j (1959).

64. Langbein, *supra* note 1, at 967.

interests.[65] These cases provide peculiar evidence of overdeterrence, because the trustees were not deterred; they simply engaged in self-dealing without obtaining advance approval. That is, these cases involved trustees who did not know the law, and who would not have responded to incentives.

If Professor Langbein's purpose in exploring these cases is to show the draconian results the rule can create and warn that cases such as these will deter trustees from self-dealing even when the transaction will benefit the trust, he misses the mark. These cases are better read as sending a clear message that obtaining advance approval before self-dealing is absolutely necessary.

## IV. PROFESSOR LANGBEIN'S PROPOSED RULE WOULD SIGNIFICANTLY UNDERDETER TRUSTEE SELF-DEALING

In passing, Professor Langbein criticizes the no further inquiry rule as inadequate to curb egregious breaches of the duty of loyalty.[66] Yet, a "best-interest" defense would underdeter to a significantly greater degree. Professor Langbein cites the multitude of conflicted relationships in which we engage daily, and argues that the absence of a no further inquiry rule does not induce people to engage in rampant exploitation of those relationships.[67] It follows, he argues, that abolishing the no further inquiry rule would not cause trustees to exploit their positions.[68]

The flaw in Professor Langbein's argument is that he fails to appreciate the ways in which trusts differ from relationships between family members, between service providers and customers, and between corporate fiduciaries and shareholders. These latter relationships are characterized by features that curb exploitative behavior—factors that are weak or nonexistent in the trust context. Although Professor Langbein's article occasionally acknowledges these differences,[69] he fails to account for them in his analysis.

Specifically, in the relationships that Professor Langbein cites as analogous to the trust, parties have strong abilities to monitor the

65. *Id.* at 954-57.
66. *See id.* at 951-52.
67. *Id.* at 934-38.
68. *See id.* at 934-35.
69. *See id.* at 934-38.

other's behavior, and to exit if the other party proves untrustworthy. In addition, external pressures, such as social disapproval and market forces, induce parties to the relationship to act in a trustworthy manner. In the trust context, however, beneficiaries' monitoring ability is poor, there is little opportunity to exit, and there are few, if any, market forces that pressure trustees to be loyal. The no further inquiry rule compensates for these deficiencies by reducing monitoring costs, expressing and enforcing the loyalty norm, and imposing unusually harsh penalties so that the threat of liability supplies the pressure that external forces do not. Abolishing the rule and replacing it with a rule that allows a "best-interest defense" would increase monitoring costs and weaken the social norm of loyalty. Compared to the no further inquiry rule, the best interest defense would significantly underdeter opportunistic behavior by trustees.

### *A. Monitoring, Exit, and External Pressure: Comparing Trusts to Other Relationships*

Trust is a key component of most voluntary long-term relationships. Strong social norms exist to ensure that parties do not betray trust.[70] Many people have internalized these norms: they view trustworthiness as an important character trait, and they honor trust out of the simple sense that to betray it would be wrong.[71] But

70. As economist Kenneth Arrow describes it,

> [s]ocieties in their evolution have developed implicit agreements to certain kinds of regard for others, agreements which are essential to the survival of the society or at least contribute greatly to the efficiency of its working. It has been observed, for example, that among the properties of many societies whose economic development is backward is a lack of mutual trust.

KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 26 (1974). Because norms of trust are efficient, the law serves an important expressive function in supporting and enforcing these norms, which ultimately encourages future compliance. *See* Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1265-77 (1999).

71. Professor Melvin Eisenberg, expanding on the work of Robert Cooter and economist Kaushik Basu, argues that fiduciary duties are obligational norms—norms of behavior that are sufficiently ingrained in the culture such that violation of the norm will incite self-censure or the judgment of others. *See* Eisenberg, *supra* note 70, at 1257 (explaining obligational norms), 1265-66 (explaining that fiduciary duties are obligational norms). Eisenberg argues that many obligational norms are internalized. Internalized norms comprise an aspect of individual character, and individuals will honor internalized norms reflexively, even if doing so causes them to forego material gain. *Id.* at 1257.

for those who have not internalized the loyalty norm, the decision whether to behave in a trustworthy fashion entails a cost-benefit analysis.[72] That analysis weighs the anticipated gain from the disloyal act against the likelihood and consequences of detection.[73] In assessing the likelihood of detection, therefore, an actor will consider the strength of the other party's monitoring ability. In assessing whether the gains will outweigh the consequences of detection, the actor will consider the ease with which the other party can exit the relationship and the costs that the larger community may impose if the disloyal behavior becomes widely known.

The degree to which these elements—ability to monitor and exit and external pressures—are present in particular contexts influences the content of the legal rules applicable to each relationship.[74] In the relationships that Professor Langbein cites as analogous to the trust relationship, these elements strongly constrain untrustworthy behavior, making legal rules less significant. In the trust context, these elements are largely absent. This difference explains the need for the no further inquiry rule.

### *1. Family, Business, and Corporate Relationships*

First, consider family relationships. It is a safe assumption that most people have internalized the social norm of loyalty to family members. Even people who often exploit others may be less willing to take advantage of the vulnerability of a close family member (just ask Michael Corleone). When family members have failed to internalize this norm, however, other factors still exert intense pressure to conform. Most people depend on intimate, trust-based relationships to meet a variety of emotional, psychological, and financial needs. The closer the relationship, the stronger the stake in ensuring that the other party does not withdraw affection or exit. The fear of experiencing that loss motivates family members to

72. *Id.* at 1257-58.

73. *Id.*

74. For example, Frank Easterbrook and Daniel Fischel note that corporate law's relaxation of the duty of care is appropriate because market monitoring exists, but that the duty of loyalty is more stringent because the market is less able to detect breach. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 96-103 (1991).

behave in a trustworthy fashion. Moreover, given the level of intimacy and proximity to the other, each party to a family relationship has strong monitoring abilities. Finally, external pressures, such as the specter of damage to reputation and social standing, create disincentives to exploit trust.

Professor Langbein also emphasizes that ordinary business relationships, such as the relationship one has with one's car mechanic or dentist, are permeated with conflict.[75] For example, we "trust" our dentist to diagnose and treat a dental problem even though he might abuse that trust by recommending unnecessary treatment. Yet, Professor Langbein states, the law does not require dentists to choose between offering diagnostic or treatment services.[76] But incentives to behave honorably put pressure on the dentist. First, service providers seek to cultivate repeat business. There is a serious risk of detection because customers can always obtain a second opinion. The best way to build client relationships is to serve the client honorably and well so that the client begins to trust the provider. The fact that the client can easily exit the relationship if trust proves misplaced creates an additional incentive. Third, the service provider's concern over reputation among customers or clients, within relevant professional communities and the larger community of the town or city in which the service provider operates, creates pressure to conform with norms. If word spreads that the service provider is dishonest, that service provider will lose business.

Finally, consider the corporate context. Shareholders have some ability to monitor executives' performance, because share price captures the quality of performance[77] and because well-developed

75. Langbein, *supra* note 1, at 936-38.

76. *Id.* at 937.

77. *See* EASTERBROOK & FISCHEL, *supra* note 74, at 17 (stating that if corporate managers "choose the inferior [charter] term from the investors' point of view ... [managers] will fail in competition with other firms competing for capital"); Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 33-45 (1990) (arguing that securities markets are efficient and that corporate terms are fully reflected in stock price, 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"); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1562-63 (1989) (arguing that stock price does telegraph information about charter terms).

information markets exist.[78] If shareholders learn of management's opportunistic behavior, they will exit, causing stock prices to fall. Even if most individual shareholders are inadequate monitors, they can free ride off the efforts of institutional investors, who have strong incentives to monitor corporate management closely.[79] More important, significant market pressures induce compliance with the loyalty norm. Managers' compensation might be linked to performance.[80] 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 the shareholders' best interests.[81] For the most part, then, fiduciaries will tend to behave in a trustworthy fashion.

### 2. *Trusts*

#### a. *Beneficiaries Are Uniquely Poor Monitors*

The three influences that exert pressure to comply with norms when the actor has failed to internalize them—the ability of the parties to monitor, the ability to exit freely, and the existence of external pressures—are remarkably feeble in the trust context. Because the trust relationship extends well beyond the death of the settlor, the responsibility for monitoring the trustee's behavior falls to the beneficiaries. Trust beneficiaries tend to be uniquely poor monitors. Often, the very reason that beneficiaries received an inheritance in trust is because the settlor did not believe they were capable of managing large sums of money on their own, either because they are minors or because they lack financial sophistication.[82] Most beneficiaries, therefore, are ill equipped to understand

78. EASTERBROOK & FISCHEL, *supra* note 74, at 96-97.

79. *Id.* 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, and that this protects uninformed investors); *see also* Gordon, *supra* note 77, at 1557-60.

80. EASTERBROOK & FISCHEL, *supra* note 74, at 5-6; *see* Butler & Ribstein, *supra* note 77, at 26-27.

81. *See* EASTERBROOK & FISCHEL, *supra* note 74, at 68, 91, 95; Butler & Ribstein, *supra* note 77, at 27.

82. *See* Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 680 (2004).

whether a trustee's actions are in the trust's best interests.[83] Moreover, institutional trustees hold themselves out as being trustworthy; that is the essence of the service they offer. Beneficiaries are likely to trust the trustee instead of closely monitoring his, her, or its behavior.

Although Professor Langbein acknowledges that beneficiaries may have trouble monitoring trustee behavior, he fails to take this insight to its logical conclusion.[84] He also neglects to consider that even the beneficiary who attempts to monitor the trustee's performance to detect self-interested transacting will face significant obstacles.[85] To detect self-dealing, the beneficiary must know the extent of the institutional trustee's other holdings or interests. In the case of an institutional trustee, for example, what are the names of the trustee's parent company and that parent company's subsidiaries? In what companies might the trustee be personally invested? To determine whether the self-dealing transaction is really in the trust's best interests, the beneficiary must engage in a comparative analysis of other investment options—has the investment trustee chosen an alternative superior to all other market options? If the trustee transacts business with the trust, the beneficiary must determine whether the price the trustee received represents fair market value, or whether the profit the trustee made was no more than the beneficiary would have paid a disinterested third party. In short, to monitor trustee behavior adequately, the beneficiary would need the same knowledge of the market, financial sophistication, and information the trustee has. This would defeat the very purpose of a trust that outlives the settlor, which is to relieve the beneficiary of the responsibility for asset management. A regime that expects the beneficiary to monitor the trustee is a

83. *Id.* (arguing that relying on liability rules is problematic because "beneficiaries are often unsuited to monitor the trustee ... because they are unborn, incapacitated, or simply irresponsible").

84. Langbein, *supra* note 1, at 957-58.

85. *See* RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. b (Tentative Draft No. 4, 2005) (recognizing that beneficiaries' attempts to monitor trustee performance are likely to be "inefficient if not ineffective" because monitoring efforts will be "wastefully expensive," and will suffer from a lack of information, resources, and necessary knowledge and experience); Robert H. Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency*, 28 J. CORP. L. 565, 573 (2003).

regime in which the beneficiary is essentially performing the trustee's job.

In his quest to allow trustees to profit, Professor Langbein downplays this important point. He emphasizes that trustees keep detailed records and are usually required to disclose these records to beneficiaries on a regular basis.[86] He suggests that any existing monitoring problems are better cured by strengthening rules that protect minors and those who lack capacity, and by adopting a rule that requires trustees to pay beneficiaries' litigation expenses if the beneficiaries' breach of duty claim prevails.[87] But if the beneficiaries lack the ability to discover from those records all of the facts necessary to assess whether the trustee's acts are in the trust's best interests, the fact that they receive trustee reports provides very little protection.[88] Most beneficiaries will lack this ability even if they are capable adults.

Professor Langbein suggests that a cost-shifting rule requiring trustees to pay beneficiaries' litigation expenses if trustees lose would address any monitoring problems that exist,[89] presumably because trustees' knowledge of the rule would deter trustee opportunism. Such a cost-shifting rule would deter only flagrant opportunism: beneficiaries have a relatively better chance of discovering obvious and egregious breaches after the fact, and this knowledge may deter trustees who are inclined to behave quite badly. But the rule will do nothing to deter trustees from profiting from deals that are minimally harmful or, more importantly, profitable but not optimal from the trust's perspective. Because the beneficiary often cannot assess adequately whether a self-dealing transaction is in the trust's best interests, Professor Langbein's proposed rule will do little to cure monitoring problems.

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86. Langbein, *supra* note 1, at 947-51 (describing the changes in trustee record-keeping and disclosure rules that have occurred since the no further inquiry rule was established).

87. *Id.* at 958.

88. In fact, record keeping may be an entrenched norm in part because the fiduciary rule against self-dealing has been so strong. Weaken that rule, and the record-keeping norm weakens.

89. Langbein, *supra* note 1, at 958.

*b. Absence of External Pressures*

When a trustee has failed to internalize the loyalty norm, there exist few external pressures to induce conformance with the norm. The pressures that do exist are more likely to apply to nonprofessional trustees, i.e., those who were close friends, relatives, or confidants of the settlor. For these trustees, the importance of remaining in good standing with family members may exert some pressure.

For professional trustees, however, almost none of the market forces that pressure service providers or corporate fiduciaries to forego opportunistic behavior exists.[90] There is no public information market that informs beneficiaries that a trustee's acts might be harming the trust, or that educates a potential settlor about a professional trustee's trustworthiness.[91] Because most trust management is secret, disclosed only to beneficiaries, trustees who have failed to internalize the loyalty norm may not worry that self-dealing acts will be communicated to their customers as a whole.[92] The fact that the trustee/beneficiary relationship is long-term will not induce the trustee to act honorably.[93] 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.[94]

Unlike the corporate context, there is no "share price" that telegraphs performance, so trustees need not worry that self-dealing practices will cause a loss in profits.[95] Trustees need not worry about raising money, maintaining or increasing stock prices, or avoiding hostile takeovers.[96] Although the desire to remain employed pressures trust company employees to perform honestly, the labor market pressures them less than it does their corporate counter-

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90. *See* Melanie B. Leslie, *Trusting Trustees: Fiduciary Duties and the Limits of Default Rules*, 94 GEO. L.J. (forthcoming 2005) (manuscript at 12, on file with author), *available at* http://ssrn.com/abstract=711849.

91. *Id.* at 13-17.

92. *Id.* at 12.

93. *See id.* at 14.

94. *Id.* at 12.

95. *Id.* at 12, 25-26.

96. *Id.* at 26.

parts.[97] 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.[98] In sum, trustees who behave opportunistically may never have to deal with a market response.[99] The problem is compounded when the trustee is an individual professional who has no boss.[100]

*c. Beneficiaries Cannot Exit*

Finally, the beneficiary's ability to exit the relationship is severely constrained.[101] Beneficiaries are often dependent, at least to some degree, on the trust assets.[102] Moreover, there is no market for beneficiaries' interests, especially if the trust is a spendthrift trust.[103] Replacing a trustee is difficult and expensive.[104] Beneficiaries' relative inability to exit is relevant for two reasons. First, trustees who have not internalized the loyalty norm can cause greater damage to beneficiaries. Unlike other relationships, where participants can end the relationship by breaking it off or selling their shares, beneficiaries may be stuck with a self-dealing trustee for years. Even if a beneficiary is able to detect the trustee's opportunistic transaction, her only option is to sue the trustee. The value of the recovery may not justify the expense of litigation.[105]

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97. *Id.*
98. *Id.*
99. *Id.*
100. *Id.*
101. *Id.* at 16.
102. *Id.*
103. *Id.* at 12 n.70.
104. *Id.* at 12 n.69.
105. 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. *See, e.g.*, Edward C. Halbach, Jr., *Significant Trends in the Trust Law of the United States*, 32 VAND. J. TRANSNAT'L L., 531, 552-53 (1999) (describing recent trends in the regulation of the trustee's duties of accounting and disclosure). Fear of regulators is also unlikely to curb spectacular, one-shot instances of self-dealing by an individual trustee

At various points in his article, Professor Langbein recognizes that monitoring problems, lack of external pressures, and beneficiaries' inability to exit play a role in trust law.[106] Yet he simply refuses to explore the import of those insights. For example, he acknowledges that beneficiaries may have difficulty detecting self-dealing, but then suggests a remedy for this problem that assumes that beneficiaries can easily detect self-dealing.[107] He recognizes that market forces play an enormous role in the development of corporate fiduciary law, that those market forces fail to function in trust law, and that beneficiaries, unlike shareholders, lack the ability to exit.[108] But, instead of exploring how those differences justify different rules, he simply concludes that "the successful experience with ridding corporation law of the sole interest rule is highly instructive for trust law."[109] Because he fails to take these differences seriously, he is able to paint the no further inquiry rule as a historical relic whose time for extinction has come. Yet, careful consideration of the role those factors play in encouraging compliance with norms shows how trust law requires a different standard for loyalty breaches than other relationships do.

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employee. *See* Langbein, *supra* note 1, 951-52. The result is that institutions that confine their business to extraordinarily high net worth clients are most likely to comply with federal or state regulations, while institutions which are newer to the business, or less scrupulous, are least likely to be influenced by fear of regulators. *Cf.* Joel C. Dobris, *Changes in the Role and the Form of the Trust at the New Millennium, or We Don't Have to Think of England Anymore*, 62 ALB. L. REV. 553, 564-66 (1998) (describing the explosive use of trusts and the less-than-wholesome efforts being made to sell trust and estate services to the mass population). Moreover, regulations do not act as a check on forms of opportunistic behavior that they do not cover. This is doubly true 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 trustee regulation fails to curb opportunism, there is no market to fill the void. *See* Sitkoff, *supra* note 85, at 570-71.

106. *See, e.g.*, Langbein, *supra* note 1, at 961-62 (discussing restrictions on exit).

107. Specifically, Langbein suggests that under the trustee pays rule trustees will still have an incentive to seek advance approval. *Id.* at 984-85.

108. Langbein concedes that beneficiaries' ability to exit is severely constrained, and admits that this difficulty "bear[s] on the more protective character of both the care and loyalty norms of trust law." *Id.* at 962 (footnote omitted).

109. *Id.*

### *B. The Enduring Value of the No Further Inquiry Rule*

Why has the no further inquiry rule endured for so long? Professor Langbein states that the rule continues to exist because exceptions and exclusions have developed that mitigate the rule's draconian approach.[110] Here, Professor Langbein is absolutely correct. The exceptions make the rule work because they permit efficient self-interested transactions that really do enhance beneficiaries' interests. This, however, is not an indictment of the rule; rather, the rule and its exceptions work together to create value for beneficiaries, to minimize monitoring problems, and to support and enforce the loyalty norm.

The no further inquiry rule responds—as Professor Langbein's alternative does not—to the absence of monitoring and market pressures in the trust setting. By dictating that trustees must obtain advance approval for *any* transaction from which the trustee stands to profit personally, the rule corrects for beneficiaries' inability to assess whether the trustee is conflicted with respect to any particular transaction. By requiring the trustee to explain to a court or to the beneficiary why the transaction is in the trust's best interests, it relieves the beneficiary of the need to have the same knowledge and expertise as the trustee. By allowing the beneficiary to state a claim upon a simple showing that the trustee sat on both sides of a transaction, it places the burden of production on the trustee. And, because disclosure does generate some cost, the rule ensures that the trustee will not habitually or regularly self-deal but will do so only when a conflicted transaction really is in the trust's best interests.

The no further inquiry rule also corrects for the lack of external pressures on the trustee. The rule's bright-line prohibition on self-dealing without advance approval, and the unusually harsh remedy it provides (disgorgement of all profits, even if the trust was not harmed),[111] create appropriate disincentives to self-dealing.[112] Were there a thick, functioning market for beneficial interests in trusts,

110. *Id.* at 963-80.

111. *Id.* at 931-32.

112. *See* RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. b (Tentative Draft No. 4, 2005); Sitkoff, *supra* note 85, at 573-74.

the rule would not be necessary. Because there is no such market, the rule operates as a substitute.[113]

Settlors are not completely hamstrung by the no further inquiry rule; a settlor may authorize her trustee to engage in a particular type of self-interested behavior by inserting an express provision in the trust document.[114] Professor Langbein points to this fact as evidence that conflicts between trustee and beneficiary are not always harmful.[115] True enough. But from there he leaps to the conclusion that trustees should be awarded more latitude to manage conflicts generally.[116] In leaping, he misses a critical step: Settlor-authorized conflicts are allowed because they reflect the *settlor's* determination that allowing the conflicted transaction will maximize the trust's value and effectuate the settlor's intent. In authorizing the transaction, the settlor relieves the beneficiary from the need to monitor the trustee's behavior with respect to that transaction. Thus, the no further inquiry rule's effect to compensate for lack of monitoring is not implicated when settlors authorize specific conflicted transactions. Moreover, excluding specifically described acts from the no further inquiry rule's reach does little harm to the social norm of loyalty; when the trustee engages in authorized acts, it is not being disloyal but is simply following settlor's express instructions.

Professor Langbein's "best-interest defense"[117] is a less efficient solution to the problem of trustee self-dealing because it would significantly increase beneficiaries' monitoring costs and would allow a large number of self-dealing transactions to pass undetected. Moreover, a best-interest defense would make litigation less attractive for trust beneficiaries because the defense would require beneficiaries to predict whether a court would view the self-dealing transaction as in the trust's best interests. Professor Langbein's proposal would, therefore, eliminate the few disincentives to self-dealing that trustees *do* face. Aside from the remote prospect of

113. The clear prohibition created by the rule also serves an expressive function; by telegraphing, in no uncertain terms, that unauthorized self-dealing is unacceptable, it strengthens and supports the efficient social norms that encourage people to act fairly and honestly.

114. Langbein, *supra* note 1, at 963.

115. *Id.* at 938-39.

116. *See id.*

117. *Id.* at 980-82.

legal liability, the only disincentive remaining would be the trustee's internal sense that self-dealing violates social norms. The trustee who has failed to internalize those norms will limit her efforts to seek the very best deal for the trust, settling instead for a deal that is "good enough" for the trust, while providing personal profit to the trustee.

Moreover, abolishing the no further inquiry rule would change the social norm of loyalty to the detriment of all settlors and beneficiaries. The best-interest defense would remove the stigma attached to profiting from one's position of trust. As the loyalty norm is eroded, trustees may increasingly push the boundaries, rationalize self-dealing behavior, or simply be less than vigilant in ensuring that the self-dealing transaction is the best option for trust beneficiaries. Moreover, as increasing numbers of trustees profit from their fiduciary positions, a "tipping point" may be reached.[118] When this occurs, the loyalty norm will lose its obligational character.[119] As a result, even more beneficiaries would be harmed. The no further inquiry rule's imposition of liability even in the face of fairness serves an important function in strengthening and supporting the social norm of loyalty.[120]

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118. *See* Eisenberg, *supra* note 70, at 1253, 1257-64.

119. Eisenberg explains that

> [t]ipping occurs when the success of a social activity depends on the formation of a critical mass, and enough actors sign on or sign 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 DICTIONARY OF ECONOMICS AND THE LAW 476, 477 (Peter K. Newman ed., 1998)).

120. The drafters of the Third Restatement recognize this function, emphasizing that the duty of loyalty is "particularly intense" in the trust context "for prophylactic reasons," because beneficiaries cannot adequately monitor trustee behavior. RESTATEMENT (THIRD) OF TRUSTS

Professor Langbein argues that "there is little reason to fear" that the best-interest defense would cause more trustees to act without advance approval, because "[a]nticipatory resolution will almost always be more attractive than a retrospective determination in which liability will attach if the court disagrees with the trustee's view ...."[121] Here, Professor Langbein undermines his premise. If most trustees will seek advance approval no matter what the rule, then the advance approval doctrine is not a significant overdeterrent. Moreover, this statement again assumes that beneficiaries are good monitors, and will bring suit whenever they detect a bad deal.

In sum, a best-interest defense would underdeter self-dealing. Although it is clear that the best-interest defense would benefit trustees, the harm to beneficiaries is equally clear. The no further inquiry rule strikes a better balance between over- and under-deterrence.

## V. EXCEPTIONS AND EXCLUSIONS TO THE RULE ARE NOT EVIDENCE THAT THE RULE IS "NO LONGER THE BASELINE" FOR FIDUCIARY CONDUCT

Professor Langbein states that the no further inquiry rule persists only because states have developed exclusions to the rule to loosen its grasp.[122] He argues that the law should embrace the theory that animates the exceptions, which, he claims, is that the beneficiaries' best interests are served by a rule that allows trustees to judge whether a self-interested transaction is in the beneficiaries' best interests.[123]

The exceptions he cites fail to prove his point. Some are not inconsistent with the no further inquiry rule's function. More important, he fails to appreciate that legislatures might create particular exceptions to the rule to achieve a conflicting policy goal, which they view as more important than the monitoring problem. Because a competing policy goal is important in a particular case does not mean that the primary rule should be abolished entirely.

§ 78 cmt. b (Tentative Draft No. 4, 2005).

121. Langbein, *supra* note 1, at 985.

122. *Id.* at 968.

123. *Id.* at 980-82.

Finally, when an exception conflicts with a rule, two conclusions are possible: either the rule is misguided, or the exception is misguided. Two exceptions Professor Langbein cites particularly lack any compelling theoretical justification. These statutes are, at most, evidence that the banking industry employs excellent lobbyists.[124]

First, some of the exceptions that Professor Langbein cites are not inconsistent with the no further inquiry rule. Because they do not undermine the rule, they are not evidence that the rule is unsound. In this category of exclusions are two that Professor Langbein cites: statutes that allow trustees to earn commissions, and statutes that allow trustees to pool trust funds for investment purposes.[125]

Statutes allowing settlors to compensate professional trustees generate obvious benefits for the trust, with no offsetting risk. At trust creation, the settlor will determine whether the trustee will be compensated. If the settlor decides to compensate the trustee, she is free to alter the commission structure. Monitoring problems are not implicated because the trustee may not unilaterally alter the commission amount after the trust has been created.

Similarly, statutes authorizing trustees to pool trust accounts to increase investment opportunities generate benefits to trustees and do not implicate monitoring issues.[126] These statutes create an exception to the prohibition on commingling of trust accounts. Commingling of accounts gives rise to duty of loyalty problems only when a trustee combines trust property with the trustee's personal property.[127] When a trustee merely combines several trust accounts for investment purposes, there is no conflict of interest. Neither of these two examples, therefore, stands as evidence that the no further inquiry rule is unsound.

Second, even if the legislature or the judiciary creates particular exceptions to the no further inquiry rule that are inconsistent with the rule's premise, it does not automatically follow that the rule should be abolished for all purposes. For example, some courts allow trustees to bill the trust for additional, nontrustee services provided,

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124. *See infra* notes 160-65 and accompanying text.

125. Langbein, *supra* note 1, at 970, 977.

126. *See, e.g.*, N.J. STAT. ANN. § 17:9A-37 (West 2005) ("[A] bank may create and maintain one or more common trust funds, and may ... invest in cash all or any part of the funds of any one or more trust estates in any one or more common trust funds.").

127. RESTATEMENT (SECOND) OF TRUSTS § 179 (1959).

such as real estate brokerage or attorney services.[128] Professor Langbein justifies this trend as best for beneficiaries because trustees, who have extensive knowledge of the trust assets and beneficiaries, may be able to provide such services more cheaply than third parties.[129] Assuming, without deciding, that this justification is persuasive, it does not follow that the no further inquiry rule should go; the justification for the exception would not support a complete repudiation of the rule.

Third, in some cases it is the exclusion that is the problem, not the no further inquiry rule. Consider two of the most egregious examples: The first example is found in the newly promulgated Uniform Trust Code. Section 802(c) exempts from the no further inquiry rule transactions between institutional trustees and entities in which the trustee (or a person who owns a significant interest in the trustee) has an interest.[130] It allows trustees to profit from a conflicted transaction as long as trustees can prove, if challenged, that the transaction was not affected by the conflict.[131] This exemption to the no further inquiry rule is brand new and has escaped critical attention.

The second example involves state statutes that authorize institutional trustees to invest trust assets in mutual fund accounts that they manage. These statutes enable institutional trustees to earn additional fees, and create an incentive for trustees to invest in assets that earn them an additional commission.[132] With a nod to

128. Langbein, *supra* note 1, at 977.

129. *Id.* at 976-78.

130. Subsection c provides:

> 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) (2003).

131. *Id.* § 802(c) cmt.

132. 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 2005); COLO. REV. STAT. § 11-109-902 (2004); GA. CODE ANN. § 53-8-2 (2004); HAW. REV. STAT. §

the monitoring problems these statutes create, many of these statutes require a trustee who earns such commissions and fees to expressly disclose that fact to the trust beneficiaries.[133] The Nebraska statute goes further, requiring trustees to obtain beneficiaries' consent to double-dipping in writing.[134] And a smaller number of states go further to protect beneficiaries: these state statutes authorize trustees to invest in their own funds but force the trustees to choose between earning trustee commissions or mutual fund administrator fees.[135] UTC section 802(f) allows trustees to earn double commissions, and requires trustees to disclose annually additional commissions and fees earned to beneficiaries.[136]

The justification for these statutes is shaky at best, because they eliminate long-standing protections and require settlors to bargain for fiduciary rules. They are a direct response to two events: the gradual erosion and eventual repeal of the Glass-Steagall Act and intensive lobbying efforts by the banking industry.[137] They provide no evidence for the argument that the no further inquiry rule has no modern day justification.

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412:8-400 (2004); IDAHO CODE ANN § 68-404A (2004); 760 ILL. COMP. STAT. § 5/5-2 (2004); IND. CODE § 28-1-12-3 (2004); IOWA CODE ANN. § 633.123A (West Supp. 2004); KY. REV. STAT. ANN. § 386.020 (West 2004); LA. REV. STAT. ANN. § 9:2127 (2005); MD. CODE ANN. FIN. INST. § 3-512 (West 2004); MICH. COMP. LAWS ANN. § 487.14405 (West Supp. 2004); MO. ANN. STAT. § 362.550 (West Supp. 2005); N.D. CENT. CODE § 6-05-15 (2003); OR. REV. STAT. § 709.175 (2004); S.C. CODE ANN. § 62-7-302 (2004); TENN. CODE ANN. § 35-3-117 (Supp. 2004); UTAH CODE ANN. § 75-7-802 (Supp. 2004); WASH. REV. CODE ANN. § 11.100.035 (West 2005); W. VA. CODE ANN. § 44-6-9 (West 2004).

133. ALA. CODE § 19-3-120.1 (2004); ARIZ. REV. STAT. ANN. § 6-246 (2004); CONN. GEN. STAT. ANN. § 45a-209 (West 2005); DEL. CODE ANN. tit. 12, § 3312 (Supp. 2004); D.C. CODE § 21-1721 (2004); FLA. STAT. ANN. § 660.417 (West 2005); ME. REV. STAT. ANN. tit. 18-A, § 7-408 (2004); MASS. GEN. LAWS ANN. ch. 167G, § 3 (West Supp. 2005); MINN. STAT. ANN. § 501B.151 (West 2005); MISS. CODE ANN. § 81-5-33 (2004); MONT. CODE ANN. § 32-1-420 (2003); NEB. REV. STAT. § 30-3205 (1995); NEV. REV. STAT. ANN. §§ 662.097, 669.225 (West 2003); N.M. STAT. ANN. § 46-2A-1 (West 2004); N.C. GEN. STAT. § 36A-66.2 (2003); OHIO REV. CODE ANN. § 1111.13 (West Supp. 2004); 20 PA. CONS. STAT. ANN. § 7314.1 (West Supp. 2004); S.D. CODIFIED LAWS § 55-1A-9 (2004); TEX. PROP. CODE ANN. § 113.053 (Vernon 2005); VA. CODE ANN. § 26-44.1 (2004); WIS. STAT. ANN. § 881.015 (West 2004); WYO. STAT. ANN. § 2-3-301 (2003).

134. NEB. REV. STAT. § 30-3205 (1995).

135. N.Y. EST. POWERS & TRUSTS LAW § 11-2.2 (Consol. 1990 & Supp. 2005); OKLA. STAT. ANN. tit. 60, § 175.55 (West 2005).

136. UNIF. TRUST CODE § 802(f) (2003).

137. *See infra* notes 155-56 and accompanying text (discussing the lobbying power of the banking industry).

Because state legislatures currently are considering whether and to what extent to adopt the UTC, it is critical to explore the wisdom of these statutes.[138] The following sections do that, while paying close attention to Professor Langbein's defense of them.

*A. Section 802(f)*

Recent changes in the legal landscape have greatly increased opportunities for institutional trustees to profit at the trust's expense. The slow erosion of the Glass-Steagall Act, which culminated in its repeal in 1999,[139] induced increasing numbers of institutional trust companies to merge, affiliate with, or purchase financial institutions offering investment banking services.[140] As a result, increasing numbers of institutions are entering the trust market,[141] and increasing numbers of institutional trustees are in a position to obtain additional financial benefits by investing trust assets in related companies; when this happens, the corporation benefits twice, earning both trustee commissions and other fees, such as those related to the management and sale of the investment.

Until quite recently, a trustee's purchase of investments from which the trustee or an affiliated company would earn a commission was considered unequivocally to be a clear breach of the duty of loyalty justifying the application of the no further inquiry rule. As both the First and Second Restatements of Trusts have put it:

> A corporate trustee violates its duty to the beneficiary if it purchases property for the trust from one of its departments, as where it purchases for the trust securities owned by it in its securities or banking department. *A corporate trustee cannot properly purchase for the trust property owned by an affiliated or*

138. For example, the UTC is scheduled to be introduced in the South Dakota legislature in 2006. UTC section 802(c)(4) would change the law in South Dakota, which applies the no further inquiry rule even to transactions between the trust and trustee's relatives. *See In re* Estate of Stevenson, 605 N.W.2d 818, 822 (S.D. 2000).

139. 12 U.S.C. § 377 (1994), *repealed by* Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 101(a), 113 Stat. 1338, 1341 (1999).

140. *See* Joan LeGraw & Stacey Davidson, Note, *Glass-Steagall and the "Subtle Hazards" of Judicial Activism*, 24 NEW ENG. L. REV. 225, 226-28 (1989).

141. *See* Samuel L. Hayes III, *Wall Street in Turmoil: Who Is Protecting the Investor?*, 70 BROOK. L. REV. 39, 43 (2004) (describing the post-Glass-Steagall investment banking world).

> *subsidiary corporation in which it has the entire interest or a controlling interest or an interest of such a substantial nature that there would be a temptation to consider its own advantage in making the sale and not to consider solely the advantage to the beneficiaries of the trust.* The rule is the same where the shares of the selling corporation are owned by the shareholders of the corporate trustee. So also, a corporate trustee cannot properly purchase property for the trust from one of its officers or directors.[142]

Throughout the twentieth century, institutional trustees argued vigorously for a change in the Restatement position. Courts and scholars, however, stuck to their guns. In a *Harvard Law Review* article, Professor Scott confronted the issue:

> It is sometimes contended that a trust company should be permitted to purchase securities for its trusts from its securities or banking department, because it is in a position to judge most wisely as to the value of such securities. If it always acted with an unbiased judgment, this might conceivably be so. But the difficulty is that it is not in a position to exercise an unbiased judgment. In a sense the difficulties are greater than those ... of an individual trustee. An honorable individual trustee can hardly help seeing the direct conflict between his own interests and his duty to the beneficiaries. On the other hand, the officers of a trust company owe allegiance to the shareholders as well as to the beneficiaries, and the temptation to favor the shareholders may well be more insidious than the temptation of an individual trustee to favor himself. It seems clear that in both cases self-dealing is too dangerous to be permitted .... *The same principle is applicable where a corporate trustee purchases property from an affiliated or subsidiary corporation in which it has the entire interest or a controlling interest or an interest of such a substantial nature that there would be a temptation to*

142. RESTATEMENT (SECOND) OF TRUSTS § 170 cmt. i (1959) (emphasis added). The Second Restatement offers the following examples of prohibited transactions:

> 1. A is trustee for B. A is also a bond dealer. A purchases certain bonds and sells them to himself as trustee. A commits a breach of trust in so doing.
>
> 2. A is trustee for B. A is a member of a firm of bond dealers. A purchases for the trust certain bonds owned by the firm. He commits a breach of trust in so doing.

*Id.* § 170 cmt. h, illus. 1-2.

> *consider its own advantage in making the sale and not to consider solely the advantage to the beneficiaries of the trust.*[143]

Historically, the problem of self-interested investing by trustees was not one of huge proportions for a few reasons: the Glass-Steagall Act required clear separation between commercial and investment banks, and trustees had a duty not to delegate investment functions.[144] The opportunities for double-dipping, though present, were on a small scale.[145] Over the past two decades, however, the Federal Reserve gradually loosened Glass-Steagall's grip, allowing banks or bank-holding companies (BHCs) to (in order): (1) offer certain discount stock brokerage services,[146] (2) offer investment advice to closed-end investment companies,[147] (3) purchase discount brokerage firms,[148] (4) establish and market trusts for IRAs,[149] (5) offer discount brokerage services through branches and at other locations both inside and outside the state,[150] and (6) underwrite and deal in municipal revenue bonds, securities, commercial paper, and annuities.[151] Then, in 1996, the Federal Reserve authorized mergers and acquisitions of banks and large

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143. Austin Wakeman Scott, *The Trustee's Duty of Loyalty*, 49 HARV. L. REV. 521, 543-44 (1936) (emphasis added).

144. *See* Banking (Glass-Steagall) Act of 1933 §§ 16, 20, 21, 32, 12 U.S.C. §§ 24 (1994 & Supp. II 1996), 78, 377, 378 (1994); Bank Holding Company Act, 12 U.S.C. §§ 1841-1859 (1994 & Supp. II 1996) (forbidding combinations of banks and insurance companies).

145. *See* LeGraw & Davidson, *supra* note 140, at 235-38 (noting that the loopholes in the Glass-Steagall Act and the Bank Holding Company Act, combined with the inapplicability of the Glass-Steagall Act to nonmember banks and subsidiaries, allowed banks to engage in securities activities).

146. *See* TASK GROUP ON REGULATION OF FIN. SERVS., BLUEPRINT FOR REFORM: THE REPORT OF THE TASK GROUP ON REGULATION OF FINANCIAL SERVICES 25-26 (1984).

147. *See* 12 C.F.R. § 225.125(f) (2001) (excluding closed-end investment companies from its restrictions on Bank Holding Company's and BHC subsidiary's actions); *see also* Bd. of Governors of the Fed. Reserve Sys. v. Inv. Co. Inst., 450 U.S. 46, 58-64, 72-74 (1981).

148. *See* Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys., 468 U.S. 207, 221 (1984) (upholding the Federal Reserve Board's approval of Bank of America's purchase of Charles Schwab, a large discount brokerage firm, by finding that the purchase was permitted by section 16 of the Glass-Steagall Act).

149. *See* Inv. Co. Inst. v. Conover, 790 F.2d 925, 926-27 (D.C. Cir. 1986) (holding that shares in a bank's trust are not "securities" as defined by the Glass-Steagall Act).

150. *See* Clarke v. Sec. Indus. Ass'n, 479 U.S. 388, 390, 404-06 (1987) (holding that the National Banking Act did not limit national banks from opening discount brokerage offices).

151. *See* Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys., 839 F.2d 47, 62-69 (2d Cir. 1988) (expanding the scope of permissible activities under the Glass-Steagall Act).

securities firms.[152] Two years later, Citicorp merged with Travelers Group to create Citigroup, the world's largest financial services company.[153] In 1999, Congress repealed the Glass-Steagall Act.[154]

With the slow erosion of Glass-Steagall, it appears that the banking industry's calls for an exemption from prohibition on self-interested investing grew more insistent.[155] Legislatures could have responded to this pressure in one of three ways. First, they could have responded by not responding—keeping the prohibition against self-dealing, in all its forms, in place. Second, legislatures could have characterized the prohibition as a default rule, waivable by settlor after full disclosure. Third, legislatures could have reversed the long-standing legal rule and decided that self-interested investing is not automatically a breach of the duty of loyalty, unless the settlor insists on a trust provision prohibiting such conduct.

The first option, a blanket prohibition on investing trust assets in any vehicle that brings the trustee an extra profit, is the option most consistent with the principles of the duty of loyalty and the objectives of the no further inquiry rule; it best ensures that trustees make investment decisions with only the trust's best interests in mind. The rule sends a clear signal to trustees, and best reinforces the loyalty norm. Of course, the trustee could profit from investing upon receiving beneficiary or court approval.

The second option, treating the prohibition against self-interested investing as a default rule and allowing parties to contract around it, would arguably address any inefficiencies created by option one, in the event that the most sound investment options are those in which the trustee's institution has an interest. Assuming full

152. *See, e.g.*, 1996 Fed. Res. Interp. Ltr. LEXIS 158 (approving the acquisition of an American securities firm by a Swiss bank).

153. Press Release, Citigroup Inc., Citigroup (CCI) to Begin Trading Today, Following Completion of Merger of Citicorp and Travelers Group (Oct. 8, 1998), *available at* http://www.citigroup.com/citigroup/press/1998/981008a.htm; Press Release, Citicorp, Citicorp and Travelers Group to Merge, Creating Citigroup: The Global Leader in Financial Services (Apr. 6, 1998), *available at* http://www.citigroup.com/citigroup/press/1998/980406a.htm.

154. 12 U.S.C. § 377 (1994), *repealed by* Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 101(a), 113 Stat. 1338, 1341 (1999).

155. *See* Robert L. Mendenhall, *Commercial Law*–Board of Governors of the Federal Reserve System v. Investment Company Institute*: The Continuing Conflict Between Commercial and Investment Banking*, 61 N.C. L. REV. 378, 381-88 (1983) (noting the effects of the banking industry's actions on the erosion of the Glass-Steagall Act).

information,[156] a settlor's consent to conflicted investing would indicate that the settlor had a high degree of trust in the trustee and that the settlor believed the provision would maximize value. This option still appears to be the law in the four states that have failed to enact legislation authorizing this type of activity.[157]

The third option, a legal rule that exempts self-interested investing from the duty of loyalty, would seem to be the least attractive alternative. It leaves it to the settlor to know that the law permits certain forms of self-dealing and to negotiate for the traditional rule.[158] This option is most likely to create asymmetrical information problems. By failing to contract around the statute, most settlors would be agreeing to an exception to the long-established prohibition on self-dealing without even knowing it. Moreover, because beneficiaries will be poor judges of whether the investment the trustee chose is an inferior option, trustees would have little incentive to invest in any products other than those in which the institution has an additional interest. Finally, this rule would erode the normative proscription against self-dealing that is the basis of trust law.

Why then have so many state legislatures opted for the least supportable option? Although paper trails are few, the available evidence suggests that the banking lobby pushed for the legislation.[159] Once a few state legislatures had taken the bait, the

156. However, trust settlors who sign trust documents authorizing self-interested investing would not be likely to have full information. Even the settlor assisted by counsel may not have full information. If lawyers wish to curry favor with banks in an effort to get referrals, they may fail to explain the provision to their clients. Although some settlors may have the sophistication to read the provision and understand the problem, most will not. Moreover, foresight problems may be significant; a settlor is in a poor position to understand how the waiver will impact a trustee's investment decisions years after the settlor's death, and beneficiaries are likely to be poor monitors of complex investment decisions.

157. Those states are New Hampshire, New Jersey, Rhode Island, and Vermont. *See supra* notes 128, 132-35 and accompanying text (demonstrating that only these four states have not enacted legislation permitting self-interested investing as a default rule).

158. It is unlikely that a lawyer who wishes to obtain future business from the institutional trustee would explain the default rule to the client and suggest that the client contract around it.

159. For example, the legislative history of the New York statutes that authorize 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 from the New York State Bankers Ass'n to The Honorable Elizabeth D. Moore, Counsel to the Governor (July 16, 1992) (on file with the Association of the Bar of the City of New York). Although government actors responding

race to the bottom was on as bankers persuaded legislators that the prohibition placed them at a competitive disadvantage.[160] In the past fifteen years, the vast majority of states have enacted statutes providing that trustee investment in vehicles owned by it or a related company is not a breach of the duty of loyalty, even though the trustee's related or parent company collects commissions and fees in its capacity as an investment bank.[161] Many state statutes

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 from James W. Wetzler, Comm'r of Taxation and Fin., to Governor Mario Cuomo (July 17, 1992) (on file with the Association of the Bar of the City of New York). The Assembly Bill's Memorandum of Support includes a "Justification" section which tracks the Bankers Association's letter verbatim and in toto. *See* New York Assembly Bill 11971, Memorandum of Support (June 10, 1992).

160. Banks and trust companies have enjoyed similar success in recent years in arguing that the common law rule against perpetuities and the common law's prohibition against self-settled spendthrift trusts should be abolished or modified to prevent the loss of trust business. *See generally* Jesse Dukeminier & James E. Krier, *The Rise of the Perpetual Trust*, 50 UCLA L. REV. 1303, 1315 (2003) (discussing the competitive pressure among states to permit perpetual trusts and thus to repeal the rule against perpetuities); Stewart E. Sterk, *Asset Protection Trusts: Trust Law's Race to the Bottom?*, 85 CORNELL L. REV. 1035, 1051-55 (2000) (noting the competition among states in permitting asset protection trusts); Stewart E. Sterk, *Jurisdictional Competition to Abolish the Rule Against Perpetuities: R.I.P. for the R.A.P.*, 24 CARDOZO L. REV. 2097, 2101-05 (2003) (analyzing the competitive pressures states faced to abolish the rule against perpetuities and thereby attract trust and banking business which would stimulate the economy); Amy Lynn Wagenfeld, Note, *Law for Sale: Alaska and Delaware Compete for the Asset Protection Trust Market and the Wealth that Follows*, 32 VAND. J. TRANSNAT'L L. 831, 857-66 (1999) (examining state competition to permit asset protection trusts); *see also* Christopher C. DeMuth, *The Case Against Credit Card Interest Rate Regulation*, 3 YALE J. ON REG. 201, 215-16 (1986) (detailing state efforts to placate local banks and attract national banks by relaxing usury limits).

The pervasive influence of the banking lobby on uniform legislation affecting bank interests, with a focus on the Uniform Commercial Code, has been detailed elsewhere. *See* A. Brooke Overby, *Modeling UCC Drafting*, 29 LOY. L.A. L. REV. 645, 679-83 (1996); Kathleen Patchel, *Interest Group Politics, Federalism, and the Uniform Laws Process: Some Lessons from the Uniform Commercial Code*, 78 MINN. L. REV. 83, 101-20 (1993).

161. The UTC's approach has not been universally adopted. In New York, for instance, a statute provides that, unless the trust document directs otherwise, a trustee who transacts business with a related institution must make a yearly decision to collect either trustee commissions or to receive, or have its affiliate receive, compensation for investment advice or services. N.Y. EST. POWERS & TRUSTS LAW § 11-2.3(d) (Consol. Supp. 2005). The New York solution is far from perfect, since settlors' information deficits may enable trustees to include trust provisions allowing double-dipping in trust documents. Nonetheless, New York made an effort to minimize harm to the trust by eliminating a trustee's incentive to purchase investments for the wrong reasons. The UTC requires no such sacrifice on the part of trustees who self-deal. As a result, institutional trustees have free reign to invest trust assets only in

attempt to address the monitoring difficulties that these statutes create by requiring trustees to expressly inform the beneficiary of the investment activity or the extra fees earned as a result of opportunistic investing,[162] obtaining beneficiaries' consent to such activity in writing,[163] or, best of all, forcing trustees to choose between earning trustee commissions or mutual fund commissions.[164]

The Uniform Trust Code accepts the trend without much critical analysis, and neglects to implement sufficient protections for beneficiaries. Section 802(f) states that trustees who purchase investments from related companies are not presumed to have violated the duty of loyalty and that the trustee may earn additional fees or commissions, payable by the trust, in so doing.[165] The comments suggest that this self-interested investing is no longer subject to the no further inquiry rule.[166] Although the comments warn that "[t]he trustee, in deciding whether to invest in a mutual fund, must not place its own interests ahead of those of the beneficiaries,"[167] it is difficult to know what this means. If the trustee chooses a mutual fund in part to gain a financial advantage, who will be the wiser? If the very point of the no further inquiry rule is to provide a substitute for inadequate monitoring, then it makes no sense to say that the duty of loyalty still applies to this type of investing. Although the statute requires the trustee to issue an annual report that includes "the rate and method by which ... compensation was determined,"[168] many beneficiaries will be unable to understand

investments that generate additional benefits for the trustee. This approach guts the duty of loyalty.

162. *See supra* note 133.

163. *See supra* note 134.

164. *See supra* note 135.

165. UNIF. TRUST CODE § 802(f) (amended 2003).

166. UNIF. TRUST CODE § 802(f) cmt. (amended 2003).

167. *Id.*

168. UNIF. TRUST CODE § 802(f) (amended 2003). Section 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 .... [T]he trustee may be compensated by the investment company or investment trust for providing those services out of fees charged to the trust .... [T]rustee must at least annually notify the persons entitled under Section 813 to receive a copy of the trustee's annual report of the

whether the trustee's proprietary funds are the best choice. Institutional trustees will have free rein to engage in self-interested investing.

What reasons do the UTC drafters give for validating this legislative trend, or for failing to adopt protections that some states have in place? In the comments to subsection (f), the drafters state that trustees' self-interested investing has often caused beneficiaries to claim breach of the duty of loyalty; the drafters do not, however, explain why they consider that a problem.[169] The drafters also assert that the rule in subsection (f) is necessary to enable trustees to invest in mutual funds.[170] The assertion is not accurate. The common law approach to mutual fund investment, which prohibited such investments as a violation of the trustee's duty not to delegate, has long been reversed in all states.[171] Thus, subsection (f) is not necessary to allow trustees to invest in mutual funds; but it is necessary to allow trustees to invest, without advance approval, in mutual funds *in which they have a financial interest.* The promulgators offer no justification for failing to follow those state statutes that support the loyalty norm by requiring beneficiary consent or prohibiting trustees from making a commission on both activities.

Professor Langbein, too, attempts to justify this statutory provision. He argues, in effect, that the statute is necessary to permit trustees to do their jobs.[172] If settlors choose trustees for the investment expertise, then it makes no sense to prohibit them from investing trust assets in investment vehicles that they have created.[173] This argument fails for two reasons. First, the better

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> rate and method by which [the] compensation was determined.

*Id.*

In the most recent draft of the Third Restatement, 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 (emphasis added)); *id.* § 78 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)).

169. UNIF. TRUST CODE § 802(f) cmt. (amended 2003).

170. *Id.*

171. *See supra* notes 132-33 and accompanying text.

172. Langbein, *supra* note 1, at 976-78.

173. *Id.*

approach, exemplified by the New York statute, is to allow trustees to invest in their own vehicles, but to prohibit them from making double commissions.[174] Second, settlors have always had the option to authorize the trustee to engage in these types of investments. If a settlor truly wants a trustee to earn additional commissions from investing in its own offerings, the settlor can simply authorize that behavior in the trust document.[175] If the settlor fails to do so, the trustee still may seek beneficiary or court approval.[176] But if trustee needs no authorization to self-deal, the temptation to do so will be great.

Insofar as it requires the settlor to bargain for protection, rather than require institutional trustees to bargain around the constraints of the no further inquiry rule, section 802(f) should be redrafted.

### *B. Section 802(c): Self-Dealing as Indirect Self-Dealing*

The UTC does an about-face with respect to traditional loyalty doctrine in its treatment of trustees who transact trust business with related individuals.[177] Transactions between a trustee and that trustee's spouse, close relatives, agents, attorneys, or entities in which the trustee (or a person who owns a significant interest in the trustee) has an interest are no longer subject to the no further inquiry rule.[178] As the comments make clear, such transactions give

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174. *See* N.Y. EST. POWERS & TRUSTS LAW § 11-2.2 (Consol. 1990 & Supp. 2005); *see also* OKLA. STAT. ANN. tit. 60, § 175.55 (West 2005).

175. *See, e.g.*, UNIF. TRUST CODE § 802(b) cmt. (amended 2003).

176. *Id.*

177. Section 802(c) provides:

> 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) (amended 2003).

178. For a recent case applying the no further inquiry rule to void trustee's leases of trust property to her husband and to husband's relatives, see *In re* Estate of Stevenson, 605 N.W.2d 818 (S.D. 2000).

rise only to a presumption of breach, which the trustee can rebut by establishing that the transaction was not affected by the conflict of interest. The comments suggest that the trustee can meet its burden by establishing that the consideration was fair or close to market value,[179] which replaces the no further inquiry rule with the corporate fairness standard. Oddly, the comments to subsection (c)(4) suggest that the section as a whole is comparable to the federal regulation governing federally chartered banks.[180] Yet the regulation to which the comment refers, 12 C.F.R. § 9.12(a), in fact flatly *prohibits* (unless otherwise authorized by state law) most types of conflicted transactions between fiduciaries and companies related to them.[181]

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179. The comments to section 802(c) provide:

> The [self-dealing] 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(c) cmt. (amended 2003).

180. The last sentence of the comment to subsection (c) reads: "For a comparable provision regulating fiduciary investments by national banks, see 12 C.F.R. Section 9.12(a)." *Id.*

181. The regulation reads as follows:

> (1) *In general.* Unless authorized by applicable law, a national bank may not invest funds of a fiduciary account for which a national bank has investment discretion in the stock or obligations of, or in assets acquired from: the bank or any of its directors, officers, or employees; affiliates of the bank or any of their directors, officers, or employees; or individuals or organizations with whom there exists an interest that might affect the exercise of the best judgment of the bank.
> (2) *Additional securities investments.* If retention of stock or obligations of the bank or its affiliates in a fiduciary account is consistent with applicable law, the bank may:
>
> (i) Exercise rights to purchase additional stock (or securities convertible into additional stock) when offered pro rata to stockholders; and
>
> (ii) Purchase fractional shares to complement fractional shares acquired through the exercise of rights or the receipt of a stock dividend resulting in fractional share holdings.

12 C.F.R. § 9.12(a) (2005).

This provision represents another significant departure from well-established doctrine. As Bogert notes, historically, the law has not distinguished between situations where the trustee acts to benefit itself and situations where the trustee acts to benefit some third party.[182] Both are violations of the duty of loyalty and subject to the no further inquiry rule.[183] The most recent draft of the Restatement (Third) continues the prohibition on indirect self-dealing, and reaffirms that the no further inquiry rule applies to such transactions.[184] Even though some have suggested that the rule is more lenient when the trustee transacts with family members, no court has suggested that this leniency should apply when an institutional trustee transacts with related institutions. In this respect, the UTC is truly troubling.

One can imagine specific situations where application of the no further inquiry rule might seem harsh. Suppose, for example, that a testator's family business is a closely-held corporation. Testator's will creates a trust of the corporation's shares to benefit one of her

182. GEORGE T. BOGERT, TRUSTS § 95, at 344 (6th ed. 1987) ("Indirect disloyalty is just as objectionable as direct.") (citation omitted).

183. Bogert's treatise gives as a specific example of indirect self-dealing, a case where a trustee sells trust property to *X* to enable *X* to resell the property for a profit; here, even if the sale is "otherwise unexceptionable" and the trustee derives no direct profit, the beneficiary can void the transaction. *Id.* § 95, at 342-43. Further, Bogert emphasizes, "[w]hether the trustee acted in good faith and with honest intentions is not relevant, nor is it important that the transaction attacked was fair and for an adequate consideration so that the beneficiary has suffered no loss as a result of the disloyal act." *Id.* § 95, at 343 (citations omitted). Bogert further explains that the harshness of the rule is necessary to send a clear message to trustees to avoid temptation. *Id.*

184. *See* RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. e (Tentative Draft No. 4, 2005), which provides:

> [T]he duty of loyalty prohibits the trustee from engaging in transactions, as trustee, with persons with whom the trustee is closely related or associated.
>
> The prohibition also applies to transactions by a trustee, acting in either a fiduciary or personal capacity, with third persons if the transaction would create a reasonably foreseeable risk of future conflict between the trustee's fiduciary duties and personal interests. Although not involving self-dealing, ... transactions of this type could expose trustees to the temptation of considering interests other than those of trust beneficiaries.
>
> The duty of loyalty therefore prohibits transactions ... between the trustee, as trustee, and family members, because these are people for whom the trustee could be expected to have a natural, personal concern. For this purpose, the reference to "family members" includes the trustee's spouse and parents, the trustee's descendants and their spouses, and other individuals who are natural objects of the trustee's bounty.

sons, Tom. She names a second son, Bob, as trustee of Tom's trust. Bob also becomes president and majority shareholder of the corporation. If the corporation buys back the trust's shares and Tom sues, under traditional rules Bob would be held liable for breach of fiduciary duty, and the no further inquiry rule would apply, no matter how fair the transaction. This result could conceivably be unfair, if, in fact, the price paid was a good one and the transaction was in the trust's best interests. One might argue that subsection (c)(4) provides a much needed escape valve.

Consider another example: Suppose settlor creates a trust and includes as trust property shares of a corporation that is related to the trustee bank. Suppose further that the trustee subsequently retains those shares and the trust loses value as a result. If the beneficiary argues that the trustee's conflict of interest caused it to retain the shares improperly, should the trustee be surcharged?

In each case, the settlor and the trustee could have anticipated the difficulty and included a limited provision authorizing the trustee to engage in the behavior that would otherwise constitute breach of the duty of loyalty. In the case of a closely-held corporation, the settlor may expressly authorize the trustee to trade shares in the closely held corporation. In the case of the corporate trustee owning shares in a related corporation, the settlor may include a trust provision shielding the trustee from liability for any loss in value of that particular investment. Moreover, in each case, even if the trust instrument is silent, a court could treat the settlor's knowledge of the impending conflict as implied consent to "fair" actions taken by the trustee in the course of managing that conflict. Effectuating the settlor's purpose does not require a change in the traditional duty of loyalty standard. The UTC provision, departing as it does from established law and the Restatement (Third), cannot be justified. It cannot, therefore, stand as evidence that the no further inquiry rule has no compelling justification.

## VI. THE NO FURTHER INQUIRY RULE AND CONCERNS FOR FAIRNESS TO INDIVIDUAL, NONPROFESSIONAL TRUSTEES

At points in his article, Professor Langbein argues that the no further inquiry rule is unfair to some trustees. Trustees who are well counseled will avoid the no further inquiry rule's bite by seeking advance approval for potentially troublesome transactions. But a nonprofessional trustee may be unsophisticated or poorly counseled and might unknowingly step into the rule's trap. These trustees do not think to obtain advance approval because the actions in which they engage are so clearly beneficial to the trust. He argues that it is necessary to abolish the no further inquiry rule to protect nonprofessional trustees.

Langbein's point that the rule is problematic when applied to nonprofessional trustees is persuasive. Although we all know ignorance of the law is no excuse, subjecting a nonprofessional trustee to the no further inquiry rule would probably frustrate settlors' intentions in most cases. It seems a safe assumption that most settlors would not want to see a trusted friend or family member held liable for unwittingly failing to seek advance approval when the trustee's action was in good faith and benefited the trust. Moreover, the no further inquiry rule's objective of creating the strongest possible deterrent to self-dealing has less force when applied to nonprofessionals because they will not be influenced by case law of which they are unaware.

Yet Langbein cannot establish that the problem is a significant one. Langbein cites just three older cases to support his point, and for good reason:[185] An examination of appellate cases from the past decade reveals that courts considering claims of breach against nonprofessional trustees usually—expressly or implicitly—reject the no further inquiry rule as the appropriate standard.[186] In fact, courts consistently shield nonprofessional trustees from liability for self-dealing if the trustee's act was a good-faith attempt to further the settlor's intentions and the trust's best interests.[187] Moreover, in the

185. Langbein, *supra* note 1, at 954-57.

186. *See, e.g.*, Helman v. Mendelson, 769 A.2d 1025, 1040-41 (Md. Ct. Spec. App. 2001) (rejecting beneficiary's claim that the no further inquiry rule should apply when trustee loaned himself trust funds); Massara v. Henery, No. 19646, 2000 Ohio App. LEXIS 5425 (Ohio Ct. App. Nov. 22, 2000) (holding that the no further inquiry rule was inapplicable and placing the burden on the beneficiary to show that he was damaged by the trustee's action); Warehime v. Warehime, 761 A.2d 1138 (Pa. 2000) (holding that the appellate court erred as a matter of law in applying the no further inquiry rule because a "good faith" standard was more appropriate).

187. For example, in *Mendelson*, 769 A.2d at 1025, although family trustees, who were also beneficiaries, borrowed money from the trust, the court rejected another beneficiary's demand to remove the trustees. The court expressly rejected the beneficiary's claim that the no further inquiry rule should apply and upheld the lower court's summary judgment award because the

two cases where courts purported to apply the rule, the trustees largely escaped personal liability.[188] On the other hand, courts will

interest rates seemed to be fair, the trustees repaid the loans, and the plaintiff offered no evidence that the trustees were not in good faith. *Id.* at 1040-42. The court in *Henery*, 2000 Ohio App. LEXIS 5425, upheld the trial court's grant of summary judgment in favor of two family trustees. The trust property consisted of the beneficiary's share of the family business, inherited from his father. The trustees sold the beneficiary's interest in the family business back to the partnership (of which trustees were partners) without the beneficiary's consent in exchange for the partnership's promise to pay to the trust a fixed sum over six years. The appellate court rejected the beneficiary's argument that the trial court erred in failing to apply the no further inquiry rule, stating, incorrectly, that the rule was inapplicable because the beneficiary could not prove damages. In response, the beneficiary correctly argued that he was not required to prove damages to establish breach, and that the burden of proof to establish the adequacy of the purchase price was on the trustee, not the beneficiary. The court rejected his argument out of hand. *Id.* at *12-13. The opinion is permeated with evidence that the trustees were acting in good faith and that the beneficiary was a drug addict who made a vocation out of trying to get money from his family. The opinion also explains that the trustees were motivated by a desire to guarantee the beneficiary a steady income and to prevent him from obtaining additional funds from the trust to fuel his drug habit. And in *Warehime v. Warehime*, 761 A.2d 1138 (Pa. 2000), the Supreme Court of Pennsylvania reversed the appellate court's application of the no further inquiry rule, stating that the court should have applied a "standard of good faith." *Id.* at 1140-41. Settlor's son was trustee of a voting trust and president of the family company. When a family dispute erupted over the direction of the family business, trustee voted the trust's shares in favor of an amendment that would extend his control over the company beyond the expiration of the trusts, effectively depriving his siblings of the right to a voice in management decisions. After determining that the trustee should escape liability if he acted in good faith, the court held that the trustee was entitled to consider his view of the bests interests of the company as well as the interests of the beneficiaries. Thus, his vote was not a breach of duty. A strongly worded dissenting opinion argued that "by using the trust's shares to adopt amendments that would extend the ten-year term of the voting trust another five years, [the trustee] voted contrary to the trust's terms and for personal advantage, plain and simple." *Id.* at 1149-50.

For additional examples, see *Beattie v. J.M. Tull Found.*, No. 97-2746, 1999 U.S. App. LEXIS 7522 (4th Cir. Apr. 16, 1999) (reversing district court to hold that trustee who, in good faith, cashed out life insurance policies and distributed them to his incapacitated aunt—which became part of her estate that he inherited—and depleted remaindermen's share, did not breach duty of loyalty because trustee was attempting to carry out the settlor's intent); *Tays v. Metler*, No. 97-2317, 1999 WL 149661 (10th Cir. Mar. 19, 1999) (holding that husband/ trustee of bypass trust did not breach duty of loyalty when he sold his personal property to the trust for cash because his actions were in good faith and were consistent with the settlor's purpose in establishing the bypass trust). *Cf.* Kinzel v. Kinzel, No. 95CA006122, 1996 Ohio App. LEXIS 1051 (Ohio Ct. App. Mar. 20, 1996) (holding that trial court improperly granted summary judgment in favor of trustee, where the trustee held proceeds from sale of trust property in trustee's personal bank account and remanding for a determination whether this act constituted a breach of the duty of loyalty). A proper application of the no further inquiry rule in *Kinzel* would have eliminated the need for remand to consider the fairness of the transaction, and would have resulted in automatic liability.

188. *See* Stegemeier v. Magness, 728 A.2d 557 (Del. 1999) (finding that trustees who sold real property held in trust to themselves, developed it, and sold it at a profit might not be

hold a nonprofessional trustee personally liable when the trustee should have known that his or her self-interested action was not in the beneficiaries' best interests.[189] The point is that courts in these cases are not generally imposing strict liability, but are carefully scrutinizing the transactions before determining whether liability should attach.[190] The common law, therefore, is evolving to create a separate rule for nonprofessional trustees. This resolution to the problem created by the no further inquiry rule is a superior approach to abandoning the rule altogether.

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liable so long as, on remand, they could demonstrate that they paid fair market value, which, as the dissent pointed out, seemed likely given the expert witness evidence that they had presented at trial); *In re* Estate of Stevenson, 605 N.W.2d 818 (S.D. 2002) (applying the no further inquiry rule, and allowing beneficiaries to void trustee's leases of trust property to trustee's husband and to his relatives, trustee suffered no personal liability).

189. For example, in *Feingberg v. Adolph K. Feinberg Hotel Trust*, 922 S.W.2d 21 (Mo. Ct. App. 1996), the trustee remaindermen, sons of the settlor, failed to make significant income distributions to their mother, the income beneficiary, and almost entirely depleted the trust corpus by making themselves unsecured loans on extraordinarily favorable terms—loans on which they defaulted—to fund their business ventures. In addition to awarding damages, the court directed trustees to pay income beneficiary's attorneys fees. *See also* Sanford v. Sanford, 137 S.W.3d 391 (Ark. 2003) (holding that husband/trustee breached duty to ex-wife beneficiary when he took unauthorized trustee compensation and sold trust property and kept her share of the proceeds to repay her alleged debts to him, which left her with no funds to pay capital gains tax); Hosey v. Burgess, 890 S.W.2d 262 (Ark. 1995) (finding trustee/remainderman breached duty by subleasing trust property and keeping the profit); Sullivan v. Hellgren, No. B164017, 2004 WL 831178 (Cal. Ct. App. Apr. 19, 2004) (trustee/beneficiary breached duty to brother/beneficiary by transferring family home from trust to herself, selling the home, keeping the proceeds, and rendering the trust worthless); Aiello v. Hyland, 793 So.2d 1150 (Fla. Dist. Ct. App. 2001) (awarding damages and removing trustee who attempted to sell trust property at below-market value to brother with whom trustee was in business); Deutsch v. Wolff, 994 S.W.2d 561 (Mo. 1999) (upholding determination that trustee was liable on an outstanding loan from trust to partnership in which trustee and one beneficiary were partners); John R. Boyce Family Trust v. Snyder, 128 S.W.3d 630 (Mo. Ct. App. 2004) (holding trustee liable for breach of fiduciary duty because he convinced beneficiary to consent to the use of trust assets to buy a soon-to-be-bankrupt store from trustee by misrepresenting his reasons for selling and the store's financial position; store went bankrupt); Coffey v. Coffey, 668 A.2d 78 (N.J. Super. Ct. App. Div. 1995) (finding settlor/trustee of trust for divorced settlor's children liable for breach of duty of loyalty when he used trust assets improperly to satisfy his personal financial obligations to his children, used trust funds to pay his legal bills, and commingled trust assets with his own); *In re* Dentler Family Trust, 873 A.2d 738 (Pa. Super. Ct. 2005) (surcharging co-trustees—settlor's son and his lawyer—for, among other things, trading trust assets on margin to raise cash to make a large distribution to trustee's son, at the expense of the other trust beneficiaries).

190. *See, e.g.*, White v. Pierson-Anderson (*In re* Estate of Heyn), 47 P.3d 724 (Colo. Ct. App. 2002) (stating that when the beneficiary can show self-dealing, the trustee can rebut the charge by showing that the transaction was "fair and reasonable" and finding trustee liable because he lived rent free in the apartment building that was held in trust).

If the no further inquiry rule really did present a problem for nonprofessional trustees, abolishing it to protect them would amount to killing the ant with a sledge hammer. But because courts are resolving the nonprofessional trustee's plight, the argument that the rule must be abolished for all trustees is unpersuasive. The only trustees who stand to gain from the rule's abolition are professionals, especially large institutional trustees, who will profit significantly.

## CONCLUSION

Much of this Article argues that if the no further inquiry rule did not exist, we would want to invent it. But the rule does exist. For generations, it has governed the relationship between trustees and beneficiaries. In light of the rule's long history and its undiminished potential to protect trust beneficiaries, the burden to prove that it should be abolished rests squarely on the shoulders of its opponents. Professor Langbein has failed to meet that burden. As a result, the drafters of the UTC should reconsider sections 802(c)(2) and 802(f). States considering the enactment of the UTC should take a closer look at those provisions.

What is certain is that replacing the no further inquiry rule with a best-interest defense will improve the financial position of institutional trustees. That, however, provides little solace to trust beneficiaries—the people for whom trusts are created, and for whom the no further inquiry rule continues to provide important protection.