

Article

Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?

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INTRODUCTION

The duty of loyalty requires a trustee “to administer the trust solely in the interest of the beneficiary.”¹ This “sole interest” rule is widely regarded as “the most fundamental”² rule of trust law. In this Article I advance the view that the sole interest rule is unsound, and I indicate how it should be modified.

The sole interest rule prohibits the trustee from “plac[ing] himself in a position where his personal interest . . . conflicts or possibly may conflict with” the interests of the beneficiary.³ The rule applies not only to cases in which a trustee misappropriates trust property,⁴ but also to cases in which no such thing has happened—that is, to cases in which the trust “incurred no loss” or in which “actual benefit accrued to the trust”⁵ from a transaction with a conflicted trustee.

The conclusive presumption of invalidity⁶ under the sole interest rule has acquired a distinctive name: the “no further inquiry” rule. What that label emphasizes, as the official comment to the Uniform Trust Code of 2000 explains, is that “transactions involving trust property entered into by a trustee for the trustee’s own personal account [are] voidable without further proof.”⁷ Courts invalidate a conflicted transaction without regard to its merits—“not because there *is* fraud, but because there *may be* fraud.”⁸ “[E]quity deems it better to . . . strike down all disloyal acts, rather than to attempt to separate the harmless and the harmful by permitting the trustee to justify his representation of two interests.”⁹ Courts have boasted of their

1. RESTATEMENT (SECOND) OF TRUSTS § 170(1) (1959); accord UNIF. TRUST CODE § 802(a) (2000), 7C U.L.A. 229 (Supp. 2004) (“A trustee shall administer the trust solely in the interests of the beneficiaries.”).

2. Both the leading treatises use this phrase to describe the duty of loyalty. See GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 543, at 217 (rev. 2d ed. 1993); 2A AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, *THE LAW OF TRUSTS* § 170, at 311 (4th ed. 1987). The phrase is widely repeated in the case law. See, e.g., *Pegram v. Herdrich*, 530 U.S. 211, 224 (2000) (quoting 2A SCOTT & FRATCHER, *supra*, § 170, at 311).

3. JOHN MOWBRAY ET AL., *LEWIN ON TRUSTS* § 20-01, at 437 (17th ed. 2000) [hereinafter *LEWIN ON TRUSTS*].

4. RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmts. b, h, l (buying, selling, using trust property).

5. BOGERT & BOGERT, *supra* note 2, § 543, at 248.

6. “Such transactions are irrebuttably presumed to be affected by a conflict between personal and fiduciary interests. It is immaterial whether the trustee acts in good faith or pays a fair consideration.” UNIF. TRUST CODE § 802 cmt., 7C U.L.A. 230 (Supp.).

7. *Id.* (explaining the “no further inquiry” rule).

8. *Piatt v. Longworth’s Devises*, 27 Ohio St. 159, 195-96 (1875).

9. BOGERT & BOGERT, *supra* note 2, § 543, at 228.

“stubbornness and inflexibility,”¹⁰ their “[u]ncompromising rigidity,”¹¹ in applying the sole interest rule. Remedies¹² include rescission,¹³ disgorgement of gain,¹⁴ and consequential damages.¹⁵

The underlying purpose of the duty of loyalty, which the sole interest rule is meant to serve, is to advance the best interest of the beneficiaries. This Article takes the view that a transaction prudently undertaken to advance the best interest of the beneficiaries best serves the purpose of the duty of loyalty, even if the trustee also does or might derive some benefit. A transaction in which there has been conflict or overlap of interest should be sustained if the trustee can prove that the transaction was prudently undertaken in the best interest of the beneficiaries. In such a case, inquiry into the merits is better than “no further inquiry.”

Part I of this Article probes the rationale for forbidding conflicts of interest under the sole interest rule. I point to the ubiquity of overlaps or conflicts of interest in trust and nontrust settings. A main theme is that the severity of the sole interest rule is premised on assumptions that have become outmoded. Two centuries ago, when trust law settled on the sole interest rule, grievous shortcomings in the fact-finding processes of the equity courts placed a premium on rules that avoided fact-finding. Subsequently, however, the reform of civil procedure and the fusion of law and equity have equipped the courts that enforce trusts with effective fact-finding procedures. I also point to improvements in the standards, practices, and technology of trust recordkeeping, as well as enhanced duties of disclosure, which have largely defused the old concern that a trustee operating under a potential conflict could easily conceal wrongdoing. Discussing the claim that the sole interest rule is needed to deter trustee

10. *Munson v. Syracuse, G. & C. Ry. Co.*, 8 N.E. 355, 358 (N.Y. 1886) (describing the trust law rule, which the court applied to corporate directors).

11. *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (Cardozo, J.). Richard Posner has called this case the “most famous of Cardozo’s moralistic opinions.” RICHARD A. POSNER, *CARDOZO: A STUDY IN REPUTATION* 104 (1990). *Meinhard v. Salmon* was not in fact a trust case; it concerned the fiduciary duties of commercial joint venturers, but it is incessantly invoked in the trust law loyalty cases. As of Posner’s writing, the case had attracted 653 citations. *Id.* at 105.

12. See RESTATEMENT (SECOND) OF TRUSTS §§ 205-206 (1959); *accord* UNIF. TRUST CODE § 1001, 7C U.L.A. 251 (Supp.).

13. RESTATEMENT (SECOND) OF TRUSTS § 206 cmts. b, c; *accord* UNIF. TRUST CODE § 1001(b)(3), 7C U.L.A. 251 (Supp.). A transaction that violates the sole interest rule is voidable, not void, meaning that the beneficiary has the option to void the transaction but the trustee does not. See UNIF. TRUST CODE § 802(b), 7C U.L.A. 229 (Supp.).

14. RESTATEMENT (SECOND) OF TRUSTS §§ 205(b), 206; *accord* UNIF. TRUST CODE § 1002(a)(2), 7C U.L.A. 253 (Supp.).

15. RESTATEMENT (SECOND) OF TRUSTS §§ 205(a), 206; *accord* UNIF. TRUST CODE § 1002(a)(1), 7C U.L.A. 253 (Supp.); see also *In re Estate of Rothko*, 372 N.E.2d 291, 298 (N.Y. 1977) (awarding penal deterrent “appreciation damages” against conflicted executors for selling estate paintings in conflict-tainted transactions). The fiduciary standards governing trust administration also govern estate administration. See, e.g., UNIF. PROBATE CODE §§ 3-703(a), 3-712 to -713 (1990), 8 U.L.A. pt. II, at 138-39, 160-66 (1998) (applying trust fiduciary standards, including the sole interest rule, to executors).

wrongdoing, I point to cases in which the resulting overdeterrence harms the interests of trust beneficiaries. I compare the trust law duty of loyalty with the law of corporations, which originally shared the trust law sole interest rule but abandoned it in favor of a regime that undertakes to regulate rather than prohibit conflicts.

What has made the harshness of the trust law sole interest rule tolerable across the last two centuries is that its bark has been worse than its bite. A group of excusing doctrines and a further group of categorical transactional exceptions, both reviewed in Part II of the Article, have drastically reduced the scope of the sole interest rule. Those devices allow the well-counseled trustee to escape much of the mischief that would otherwise result from the overbreadth of the rule. Of these excusing doctrines, the rule allowing a trustee to petition for advance judicial approval of a conflicted transaction is particularly revealing. When deciding whether to authorize the transaction, the court inquires whether it is in the best interest of the beneficiary. Thus, practice under the advance-approval doctrine supports the theme of this Article, that conflicted transactions that are beneficial to trust beneficiaries ought to be allowed.

Section II.B of the Article reviews exceptions to the sole interest rule that have developed to legitimate particular classes of conflicted transactions. These categorical exceptions are mostly rooted in statute. Many reflect the business practices of bank trust departments and other institutional trustees—for example, allowing the deposit of trust funds in the trustee's commercial banking division or investing trust funds in trustee-sponsored investment pools such as mortgage participations, common trust funds, and mutual funds. Institutional trustees did not exist in the early nineteenth century, when the English and American courts settled the sole interest rule. Modern trusteeship is increasingly embedded in commerce, from which the patterns of mutual advantage that are characteristic of bilateral exchange are being absorbed into fiduciary administration. The common thread that runs through the categorical exceptions is that they facilitate the best interest of the beneficiary, even though the trustee also benefits or may benefit.

I recommend (in Section II.C) reformulating the trust law duty of loyalty in light of these developments. I would generalize the principle now embodied in the exclusions and exceptions, which is that the trustee must act in the beneficiary's best interest, but not necessarily in the beneficiary's sole interest. Overlaps of interest that are consistent with the best interest of the beneficiary should be allowed. What is needed to cure the overbreadth of the sole interest rule is actually quite a modest fix: reducing from conclusive to rebuttable the force of the presumption of invalidity that now attaches to a conflicted transaction. Under a rule thus modified, the trustee

would be allowed to defend a breach-of-loyalty case by proving that a conflicted transaction was prudently undertaken in the best interest of the beneficiary.

I. ADDRESSING CONFLICTS OF INTEREST

There can be no quibble with the core policy that motivates the duty of loyalty. Any conflict of interest in trust administration, that is, any opportunity for the trustee to benefit personally from the trust, is potentially harmful to the beneficiary. The danger, according to the treatise writer Bogert, is that a trustee “placed under temptation” will allow “selfishness” to prevail over the duty to benefit the beneficiaries.¹⁶ “Between two conflicting interests,” said the Illinois Supreme Court in an oft-quoted opinion dating from 1844, “it is easy to foresee, and all experience has shown, whose interests will be neglected and sacrificed.”¹⁷ In the law and economics literature this phenomenon of divergence between the interest of the manager and that of the beneficial owner has been much discussed in recent years, especially in corporate law, under the rubric of agency costs.¹⁸

A. *The Ubiquity of Conflicts*

What is troubling about the sole interest rule is not its sensitivity to the dangers of conflicting or overlapping interests, but its one-sidedness in failing to understand that some conflicts are not harmful, and indeed, that some may be positively beneficial. Bogert, for example, asserts that “[i]t is *not possible* for any person to act fairly in the same transaction on behalf of himself and in the interest of the trust beneficiary.”¹⁹ The sole interest rule is premised on this notion that a conflict of interest inevitably imperils the interest of the beneficiary. On that premise rests the “no further inquiry” rule, which prevents a court even from inquiring “whether the trustee did in fact take any advantage of his situation.”²⁰ For the beneficiary to invalidate the transaction, it suffices to show merely that the defendant “held the

16. BOGERT & BOGERT, *supra* note 2, § 543, at 227.

17. *Thorp v. McCullum*, 6 Ill. (1 Gilm.) 614, 626 (1844).

18. The leading economics literature is cited in Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 623 n.1 (2004) [hereinafter Sitkoff, *Agency*]. For discussion of the agency cost problem in trust and other fiduciary law, see Kenneth B. Davis, Jr., *Judicial Review of Fiduciary Decisionmaking—Some Theoretical Perspectives*, 80 NW. U. L. REV. 1, 4-19 (1985); Sitkoff, *Agency*, *supra*, at 638-48; and Robert H. Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency*, 28 J. CORP. L. 565 (2003) [hereinafter Sitkoff, *Efficiency*].

19. BOGERT & BOGERT, *supra* note 2, § 543, at 227 (emphasis added).

20. LEWIN ON TRUSTS, *supra* note 3, § 20-60, at 469.

office of trustee and *might possibly* have had the means of taking advantage of his situation.”²¹

The stringent view of conflicts of interest that motivates the sole interest rule misunderstands a central truth: Conflicts of interest are endemic in human affairs, and they are not inevitably harmful. Accordingly, indiscriminate efforts to prohibit conflicts can work more harm than good.

1. *Family and Personal Life*

Most of us confront conflicts incessantly and solve them in ways beneficial to all the affected interests. For example, how much of a parent’s time should he or she devote to raising children, as opposed to pursuing career goals; rendering public or community service; or seeking personal, cultural, or recreational fulfillment? How much of one’s wealth should one consume during life, and how much should one leave for survivors and good causes? How much time should a board member or an officer or an employee of a business corporation or a charity devote to the affairs of that entity, as opposed to his or her personal business?

Much of what daily life is about is managing such conflicts, by setting and adjusting priorities appropriate to the circumstances. To take the first of my examples, children are commonly better off being raised by parents who have the moral, financial, and cultural enrichment of wider engagement in commerce and community. Thus, ordinary human experience belies the premise on which the sole interest rule rests, that it is impossible “to act fairly in the same transaction on behalf of [one]self and in the interest of [others].”²² Most of us do it daily.

There are, to be sure, material distinctions between the conflicting impulses of daily life and strictures about fiduciary administration of someone else’s property. The contrast between unavoidable and avoidable conflict is particularly notable. The parent/child conflict is intrinsic in rearing children, the conflict of trustee and beneficiary is not (or was not, until the rise of professional trusteeship, discussed below). The distinction between unavoidable and avoidable conflict is implicit in formulations of the sole interest rule that forbid the trustee to “place himself”²³ in a situation of conflict. It will often be sound policy to discourage avoidable conflicts even though other conflicts are inescapable. I have elsewhere made the point that avoiding some conflicts is commonly quite costless to the trustee,

21. *Id.* § 20-60, at 469-70 (emphasis added).

22. BOGERT & BOGERT, *supra* note 2, § 543, at 227.

23. LEWIN ON TRUSTS, *supra* note 3, § 20-01, at 437.

who is told: "You are left with the entire universe of investment possibilities as outlets for your entrepreneurial impulses; you are required only to stay away from the trust assets when you seek your own fortune."²⁴ Prohibition is far from costless, however, when a conflicted transaction would benefit the trust beneficiary or when prohibition imposes material compliance costs. It follows that not all conflicts or potential conflicts should be dealt with by prohibition. The judgment whether it is best to prohibit a conflict or to allow it should turn on the tradeoff between cost or danger on the one hand and benefit or prospect of benefit on the other.

2. *Nontrust Service Providers*

Trustees are not alone in being service providers whose interests have the potential to conflict with the interests of their clients. Consider the conflicts that I confront when I go to the dentist or to the auto repair shop. My dentist tells me that my tooth is decayed and that I need a gold crown costing a thousand dollars, which he will supply and from which he will profit.²⁵ Similarly, my auto repair shop tells me that I need to replace the cooling system in my car, because no lesser fix will cure the leaks that the car has been experiencing. The shop will profit from doing the work. In both these cases, I am at risk that the conflicted service provider is trying to sell me excessive or unneeded repairs. Such conflicts are not merely hypothetical. In 1992, undercover investigations of Sears Auto Center stores in California and New Jersey revealed evidence that employees were selling unneeded repairs to trusting customers.²⁶ The dentist case also occurs,²⁷ although less is known about how frequently.

24. John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625, 657 (1995) (internal quotation marks omitted).

25. This conflict inheres in most fee-for-service medical care, as the Supreme Court has remarked in a prominent ERISA case. "In a fee-for-service system, a physician's financial incentive is to provide more care, not less, so long as payment is forthcoming." *Pegram v. Herdrich*, 530 U.S. 211, 218 (2000). The Court contrasted the opposite conflict that inheres in fixed-fee medical service arrangements such as health maintenance organizations (HMOs). "[I]n an HMO system, a physician's financial interest lies in providing less care, not more." *Id.* at 219. In either case, fee-for-service or HMO, the main safeguard is the physician's loyalty-like duty to act in the patient's best interest. Said the Court: "The check on this influence [the incentive to undertreat in an HMO] (like that on the converse, fee-for-service incentive) is the professional obligation to provide covered services with a reasonable degree of skill and judgment in the patient's interest." *Id.*

26. See Lawrence M. Fisher, *Accusation of Fraud at Sears*, N.Y. TIMES, June 12, 1992, at D1; Lawrence M. Fisher, *Sears Auto Centers Halt Commissions After Flap*, N.Y. TIMES, June 23, 1992, at D1; Tung Yin, *Sears Is Accused of Billing Fraud at Auto Centers*, WALL ST. J., June 12, 1992, at B1. The California investigation is summarized in *Twigg v. Sears, Roebuck & Co.*, 153 F.3d 1222, 1224-25 (11th Cir. 1998).

27. See, e.g., *Patients Sue for Unneeded Dental Work* (KRON (San Francisco) television broadcast, May 26, 2004), available at <http://www.kron.com/global/story.asp?S=1899169>.

There is an easy way to deter the conflict between dentist and patient, between auto shop and customer: Apply the sole interest rule to all service providers. The trust rule forbids the trustee from selling to or buying from the trust. The principle could be applied to my dentist and my auto shop by requiring the separation of diagnosis and cure. The dentist who diagnoses my problem would be forbidden to cure it; I would have to find my way to another dentist for my new crown. Likewise, if Sears identifies my car's problem, require that I go to Meineke or Midas for the repair.

Why do our consumer protection authorities not follow the trust model and forbid these conflicts in this way? The principal answer, of course, is that in the aggregate and ex ante, allowing such conflicts is more beneficial on cost-benefit grounds than prohibiting them. It is costly to put me to the double effort and delay inherent in locating and scheduling duplicate visits, as well as to the double expense of having two dentists examine my aching tooth and two auto shops work with my car's radiator. Prohibition would indeed prevent some schemers from selling some unneeded services, just as the trust law sole interest rule undoubtedly prevents some harm to trust beneficiaries, but those savings would not in the aggregate be commensurate with the compliance costs that they would inflict on dental patients and auto repair customers. As a result, it has been found more cost effective, that is, more beneficial, to endure the risk of the conflicts.

Although the law allows the conflicts that pervade service industries, it does not allow the abuses. Rather, the law's strategy in these fields is regulation rather than prohibition. To remain with the example of my dentist, he operates under powerful legal and reputational constraints. If he abuses my trust, he risks liability in tort, professional decertification, criminal sanctions, and public disgrace. My auto shop will recall the fate of Sears in the 1990s: fines, tort liability,²⁸ and grievous reputational injury.²⁹

Similar reputational incentives pervade the world of professional trusteeship. To be sure, the typical trust settlor is not a repeat player; he or she will commonly die before there is much (or, in the case of a testamentary trust, any) experience with the trustee's performance under that trust. But the settlor commonly works with specialist trust counsel, whose frequent contacts with the various corporate fiduciaries active in the locality create strong reputational incentives for those firms.³⁰

28. In the third quarter of 1992, Sears "took a \$27 million after-tax charge to deal with the cost of settling claims" arising from the California and New Jersey investigations. Barnaby J. Feder, *Sears Posts First Loss Since 1933*, N.Y. TIMES, Oct. 23, 1992, at D1.

29. See Gregory A. Patterson, *Sears Is Dealt a Harsh Lesson by States; Mishandling of Auto-Repair Inquiries Proves Costly*, WALL ST. J., Oct. 2, 1992, at A9.

30. In an article not yet published, Melanie Leslie takes a sterner view of the difficulties of monitoring trustees than I do. Melanie Leslie, *Trusting Trustees: Fiduciary Duties and the Limits of Default Rules* (July 27, 2004) (unpublished manuscript, on file with author). We differ in

What is wrong with the trust tradition as embodied in the sole interest rule is the failure to take adequate account of the truth that prohibiting some conflicts is too costly, either because the compliance costs of prohibition outweigh the gain or because a conflicted transaction is benign. The very term “conflict” is an epithet that prejudices our understanding that some overlaps of interest are either harmless or positively value enhancing for all affected interests. To be sure, some conflicts of interest may harbor incentives so perverse, yet so hard to detect and deter, that categorical prohibition, as under the sole interest rule, is the cost-effective way to deal with the danger. The athlete betting on his or her team’s performance is a good example, as is the lawyer representing both parties in a contested lawsuit. I demonstrate in this Article that trust administration is not a good example of a conflict worth prohibiting categorically, because there is so much evidence that various forms of trustee/beneficiary conflict promote the best interest of the beneficiary. Trust law has taken this lesson to heart in the numerous exclusions and exceptions to the sole interest rule that I discuss below. The view this Article advances is that the logic of the exclusions and exceptions should become the rule.

3. *Settlor-Authorized Conflicts in Trusts*

One reason that routine trust administration abounds with conflicts, despite the sole interest rule, is that the sole interest rule is a default rule, which yields to contrary terms in the particular trust.³¹ Trust settlors commonly abridge the sole interest rule, either expressly or by implication when naming a conflicted trustee. For example, a recurrent pattern in family succession arrangements is for one spouse to create a trust, testamentary or inter vivos, that provides a life interest to the other spouse and the remainder to the children. Frequently in such cases the settlor names one (or more) of the children as the trustee. In such a case, the trustee’s investment and distribution decisions have the potential to enrich his or her interest, by skimping on the surviving parent’s life interest. The settlor who installs this conflicted trustee is making the judgment that the person named as trustee will do exactly what Bogert says “is not possible

particular on the significance of trust counsel. I regard the role of the settlor’s counsel in drafting the trust (and often counseling the beneficiaries) as an important safeguard against imposition by the trustee. Leslie fears that counsel as a repeat player is inclined to curry favor with an institutional trustee in the hope of attracting future business. I discuss monitoring issues *infra* text accompanying notes 139-144.

31. The black letter: “By the terms of the trust the trustee may be permitted to sell trust property to himself individually, or as trustee to purchase property from himself individually, or to lend to himself money held by him in trust, or otherwise to deal with the trust property on his own account.” RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. t (1959); *accord* UNIF. TRUST CODE § 802(b)(1) (2000), 7C U.L.A. 229 (Supp. 2004). Settlor authorization is discussed further *infra* text accompanying notes 169-173.

for any person” to do, that is, to “act fairly in the same transaction on behalf of himself and in the interest of the trust beneficiary.”³² In cost-benefit terms, the settlor who chooses the conflicted trustee is deciding that the advantages of having that person serve outweigh the risk of harm.

Most of the time the conflicted trustee serves with distinction, resisting the temptation to enrich him- or herself by pauperizing the widowed parent. In the rare case in which the conflicted trustee does seek improper advantage, the law responds by enforcing a fairness norm, derived from the duty of loyalty,³³ called the duty of impartiality, which places the trustee “under a duty to the successive beneficiaries to act with due regard to their respective interests.”³⁴ Thus, trust fiduciary law has two regimes for dealing with conflict of interest, prohibition and regulation. The sole interest rule undertakes to prevent conflicts; the duty of impartiality regulates trustee/beneficiary conflicts when the trust terms create a conflict that abridges the sole interest rule.

4. *Trustee Compensation*

Another example of endemic conflict of interest in routine trust administration arises from the modern American rule allowing reasonable trustee compensation.³⁵ The Americans reversed³⁶ the time-honored English rule³⁷ that trustees had to serve gratuitously. That rule is still nominally in effect in England, although it has been restricted in scope as the result of contrary drafting of trust instruments and through legislation authorizing compensation for professional trustees.³⁸ The English rule derives from the sole interest rule. *Lewin*, the English treatise, explains that a “conflict of duty” would arise “if the trustee were allowed to perform the duties of the office and to claim remuneration for his services,” because the trustee’s

32. BOGERT & BOGERT, *supra* note 2, § 543, at 227.

33. Impartiality follows from loyalty because when the trustee owes a duty of loyalty to more than one beneficiary, the duty can only be discharged by giving “due regard” to the interests of all beneficiaries. In ERISA fiduciary law, in which the statute codifies the duties of loyalty and prudence but not the many subrules of trust administration, the courts have derived the impartiality principle from the duty of loyalty. *See, e.g.*, *Morse v. Stanley*, 732 F.2d 1139, 1145 (2d Cir. 1984).

34. RESTATEMENT (SECOND) OF TRUSTS § 232; *accord* UNIF. TRUST CODE § 803, 7C U.L.A. 233 (Supp.).

35. RESTATEMENT (SECOND) OF TRUSTS § 242 cmt. b; *accord* UNIF. TRUST CODE § 708, 7C U.L.A. 224 (Supp.) (“[A] trustee is entitled to compensation that is reasonable under the circumstances.”); *see also id.* § 802(h)(2), 7C U.L.A. 229 (Supp.) (exempting the payment of reasonable compensation from attack under the duty of loyalty).

36. *See* 3A SCOTT & FRATCHER, *supra* note 2, § 242, at 272-74 & n.4.

37. *See* BOGERT & BOGERT, *supra* note 2, § 975, at 2-3.

38. *Id.* § 975, at 4-5; DAVID J. HAYTON, UNDERHILL AND HAYTON: LAW RELATING TO TRUSTS AND TRUSTEES art. 58, at 651-52 (16th ed. 2003).

“interest would be opposed to his duty to” the beneficiaries.³⁹ The American rule allowing compensation necessarily subjects the trust to the conflict of interest that the English rule was designed to prevent. Every dollar that the trustee pockets in fees is a dollar less for the beneficiaries.

The American rule reflects a cost-benefit judgment that allowing this conflict of interest is beneficial to trust beneficiaries. Paying compensation allows the trust to engage the services of skilled persons, now often trust professionals,⁴⁰ who will be able to devote their skills and resources to the task. The way to deal with the danger inherent in the conflict of interest is not to prohibit the conflict, as the sole interest rule would, but to regulate it, in this instance by insisting that compensation be reasonable.

The movement from unpaid to paid trustees is intimately connected to fundamental changes in the nature of wealth that occurred across the later nineteenth and twentieth centuries, changes that transformed the function of the trust and the nature of trusteeship.⁴¹ Anglo-American trust law developed at a time when most wealth took the form of land.⁴² The trust originated as a device for holding and transferring real property within the family. Trustees were commonly family members or confidants of the settlor.⁴³ Sanders, the late-eighteenth-century English treatise writer, observed that “courts of equity look upon trusts as honorary, and as a burden upon the honor and conscience of the [trustee], and not undertaken upon mercenary motives.”⁴⁴ Writing at the turn of the twentieth century, Maitland could still say that “[a]lmost every well-to-do man was a trustee,”⁴⁵ serving gratuitously.

The rule forbidding trustee compensation reflected the expectation that such gentlemen trustees, who were commonly little more than stakeholders lending their names for a conveyancing device, would have few duties, few

39. LEWIN ON TRUSTS, *supra* note 3, § 20-132, at 503.

40. The American rule allowing reasonable compensation, although driven by the need to compensate professionals, is not limited to them. Lay trustees are also entitled to reasonable compensation. Many trustees decline to claim fees in simple family trusts, but there are situations in which family trusteeships can be time consuming and demanding in ways that would make uncompensated service burdensome.

41. I have discussed these trends in John H. Langbein, *Rise of the Management Trust*, TR. & EST., Oct. 2004, at 52. See also Langbein, *supra* note 24, at 637-40; John H. Langbein, *The Twentieth-Century Revolution in Family Wealth Transmission*, 86 MICH. L. REV. 722 (1988).

42. By contrast, Pound remarked, “[w]ealth, in a commercial age, is made up largely of promises,” by which he meant financial instruments and other contract rights. ROSCOE POUND, AN INTRODUCTION TO THE PHILOSOPHY OF LAW 236 (1922).

43. Stebbings thinks that the use of lawyer-trustees increased in late Victorian times and that they began inserting compensation clauses into the trust instruments they drafted. CHANTAL STEBBINGS, *THE PRIVATE TRUSTEE IN VICTORIAN ENGLAND* 34-36 (2002).

44. FRANCIS WILLIAMS SANDERS, AN ESSAY ON THE NATURE AND LAWS OF USES AND TRUSTS 256 (London, E. & R. Brooke 1791) (emphasis omitted).

45. FREDERIC W. MAITLAND, *Trust and Corporation*, in MAITLAND: SELECTED ESSAYS 141, 175 (H.D. Hazeltine et al. eds., 1936).

powers, and few skills.⁴⁶ When, however, the trust ceased to be primarily a tool for conveying ancestral lands and became instead a device for the active management of a portfolio of financial assets, the advantages of using skilled professionals came to outweigh the disadvantage of having to compensate them.

The abandonment of the rule against trustee compensation is part of the larger saga of the steady growth of exceptions to the sole interest rule, which I discuss below in Section II.B. I emphasize trustee compensation in the present setting because it further exemplifies the phenomenon of widespread conflict of interest within routine trust administration. Conflicts abound and can be successfully managed; prohibition is not always the optimal solution to such overlaps. Bogert's claim that "[i]t is not possible for any person to act fairly in the same transaction on behalf of himself and in the interest of the trust beneficiary"⁴⁷ is simply wrong.

5. *Estate Administration*

It is quite common for the personal representative (that is, the executor or administrator, who is the trustee-equivalent fiduciary⁴⁸ in administering a decedent's estate) to be beneficially interested in the estate,⁴⁹ and thus to have an interest adverse both to the creditors and to the other beneficiaries. The traditional American safeguard was to require these fiduciaries to conduct the work of estate administration under court supervision, hence to secure advance judicial approval of routine steps.

Across the second half of the twentieth century, there has been a strong movement away from such court-supervised wealth transfers on death, on account of the expense, nuisance, and delay inherent in the procedure. The animating reform of the Uniform Probate Code of 1969 was the shift to unsupervised probate administration.⁵⁰ By allowing the personal representative to administer the estate without court supervision unless an interested party objects, the Code reflects a cost-benefit judgment that most

46. I have discussed the older patterns of trusteeship in Langbein, *supra* note 24, at 632-42.

47. BOGERT & BOGERT, *supra* note 2, § 543, at 227.

48. *See supra* note 15.

49. Indeed, in establishing priorities for the appointment of the administrator for an intestate estate, the statutes invariably prefer the persons (spouse, heirs) who take beneficially under the intestate distribution provisions. *See* UNIF. PROBATE CODE § 3-203 (1990), 8 U.L.A. pt. II, at 49-50 (1998) (priority for appointment); *see also id.* §§ 2-102 to -103, 8 U.L.A. pt. I, at 274-76 (distributive shares).

50. *See* UNIF. PROBATE CODE art. III (1969), 8 U.L.A. 221-411 (1983). Even in jurisdictions that retain supervised administration as the default regime, the tendency is widespread to allow smaller estates to elect unsupervised administration, usually by means of a simplified affidavit procedure. *E.g.*, CAL. PROB. CODE §§ 13100-13506 (West 1991 & Supp. 2004); 755 ILL. COMP. STAT. 5/25-1 (2004).

personal representatives can be trusted to act in accord with the fiduciary duties of loyalty and prudence even though conflicted. Neither the prohibitory regime of the sole interest rule nor the adjudicative safeguards of supervised administration are needed to protect the affected interests. Rather, unsupervised administration can be the norm, so long as the option is preserved for any mistrustful or aggrieved beneficiary to remove the estate from that track and place it under judicial supervision.⁵¹

Thus, our law is ceasing to require routine wealth transfer on death to be court supervised, even when the fiduciary is conflicted. Wealth transfer now more closely resembles the conduct of ordinary business. Doubtless some misappropriation occurs that would have been prevented under court supervision, but the aggregate transaction costs of requiring court supervision of all estates would far outweigh the gains. If all businesses were required to operate under the protection of court supervision, as, for example, is the norm in bankruptcy proceedings, some frauds and mismanagement would be prevented, but at such excessive cost that no such regime has ever been attempted.

a. *Health Care Surrogacy*

In other fiduciary fields proximate to estate administration there has been a comparable erosion of the tradition of mandating court supervision to protect against conflicted fiduciaries. The Uniform Health-Care Decisions Act⁵² empowers the spouse or another near relative of an incapacitated person to serve as the so-called surrogate, who decides whether to terminate the person's life support.⁵³ Although this surrogate is empowered to make a life-or-death decision to withhold treatment, he or she typically has an adverse financial interest in the patient's affairs: The closest relatives are commonly the patient's heirs or devisees, and the more money spent on medical care and life support, the less will remain for survivors. The legislation reflects a cost-benefit determination that the danger of the conflicted surrogate using his or her authority to extinguish the patient prematurely is outweighed by the benefits of empowering the person most likely to know the patient's wishes and to have the patient's best interest at heart. The statute deals with the danger inherent in the conflict through regulation rather than prohibition. Three alternative safeguards are provided. First, a person who does not trust his or her spouse

51. See UNIF. PROBATE CODE §§ 3-501 to -502 (1990), 8 U.L.A. pt. II, at 105-06 (1998).

52. UNIF. HEALTH-CARE DECISIONS ACT (1993), 9 U.L.A. pt. IB, at 143 (1999).

53. *Id.* § 5(b), 9 U.L.A. pt. IB, at 167. The surrogacy provisions apply when the incapacitated person has not previously executed an advance direction naming someone to act. See *id.* §§ 2(a), 2(b), 4, 9, 9 U.L.A. pt. IB, at 151-52, 156-57, 175-76 (describing the procedure for providing an advance direction).

or close relative to exercise this power can defeat surrogacy by designating someone else as the health care agent or by spelling out particular health care instructions in the event of incapacity. Second, the Act provides for judicial review of a surrogate's decisions at the insistence of a dissatisfied relative or other interested person.⁵⁴ Third, the health care provider can veto an instruction that is "contrary to generally accepted health-care standards."⁵⁵

b. *Durable Powers*

Another commonly used regime for dealing with incapacity, the durable power, is presently undergoing revision, and one of the projected reforms is to replace the sole interest rule with a best interest rule. The Uniform Durable Power of Attorney Act of 1979,⁵⁶ which is widely enacted,⁵⁷ allows the owner of property to appoint an agent to manage the property in the event of the owner's incapacity, thereby overcoming the common law rule⁵⁸ that incapacity terminates an agency. The effect of a durable power is to create a noncourt regime for administering the affairs of someone who becomes incompetent, bypassing the default regime of court-supervised guardianship, which suffers many of the drawbacks (expense, cumbersomeness, delay) that have caused resentment of supervised probate administration. A person choosing to designate an agent under the durable power statute commonly names a spouse or child as agent. Such an agent commonly has a conflict of interest similar to that of the spouse or relative exercising a health care power. Because the agent is likely to be an heir or devisee of the incapacitated principal, the agent stands to gain from minimizing expenditures on the principal's well-being.

The 1979 Act does not regulate the fiduciary duties of such agents, hence it remits fiduciary issues to the common law of agency, which applies a sole interest rule comparable to that of trust law.⁵⁹ The Uniform Law Commission is now proposing to abrogate that rule in the Uniform Power of Attorney Act, presently scheduled for promulgation in 2005. The draft Act would expressly negate the sole interest rule, providing instead

54. *Id.* § 14, 9 U.L.A. pt. IB, at 180.

55. *Id.* § 7(f), 9 U.L.A. pt. IB, at 173.

56. 8A U.L.A. 246 (2003).

57. The Act, whose main provisions were first promulgated as sections 5-501 and 5-502 of the Uniform Probate Code of 1969, has been enacted in thirty-six states and the District of Columbia. *See id.* at 233. In other states nonuniform versions are in force. *See* Am. Coll. of Probate Counsel, *Durable Powers of Attorney*, in AM. COLL. OF TRUST AND ESTATE COUNSEL, ACTEC STUDIES, at study 17 (2003).

58. RESTATEMENT (SECOND) OF AGENCY §§ 120(1), 122(1) (1958).

59. *Id.* § 387 ("[A]n agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency.").

that an agent acting “for the best interest of the principal is not liable solely because the agent also benefits from the act or has an individual or conflicting interest in relation to the property or affairs of the principal.”⁶⁰ Once again, the modern judgment is that because so many potential conflicts are benign, best interest should trump sole interest.

B. *The Concern About Concealment*

A main theme in the cases that developed the sole interest rule was the fear that without the prohibition on trustee self-interest, a conflicted trustee would be able to use his or her control over the administration of the trust to conceal wrongdoing, hence to prevent detection and consequent remedy. Lord Hardwicke, sitting in 1747, before the sole interest rule had hardened in English trust law,⁶¹ was worried about a self-dealing trustee being able to conceal misappropriation.⁶² In 1816 in *Davoue v. Fanning*, the foundational American case recognizing and enforcing the then-recently-settled English rule, Chancellor Kent echoed this concern: “There may be fraud, as Lord Hardwicke observed, and the [beneficiary] not able to prove it.”⁶³ In order “to guard against this uncertainty,” Kent endorsed the rule allowing the beneficiary to rescind a conflicted transaction “without showing actual injury.”⁶⁴ In his *Commentaries on American Law*, Kent returned to the point that the sole interest rule “is founded on the danger of imposition and the presumption of the existence of fraud, inaccessible to the eye of the court.”⁶⁵

Commentators continue to invoke this concern about trustee concealment when justifying the severity of the sole interest rule.⁶⁶ Says Bogert: “Equity will not inquire into the fairness of particular sales. It realizes that if it did, in many cases the unfairness would be so hidden as to

60. UNIF. POWER OF ATTORNEY ACT § 115(c) (Tentative Draft 2004). The draft Act also requires the agent to act “in good faith, with the competence, diligence and prudence normally exercised by agents in similar circumstances, and for the best interest of the principal,” *id.* § 115(b)(1), and to “avoid a conflict of interest that would impair the agent’s ability to act in the best interest of the principal,” *id.* § 115(b)(2). Various family members and other interested persons are empowered to seek judicial review of the agent’s conduct. *Id.* § 117.

61. Although there were earlier impulses toward the sole interest rule, it was not settled in England until the early nineteenth century. See 2A SCOTT & FRATCHER, *supra* note 2, § 170.1, at 314-16.

62. “[I]t is in [the trustee’s] own power to conceal” fraud. *Whelpdale v. Cookson*, 1 Ves. Sen. 9, 27 Eng. Rep. 856, 856 (Ch. 1747).

63. 2 Johns. Ch. 252, 261 (N.Y. Ch. 1816) (italics omitted).

64. *Id.*

65. 4 JAMES KENT, COMMENTARIES ON AMERICAN LAW *438.

66. E.g., BOGERT & BOGERT, *supra* note 2, § 543(A), at 274-77; Robert W. Hallgring, *The Uniform Trustees’ Powers Act and the Basic Principles of Fiduciary Responsibility*, 41 WASH. L. REV. 801, 802-27 (1966); Earl R. Hoover, *Basic Principles Underlying Duty of Loyalty*, 5 CLEV.-MARSHALL L. REV. 7 (1956).

be undiscoverable.”⁶⁷ As a matter of logic, I find this line of reasoning dubious. The claim is that because some trustee misbehavior might be successfully concealed, the law should refuse to examine the merits of the trustee’s conduct even in a case in which there has not been concealment.

There is a far deeper objection to the old preoccupation with the danger of trustee concealment: Changed circumstances have materially reduced the danger. However serious the hazard may have been in the days of Lord Hardwicke and Chancellor Kent, in modern trust administration the concern is no longer well founded.

1. *The Revolution in Equity Fact-Finding*

The sole interest rule was developed and finally settled in the English Court of Chancery across the later eighteenth and early nineteenth centuries.⁶⁸ At that time Chancery had its own system of civil procedure, which had become profoundly defective for investigating issues of fact.⁶⁹ The defects were widely lamented by contemporaries⁷⁰ and caricatured by Dickens in *Bleak House*.⁷¹

In most circumstances the only evidence that Chancery could consider, apart from the parties’ pleadings, consisted of the responses of the parties and witnesses to party-propounded interrogatories administered *ex parte*. Interrogatories could be administered to a person only once and had to be framed in writing in advance, hence neither counsel nor court had the opportunity to react to and inquire about unexpected leads.⁷² Because

67. BOGERT & BOGERT, *supra* note 2, § 543(A), at 277. The passage quoted in text continues in the same vein: “The trustee might have had secret information of values [of the property involved in the transaction] which the beneficiary cannot prove he had.” *Id.*

68. *See supra* note 61.

69. The procedure is described in 3 WILLIAM BLACKSTONE, COMMENTARIES *442-55. For modern accounts, see JOHN P. DAWSON, A HISTORY OF LAY JUDGES 154-59 (1960); and 9 WILLIAM HOLDSWORTH, A HISTORY OF ENGLISH LAW 353-69 (3d ed. 1944).

70. “The middle classes were alarmed at [Chancery’s] very name, for it swallowed up smaller fortunes with its delays, its fees, its interminable paper processes.” Baron Bowen, *Progress in the Administration of Justice During the Victorian Period*, in 1 SELECT ESSAYS IN ANGLO-AMERICAN LEGAL HISTORY 516, 527 (Ass’n of Am. Law Sch. ed., 1907); *see also* W. CHALLINOR, THE COURT OF CHANCERY (London, Stevens & Norton 2d ed. 1849) (recounting a suit about a small legacy in which the litigation endured for years and the costs far exceeded the value of the property in dispute).

71. *Bleak House* was probably set in 1827, a year after “[t]he report of the first Chancery Commission.” WILLIAM S. HOLDSWORTH, CHARLES DICKENS AS A LEGAL HISTORIAN 79 (1928). “I am sure that it would be possible to produce an edition of *Bleak House*, in which all Dickens’s statements could be verified by the statements of the witnesses who gave evidence before the Chancery Commission” *Id.* at 81. On the report of the Chancery Commission in 1826, see Michael Lobban, *Preparing for Fusion: Reforming the Nineteenth-Century Court of Chancery, Part I*, 22 LAW & HIST. REV. 389, 409-14 (2004).

72. “As the interrogatories were framed by counsel without knowing what . . . answers they would [get], it was necessary to frame questions to meet many possible contingencies. . . . [I]n

witnesses did not testify at trial, the unreformed equity procedure made no provision for confrontation, cross-examination, or demeanor evidence.⁷³ A corrupt corps of court officials, many with ownership rights in their offices, saddled litigants with make-work and expense.⁷⁴ Adjudication required reading the mounds of paper generated in this process, but the Chancery bench was chronically understaffed; the Lord Chancellor, who had many other duties, was the only judge until 1813, when a vice-chancellor was appointed.⁷⁵ Accordingly, the court was so choked with paperwork that it had to delegate the processing of much of its caseload—internally to masters⁷⁶ and externally to other courts.⁷⁷

The potential for protracted proceedings, a theme of *Bleak House*, was widely acknowledged in the contemporary legal sources. Spence wrote in 1839: “No man, as things now stand, can enter into a Chancery suit with any reasonable hope of being alive at the termination if he has a determined adversary.”⁷⁸ In the early nineteenth century, when the Chancellors were hardening the sole interest rule, the fact-finding procedures of Chancery were as “futile . . . [as ever] existed in any mature legal system.”⁷⁹ Dawson considered Chancery procedure of the day to have been “one of the most irrational and inefficient systems of proof that Europe had known since the duels and ordeals were abolished.”⁸⁰

these circumstances, no effective cross-examination was possible” 9 HOLDSWORTH, *supra* note 69, at 341. “Under this system the cross-examination of witnesses, both friendly and hostile, had to be undertaken before their testimony had been heard.” DAWSON, *supra* note 69, at 157.

73. Blackstone points to these shortcomings, contrasting the weaknesses of Chancery procedure with common law jury trial. 3 BLACKSTONE, *supra* note 69, at *373; *see also* A.V. DICEY, LECTURES ON THE RELATION BETWEEN LAW AND PUBLIC OPINION IN ENGLAND DURING THE NINETEENTH CENTURY 90-91 (1914) (describing how Chancery would accept evidence “only in the form of written answers”); Patrick Devlin, *Jury Trial of Complex Cases: English Practice at the Time of the Seventh Amendment*, 80 COLUM. L. REV. 43, 59 (1980) (explaining that Chancery procedure allowed for “no oral examination at all”).

74. *See* Lobban, *supra* note 71, at 393-97.

75. *See* THEODORE F.T. PLUCKNETT, A CONCISE HISTORY OF THE COMMON LAW 689 (5th ed. 1956) (characterizing Chancery as “a one-man court”). The Lord Chancellor was a high political officer, a member of the Cabinet; he was the presiding officer of the House of Lords and chair (and often the only member) of its judicial committee, the court of last resort for appeals from Scottish and English courts. *See* ROBERT STEVENS, LAW AND POLITICS: THE HOUSE OF LORDS AS A JUDICIAL BODY, 1800-1976, at 6-13 (1978). The Chancellor was assisted by a deputy, the Master of the Rolls, whose judicial authority was quite restricted. 1 HOLDSWORTH, *supra* note 69, at 419-21.

76. “The ‘hearing’ of a cause in equity means only the committing of it, in whole or in part, to be dealt with by the Master,” who, often years later, reports his findings back “into court, for further directions.” WILLIAM CARPENTER, CHANCERY REFORM: THE EQUITY JURISDICTION OF THE COURT OF CHANCERY 12 (London, Effingham Wilson 1850). On the frustrations with the masters, *see*, for example, CHALLINOR, *supra* note 70, at 13-16; and Lobban, *supra* note 71, at 393-94.

77. I have discussed these techniques in John H. Langbein, *Fact Finding in the English Court of Chancery: A Rebuttal*, 83 YALE L.J. 1620 (1974).

78. Bowen, *supra* note 70, at 529 (emphasis omitted). The quotation is attributed to George Spence in 1839.

79. 9 HOLDSWORTH, *supra* note 69, at 353.

80. DAWSON, *supra* note 69, at 157.

The movement to reform equitable procedure, which culminated in the fusion of law and equity, began in England in the 1820s⁸¹ and concluded, in a sense, in the United States with the promulgation of the Federal Rules of Civil Procedure in the 1930s.⁸² To the techniques of equity, which were refined for use in pretrial discovery, fusion added trial procedures drawn from the common law, especially examination and cross-examination⁸³ at oral public trial. During the same period, legislation both in England⁸⁴ and in the United States⁸⁵ cured the worst feature of fact-finding at common law, the testimonial disqualification of the parties for interest.⁸⁶

The trust law sole interest rule is *Bleak House* law, born of the despair that Lord Chancellor Eldon voiced in 1803 that “however honest the circumstances” of a particular transaction, “no Court is equal to the examination and ascertainment of the truth in much the greater number of cases.”⁸⁷ Today, by contrast, in the wake of fusion and the reform of civil procedure, courts dealing with equity cases command effective fact-finding procedures.⁸⁸ Accordingly, much of the concern voiced by Hardwicke, Eldon, and Kent—that without the sole interest rule the beneficiary would be “not able to prove”⁸⁹ trustee misbehavior—is archaic.

2. *Fiduciary Recordkeeping*

Another significant change that has occurred since the period when the sole interest rule entered trust law, and which bears on the danger of concealment by trustees, is the development in modern trust administration

81. See Lobban, *supra* note 71, at 409-17.

82. See generally Stephen B. Burbank, *The Rules Enabling Act of 1934*, 130 U. PA. L. REV. 1015 (1982); Stephen N. Subrin, *How Equity Conquered Common Law: The Federal Rules of Civil Procedure in Historical Perspective*, 135 U. PA. L. REV. 909 (1987).

83. Chancery Procedure Act, 1852, 15 & 16 Vict., c. 86, §§ 28-29 (Eng.).

84. Evidence Act, 1851, 14 & 15 Vict., c. 99, § 2 (Eng.).

85. The movement to abolish the party disqualification in civil cases in the United States, which began in Connecticut in 1848, took a generation to complete. George Fisher, *The Jury's Rise as Lie Detector*, 107 YALE L.J. 575, 659-62, 669-74 (1997); see also Joel N. Bodansky, *The Abolition of the Party-Witness Disqualification: An Historical Survey*, 70 KY. L.J. 91 (1981-1982).

86. Regarding the unreformed practice, see John H. Langbein, *Historical Foundations of the Law of Evidence: A View from the Ryder Sources*, 96 COLUM. L. REV. 1168, 1184-86 (1996); and James Oldham, *Truth-Telling in the Eighteenth-Century English Courtroom*, 12 LAW & HIST. REV. 95, 107-17 (1994). The movement to eliminate the rule is discussed in 2 JOHN HENRY WIGMORE, A TREATISE ON THE ANGLO-AMERICAN SYSTEM OF EVIDENCE IN TRIALS AT COMMON LAW §§ 575-576 (3d ed. 1940).

87. *Ex parte James*, 8 Ves. Jun. 337, 345, 32 Eng. Rep. 385, 388 (Ch. 1803).

88. A point emphasized by the English Court of Appeal, expressing doubt about the continued force of Lord Eldon's concern and remarking on “the almost daily experience of any [contemporary] judge engaged in ascertaining the knowledge and intentions of a party to proceedings.” *Holder v. Holder*, 1968 Ch. 353, 398 (Eng. C.A. 1967).

89. *Davoue v. Fanning*, 2 Johns. Ch. 252, 261 (N.Y. Ch. 1816).

of powerful norms regarding appropriate recordkeeping by trustees. Today's trustee operates "under a duty to the beneficiary to keep and render clear and accurate accounts with respect to the administration of the trust."⁹⁰ Good trust administration is suffused with process values—having competent persons follow intelligent procedures in managing, investing, auditing, and distributing trust assets; subjecting operational decisionmakers to internal review and oversight; and keeping careful records of these steps.⁹¹ A treatise cautions trustees that, in the case law governing fiduciary investment, "the decision-making process may be almost as important as the decision itself, at least for purposes of determining the trustee's responsibility."⁹² Regulatory authorities emphasize trust recordkeeping as part of their audit and examination standards,⁹³ and courts draw adverse inferences against trustees whose recordkeeping has been substandard.⁹⁴

Quite apart from the legal and regulatory pressures, the needs of ordinary business practice incline institutional trustees toward good recordkeeping. A bank trust department or other institutional fiduciary is an intrinsically bureaucratic entity. Performing trust functions necessarily involves the conduct of many persons deliberating and acting over time—account officers, investment officers, accountants, information technology personnel, supervisors, review committees. Internal coordination requires that transactions, authorizations, and committee decisions be documented. The data processing revolution has reinforced these tendencies by lowering the cost of creating and retaining many kinds of records.

The recordkeeping norms of trust law and practice have a strong deterrent effect on trustee misconduct. Modern trustees know that they are leaving a paper trail that can protect them when they adhere to good practice⁹⁵ and condemn them when they do not.

Accordingly, the concern of the older law that a conflicted trustee could easily conceal the true circumstances and merits of an abusive transaction seems exaggerated in the circumstances of twenty-first-century trust recordkeeping and record retention. On the other hand, it is important not to

90. RESTATEMENT (SECOND) OF TRUSTS § 172 (1959); accord UNIF. TRUST CODE § 810(a) (2000), 7C U.L.A. 237 (Supp. 2004).

91. See, e.g., FOUND. FOR FIDUCIARY STUDIES, PRUDENT INVESTMENT PRACTICES: A HANDBOOK FOR INVESTMENT FIDUCIARIES (2004).

92. 1A WALTER L. NOSSAMAN & JOSEPH L. WYATT, JR., TRUST ADMINISTRATION AND TAXATION § 29.05[3], at 29-50 (2004).

93. E.g., 12 C.F.R. §§ 9.8-9 (2004) (regulating recordkeeping, record retention, and audit by the Comptroller of the Currency).

94. Scott and Fratcher collect considerable case law supporting the proposition that "[i]f the trustee fails to keep proper accounts, all doubts will be resolved against him." 2A SCOTT & FRATCHER, *supra* note 2, § 172, at 452 & n.2, 454 n.3.

95. A prominent case illustrating the extent of deference to trust recordkeeping is *Stark v. United States Trust Co. of New York*, 445 F. Supp. 670 (S.D.N.Y. 1978).

exaggerate the significance of this development. There is no guarantee that trust recordkeeping practices oriented to documenting regular trust affairs will catch every irregularity. Furthermore, amateur trustees, who operate under a lower standard of care,⁹⁶ have been less affected than professional trustees by the trends toward better recordkeeping and record retention.

3. *The Fiduciary Duty of Disclosure*

A notable trend in trust fiduciary law is the steady expansion of the scope of the trustee's duty to inform the beneficiaries. Thus, not only is trust recordkeeping vastly enhanced by comparison with the period in which the sole interest rule formed, so is the duty to disclose that information. Moreover, in litigation settings, the extensive disclosure obligations of modern discovery procedure reinforce this trust law duty to disclose.

Under the *Restatement (Second) of Trusts*, which states the law as of the 1950s, the burden of seeking disclosure about trust affairs was upon the beneficiary: "Ordinarily the trustee is not under a duty to the beneficiary to furnish information to him in the absence of a request for such information."⁹⁷ However, in conflict-of-interest situations, the burden of initiating disclosure shifted to the trustee. Cardozo put the matter in his pithy way in 1918, cautioning that a "beneficiary, about to plunge into a ruinous course of dealing, may be betrayed by silence as well as by the spoken word."⁹⁸ The *Restatement (Second)* provides: "The trustee in dealing with the beneficiary on the trustee's own account is under a duty to the beneficiary to deal fairly with him and to communicate to him all material facts in connection with the transaction which the trustee knows or should know."⁹⁹

By the time of the Uniform Trust Code in 2000, the higher duty of disclosure characteristic of conflict-of-interest situations had become the trust law norm, displacing the more reactive standard that placed the burden on the beneficiary to demand information. The Code emphasizes the trustee's responsibility to initiate disclosure whenever it would be germane to keep the beneficiaries "reasonably informed about the administration of

96. The standard of care under the duty of prudent trust administration is higher for a professional trustee. See RESTATEMENT (SECOND) OF TRUSTS § 174 (1959); accord UNIF. TRUST CODE § 806 (2000), 7C U.L.A. 234 (Supp. 2004). The Uniform Prudent Investor Act, which also codifies the rule, explains that "the standard for professional trustees is the standard of prudent professionals; for amateurs, it is the standard of prudent amateurs." UNIF. PRUDENT INVESTOR ACT § 2(f) cmt. (1994), 7B U.L.A. 292 (2000).

97. RESTATEMENT (SECOND) OF TRUSTS § 173 cmt. d.

98. *Globe Woolen Co. v. Utica Gas & Elec. Co.*, 121 N.E. 378, 380 (N.Y. 1918).

99. RESTATEMENT (SECOND) OF TRUSTS § 170(2); accord *id.* § 173 cmt. d.

the trust and of the material facts necessary for them to protect their interests.”¹⁰⁰ The Code’s official comment, following the leading case, *Allard v. Pacific National Bank*,¹⁰¹ explains that, under the Code’s disclosure standard, “the trustee may be required to provide advance notice of transactions involving real estate, closely-held business interests, and other assets that are difficult to value or to replace,” in order to “enable the beneficiaries to take action to protect their interests.”¹⁰²

Under a loyalty standard of the sort I favor, which would allow a trustee to defend a conflicted transaction on the ground that it was prudently undertaken in the best interest of the beneficiary, the conflicted trustee would act under this duty to disclose the material facts in advance.¹⁰³

The federal courts have worked a similar expansion of the duty of disclosure in ERISA¹⁰⁴ fiduciary law for pension and other employee benefit plans and trusts. Congress based ERISA on the law of trusts¹⁰⁵ and imposed a rule of mandatory trusteeship on ERISA-covered plans. Although the statutory text does not express the duty of disclosure, the courts have derived it from the duties of loyalty and prudence,¹⁰⁶ which ERISA transposes from trust law.¹⁰⁷ The courts have held that an ERISA fiduciary has a duty “to convey complete and accurate information when it speaks to participants and beneficiaries regarding plan benefits.”¹⁰⁸ ERISA allows the plan sponsor to use company officers and other personnel as plan fiduciaries,¹⁰⁹ hence the statute “expressly contemplates fiduciaries with dual loyalties,” which is “an unorthodox departure from the common law rule.”¹¹⁰ The court-created disclosure duties of ERISA fiduciaries respond

100. UNIF. TRUST CODE § 813(a), 7C U.L.A. 239 (Supp.).

101. 663 P.2d 104 (Wash. 1983), cited in UNIF. TRUST CODE § 813 cmt., 7C U.L.A. 240 (Supp.). Legislation in Washington has codified the rule of the case, requiring advance written notice of any “significant nonroutine transaction,” including specified dealings in real estate and corporate interests. WASH. REV. CODE § 11.100.140 (2005).

102. UNIF. TRUST CODE § 813 cmt., 7C U.L.A. 240 (Supp.) (citing *Allard* and *In re Green Charitable Trust*, 431 N.W.2d 492 (Mich. Ct. App. 1988)). *Green* was a conflict-of-interest case invoking the sole interest rule; both cases involved fiduciary transactions with real estate.

103. I discuss *infra* Section I.C three decided cases that exemplify the repugnant results reached under the present sole interest rule. In each case the conflicted fiduciary had disclosed the material facts in advance to cotrustees and/or beneficiaries.

104. Employee Retirement Income Security Act (ERISA) of 1974, 29 U.S.C. §§ 1000-1461 (2000).

105. ERISA § 403(a), 29 U.S.C. § 1103(a). A proviso excuses from the requirement a few sorts of plans regulated in other ways, such as those funded by means of insurance policies.

106. “[A] fiduciary may not materially mislead those to whom [ERISA section 404(a)’s] duties of loyalty and prudence are owed.” *In re Unisys Sav. Plan Litig.*, 74 F.3d 420, 440 (3d Cir. 1996).

107. ERISA § 404(a)(1)(A)-(B), 29 U.S.C. § 1104(a)(1)(A)-(B).

108. *In re Unisys*, 74 F.3d at 441.

109. ERISA § 408(c)(3), 29 U.S.C. § 1108(c)(3).

110. *Donovan v. Bierwirth*, 538 F. Supp. 463, 468 (E.D.N.Y. 1981), *aff’d as modified*, 680 F.2d 263 (2d Cir. 1982). I have developed this point elsewhere. Daniel Fischel & John H. Langbein, *ERISA’s Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV.

to (and to some extent compensate for) the widespread use of conflicted fiduciaries in ERISA plan administration.

To summarize: The expansive disclosure standards of modern trust fiduciary law, reinforced by the modern trustee's extensive recordkeeping responsibilities, oblige the trustee to create suitable records and make them available when they bear on the beneficiary's interest. Furthermore, a trustee who is tempted to disobey these norms must now fear the discovery and trial techniques of the reformed civil procedural system. These radically changed circumstances largely overcome the concern of the eighteenth- and early-nineteenth-century chancellors that a conflicted trustee had an insuperable advantage at concealment.

C. *Deterrence (and Overdeterrence)*

An oft-repeated justification for the severity of the sole interest rule is that deterrence requires it. Scott's treatise says: "Courts of equity have felt that it is only by imposing a strict rule like this that all temptation to the trustee to act in his own interest rather than in that of the beneficiaries can be removed."¹¹¹ In a similar vein, Bogert writes, "The principal object of the administration of the rule is preventative, to make the disobedience of the trustee to the rule so prejudicial to him that he and all other trustees will be induced to avoid disloyal transactions in the future."¹¹²

This preoccupation with prophylaxis follows naturally enough from the two suspect assumptions already examined, that when a trustee has a conflict it must be harmful to trust beneficiaries, and that a conflicted trustee can easily conceal wrongdoing. The more opprobrious the conduct, and the harder it is to detect, the more attractive appear drastic measures to deter it.¹¹³ The counterargument, of course, is that in cost-benefit terms, the value of beneficiary-regarding conduct now foreclosed under the sole interest rule outweighs any losses that might arise from changing the force of the presumption of wrongdoing from conclusive to rebuttable.

A theme of the law and economics literature is that a rule may both under- and over-deter. The sole interest rule exhibits both traits.¹¹⁴ "Any economist will tell you that the rational self-serving defendant knows that he will not be caught and sued to judgement every time he puts himself in a

1105, 1126-28 (1988); John H. Langbein, *The Conundrum of Fiduciary Investing Under ERISA, in PROXY VOTING OF PENSION PLAN EQUITY SECURITIES* 128 (Dan M. McGill ed., 1989).

111. 2A SCOTT & FRATCHER, *supra* note 2, § 170.2, at 323.

112. BOGERT & BOGERT, *supra* note 2, § 543, at 246-47.

113. See Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1051-56 (1991) (resting the complete prohibition of conflicted transactions in trust law on asserted deterrence needs).

114. A theme discussed in Davis, *supra* note 18, at 25-99.

conflict of interest and duty,” and accordingly, that the winnings from undetected misappropriation would be likely to outweigh the costs of having to disgorge gains only when caught.¹¹⁵ More important for present purposes, the sole interest rule also overdeters.¹¹⁶ By penalizing trustees in cases in which the interest of the trust beneficiary was unharmed or advanced, the rule deters future trustees from similar, beneficiary-regarding conduct.

1. *The Auction Rule*

The rule against self-dealing with trust property is said to respond to the danger that a trustee transacting on his or her own account may subordinate the interest of the trust when valuing the property or setting other terms of the transaction. Yet even in a case in which the trustee consigns trust property for sale at a public auction open to all bidders, and hence cannot control the price or alter the terms, the sole interest rule will invalidate the trustee's purchase.

Thus, for example, supposing the trust in question to own a Monet that must be sold to pay taxes, and I as trustee place it for sale at Sotheby's annual spring auction of Impressionist paintings, I cannot safely bid on the picture. Even though my bid, in order to be successful, would have to be higher and thus more beneficial to the trust than any other, the sole interest rule would apply to my purchase. In consequence, were I to resell the painting a few years later at a profit, the trust beneficiary would be able to invoke the rule and capture the gain for the trust.¹¹⁷ Or, if I held the painting and a beneficiary later determined to reacquire it, I could be ordered to rescind the purchase.¹¹⁸ Knowing that my title would be infirm in this way, I would be, as the rule intends, deterred from purchasing the painting. This outcome is value impairing; it harms the beneficiary by successfully deterring what would have been the high bid.

The treatise writers valiantly defend the auction rule. Consider Scott's account: "The duty of the trustee in conducting the sale is to obtain as high a price as possible, but if he is allowed to purchase for himself at the sale it would be to his interest to have the property sold at the lowest possible price."¹¹⁹ But how could I as the trustee affect the amounts bid by others at Sotheby's? Scott's answer: By badmouthing the Monet on which I am

115. Lionel Smith, *The Motive, Not the Deed*, in RATIONALIZING PROPERTY, EQUITY AND TRUSTS: ESSAYS IN HONOUR OF EDWARD BURN 53, 60 (Joshua Getzler ed., 2003).

116. Speaking of overbreadth in the equivalent rule of agency law, Easterbrook and Fischel caution that it risks "fewer agents, or higher costs of hiring agents." Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 427 (1993).

117. *E.g.*, *Hartman v. Hartle*, 122 A. 615 (N.J. Ch. 1923).

118. RESTATEMENT (SECOND) OF TRUSTS § 210(1)(b) (1959).

119. 2A SCOTT & FRATCHER, *supra* note 2, § 170.4, at 326-27.

bidding. “The trustee is in a position where he can depreciate the sale, either by discouraging the attendance of bidders or by discouraging their bids.”¹²⁰ The likelihood that the world’s great museums, art dealers, and collectors will be thrown off the scent at Sotheby’s by my attempts at denigrating the merchandise is, to put it mildly, remote. Nevertheless, Scott concludes, “[i]n view of the dangers resulting from this conflict of duty and interest, the sale will be set aside even though in fact it appears that the trustee did his best to sell at the highest price.”¹²¹ Don Quixote could not have tilted at a more menacing windmill.

What the sole interest rule does in such a case is to identify some conceivable but conjectural evil and then conclusively presume that this farfetched plot actually transpired, by refusing to let the putative evildoer prove that no such thing happened. In my view, the trustee who purchases the Monet at Sotheby’s should be allowed to defend by proving that the plot did not happen, for example, by adducing evidence of the regularity of the procedures followed in placing the painting. The proofs in such a case would be simple. The trustee would testify about the steps that he or she took to promote the sale, including the complete absence of conduct impeding the auction or impairing the price. Further, a person or two from Sotheby’s might be summoned to testify that there had been no evidence of such disturbance in the market. Knowing that the trustee could easily defeat such a suit on the merits, the beneficiary would lose the incentive to bring it. I shall return to the question of how to frame a reform of the sole interest rule that would allow such a principled defense in Section II.C.

I do not mean to say that the trust tradition is wrong in being alert to the possibility of abuse in auction sales. In 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.¹²² Scott’s concern about the trustee “discouraging the attendance of bidders or . . . discouraging their bids”¹²³ can be quite legitimate. Moreover, in selecting which property to sell when there is a choice, or in engaging the

120. 2A *id.* § 170.4, at 327.

121. 2A *id.*

122. A case could also be imagined in which the trustee possesses undisclosed information about the value of the land, for example, that it sits on an oil field or that it is about to be favorably rezoned. A trustee contemplating buying under those circumstances, knowing that he or she would bear the burden of proof that he or she lacked such knowledge, would be hesitant to risk such a purchase, because of the constant risk of liability (rescission, disgorgement of profits) in the event of detection.

123. 2A SCOTT & FRATCHER, *supra* note 2, § 170.4, at 327.

auctioneer and setting any discretionary terms of sale, the conflicted trustee has other potential opportunities to prefer his or her own interest over that of the beneficiaries. But the better way to take account of such dangers is to presume them rebuttably, not irrebuttably. Allow the trustee to prove that he or she sold the right property, on the right terms; promoted the sale strenuously; and then further benefited the estate by tendering the highest bid.

2. Boardman v. Phipps

The celebrated 1967 House of Lords decision in *Boardman v. Phipps* provides another example of the severity and overdeterrence of the sole interest rule.¹²⁴ The rule forbids a trustee from appropriating an opportunity belonging to the trust or from using information belonging to the trust for personal profit.¹²⁵ The trust in question owned just over a quarter of the shares of a close corporation. The defendants, as agents for the trust and thus trustee-like fiduciaries,¹²⁶ developed a plan to reorganize and partially liquidate the company, with considerable profit to the shareholders. The trust declined to buy the additional shares needed to make the plan work. Using information acquired while representing the trust,¹²⁷ the defendants bought the additional shares for themselves, which allowed the plan to succeed. All shareholders benefited from the reorganization that was achieved by combining the trust's shares with those that the defendant fiduciaries purchased.

The House of Lords held the defendants liable under the sole interest rule to disgorge to the trust the profit made on their personal shares.¹²⁸ Because, however, the conduct at issue in the transaction in *Boardman* was (and was at all times meant to be) value enhancing for the trust, the policy of deterring the overlap or conflict of interest was contrary to the best

124. [1967] 2 A.C. 46 (Eng. H.L.), *aff'g* [1965] 1 Ch. 992 (Eng. C.A.). The decisions are discussed in Gareth Jones, *Unjust Enrichment and the Fiduciary's Duty of Loyalty*, 84 LAW Q. REV. 472, 481-86 (1968). Jones expresses disquiet about applying the sole interest rule "to a fiduciary who has acted honestly and in the best interest of his principal." *Id.* at 478.

125. The Uniform Trust Code applies the duty of loyalty to a "transaction concern[ing] an opportunity properly belonging to the trust." UNIF. TRUST CODE § 802(e) (2000), 7C U.L.A. 229 (Supp. 2004). Likewise, the trustee may not compete with the interest of the beneficiary, such as by establishing a business that competes with a trust-owned business. *See* RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. p, illus. 6 (1959); BOGERT & BOGERT, *supra* note 2, § 543(O); 2A SCOTT & FRATCHER, *supra* note 2, § 170.23.

126. *Boardman*, [1967] 2 A.C. at 88 (stating that the defendants' fiduciary "relationship arose from their being employed as agents of the trust"); *id.* at 106 (claiming that "[h]e was acting as agent for the trustees").

127. "This was the principal ground" of decision in the case. ROBERT GOFF & GARETH H. JONES, *THE LAW OF RESTITUTION* § 33-017, at 730 n.1 (6th ed. 2002).

128. The House did approve of allowing liberal compensation for professional services to the primary defendant, Boardman, who was a solicitor. *Boardman*, [1967] 2 A.C. at 112.

interest of the trust. But for the conflict-tainted conduct, the trust would have been worse off.

Bogert's treatise remarks that remedy under the sole interest rule "is not primarily granted to prevent unjust enrichment of the trustee but for its deterrent effect."¹²⁹ In *Boardman v. Phipps* the sole interest rule was applied in a manner that created rather than prevented unjust enrichment, by transferring to the beneficiaries of the trust a gain that the defendant fiduciaries earned on their own property in the course of maximizing the interests of the trust.

The House of Lords's message to trustees is: Thou shalt not create value for thy trust beneficiary in circumstances in which there may be actual or potential benefit to thyself. In such cases, the deterrent effect of the sole interest rule contravenes the purpose of the rule, which is to benefit the beneficiary.

3. In re Kilmer's Will

The New York case *In re Kilmer's Will*¹³⁰ echoes *Boardman v. Phipps* in its insensitivity to a fiduciary's efforts to advance the best interests of the beneficiaries. The executors of a probate estate needed to sell a parcel of commercial realty to pay estate taxes. They had it appraised, marketed it, and received one offer above the appraisal price from an investor named Cohen. One of the executors, Ely, asked his coexecutors to decline Cohen's offer, because Ely thought he could get the F.W. Woolworth Company to pay more for the site. The other executors were hesitant about Ely's plan, but finally agreed on condition that Ely personally guarantee to purchase the property for the amount offered by Cohen in the event that the deal with Woolworth could not be arranged and that Cohen then did not renew his offer. Ely agreed, thus providing the estate with a guarantee that took the form of a costless put. The estate acquired the right to force him to buy the property at the price Cohen had offered in the event that Woolworth would not pay more and Cohen would not renew his offer. As events transpired, Woolworth declined to bid, Cohen did not renew, and Ely was forced to buy the property. Some years later some of the estate beneficiaries sought to void the transaction, presumably because the value of the property had increased. The New York court held in their favor, although the judge candidly acknowledged that he had "no doubt" that the transaction had been free of "any ulterior motive on the part of any of the executors," and that

129. BOGERT & BOGERT, *supra* note 2, § 543, at 247.

130. 61 N.Y.S.2d 51 (Sur. Ct. 1946).

“the sale was consummated at a fair price . . . and in good faith on the part of all of them.”¹³¹

Why void a conflicted transaction that the court knew was fair, and in which the conflict arose entirely from a hold-harmless guarantee given to facilitate efforts to obtain even greater benefit for the estate? The court’s answer: to deter future schemers. “[U]pholding . . . this sale would be a very bad precedent. It might well practically provide a blueprint to be followed by some fiduciary of a character less reputable than” these executors.¹³² In truth, this “blueprint” for a plot among multiple executors to allow one of their number to buy estate property at the market-clearing price offered by a third party is wholly improbable. If the executors attempted to conceal such a scheme, they would risk detection under modern pretrial discovery techniques. Liability for perjury as well as breach of trust could result. Nevertheless, the court insisted that “the possibility that the trustee might make a profit from dealing in an estate asset is prohibited.”¹³³ The lesson for future Elys: Do not be so vigorous about trying to benefit the beneficiaries. Even when you have been forced to buy a trust asset under a gratuitously provided hold-harmless guarantee that you gave solely in connection with an effort to maximize the best interest of the beneficiaries, you can be made to rescind the purchase years later if some beneficiary takes a fancy to the property.

4. *In re Will of Gleeson*

The Illinois case *In re Will of Gleeson* shows the sole interest rule applied to punish a trustee who engaged in a conflicted transaction as an emergency matter to prevent loss to the trust.¹³⁴ Gleeson, the settlor of a testamentary trust, owned a parcel of agricultural land, which she leased out for farming on year-to-year leases. During her lifetime, Colbrook, her executor and trustee, leased the land from her in Year One and in Year Two. Fifteen days before the planting season began in Year Three, Gleeson died, not having concluded a new lease for the year. Colbrook as trustee renewed the lease to himself as tenant for that year, acting on the ground “that satisfactory farm tenants are not always available, especially on short notice.”¹³⁵ Colbrook contended that he acted openly and “in the best interests of the trust,” which “suffered no loss as a result of the

131. *Id.* at 55.

132. *Id.* at 58. For a gullible endorsement of the decision and its rationale, see Charles Bryan Baron, *Self-Dealing Trustees and the Exoneration Clause: Can Trustees Ever Profit from Transactions Involving Trust Property?*, 72 ST. JOHN’S L. REV. 43, 53-54 (1998).

133. *In re Kilmer’s Will*, 61 N.Y.S.2d at 58.

134. *In re Will of Gleeson*, 124 N.E.2d 624 (Ill. App. Ct. 1955).

135. *Id.* at 626.

transaction.”¹³⁶ The court awarded the profits that Colbrook earned from his crop to the trust, emphasizing that neither the shortness of time, nor his advance disclosure to two of the beneficiaries, nor his “good faith and honesty,”¹³⁷ nor the absence of loss to the trust would sustain a defense for self-dealing.

The lesson of the case is that the sole interest rule requires the trustee to inflict loss on the trust, in this case by letting the land go unused for the year, rather than engage in a conflicted transaction that would enrich the trust.

D. *Monitoring*

Another factor that might be thought to motivate the sole interest rule is concern that a less protective rule might leave trust beneficiaries at a disadvantage in enforcing the duty of loyalty. Although trust law makes the beneficiaries the sole enforcers of the trust,¹³⁸ “[s]ome beneficiaries lack a sufficient stake” to justify bringing suit, and others can be “unsuited to monitor the trustee, perhaps because they are unborn, incapacitated, or simply irresponsible.”¹³⁹

The potential difficulty of beneficiary monitoring underscores the importance of the duty of loyalty but does not justify the “no further inquiry” rule. The trust beneficiary faces comparable difficulties in enforcing the duty of prudent administration and its many subrules,¹⁴⁰ yet the law imposes no analogue to the “no further inquiry” rule when a trustee defends a claim of imprudence. Rather, the court inquires into the merits of the trustee’s defense that the challenged conduct was prudent. In a similar vein, Lionel Smith has remarked that “if prophylaxis was premised on vulnerability, we should have a lot of prophylaxis outside fiduciary

136. *Id.*

137. *Id.* at 627.

138. “No one except a beneficiary or one suing on his behalf can maintain a suit against the trustee to enforce the trust or to enjoin or obtain redress for a breach of trust.” RESTATEMENT (SECOND) OF TRUSTS § 200 (1959). For charitable trusts the monitoring regime is quite different. Because the beneficiaries of such a trust must be indefinite, *see id.* § 364, the state attorney general is commonly the only person who can enforce it, *see id.* § 391. *But see* UNIF. TRUST CODE § 405(c) (2000), 7C U.L.A. 184 (Supp. 2004) (allowing the settlor to enforce such a trust). In such circumstances a trustee who obtains the attorney general’s approval for a conflicted transaction will have practical immunity. In this respect the attorney general performs a role that resembles somewhat both that of the nonconflicted directors who can approve such a transaction in corporate law, *see infra* text accompanying notes 158-161, and the court acting under the advance-approval doctrine in conventional trust law, *see infra* text accompanying notes 181-193.

139. Sitkoff, *Agency*, *supra* note 18, at 679-80.

140. Speaking of ERISA’s trust-based fiduciary law, Fischel and I have observed that all the fiduciary duties, not just loyalty, “act as substitutes for monitoring by the directly interested parties.” Fischel & Langbein, *supra* note 110, at 1114.

relationships. A pedestrian on a crossing is extremely vulnerable to motorists, but is protected only by the ordinary law of negligence.”¹⁴¹

The example of the unborn or incapacitated beneficiary points elsewhere, not to the “no further inquiry” rule but to the accustomed procedural safeguards for such persons. Precisely because it is so hard to bind such persons, a well-counseled trustee contemplating a conflicted transaction would strongly incline to use the advance-approval procedure discussed below, in which a guardian ad litem, conservator, or other representative would stand in for such a beneficiary.

Litigation expenses often constitute the most serious obstacle that a beneficiary faces in enforcing rights based on trust fiduciary law, whether the duty arises in loyalty, to which the sole interest rule applies, or in prudence, to which it does not. Normally, the beneficiary’s enforcement expenses fall on the trustee if the beneficiary’s case succeeds,¹⁴² but not if the trustee prevails. By contrast, when the trustee seeks judicial instruction, the expenses normally fall on the trust,¹⁴³ hence on all the beneficiaries, not just those who contest the trustee’s petition. Under a loyalty regime of the sort I favor, which would allow the trustee to litigate an issue that is now foreclosed to the advantage of the beneficiaries, there is a concern that the prospect of having to bear the litigation expenses would deter a beneficiary from bringing suit to challenge the trustee’s assertion that a suspect transaction was prudently undertaken for the best interest of the trust. Accordingly, it would be appropriate to adjust the cost rule, at least in the case in which the trustee could prudently have sought advance judicial approval without jeopardizing the transaction. In that case the trustee’s failure to use the superior procedure of advance judicial instruction has caused avoidable disadvantage in the form of litigation expenses to the beneficiary who contests the conflicted transaction, and thus the trustee should absorb the beneficiary’s reasonable litigation expenses.¹⁴⁴

E. *The Contrast with Corporation Law*

The handling of directors’ conflicts of interest in the law of corporations presents an instructive contrast with the sole interest rule of trust law. In corporate law, regulation has replaced prohibition.

Initially, the law of corporations applied the trust law sole interest rule to a corporate transaction with a director, and hence the transaction was

141. Smith, *supra* note 115, at 61.

142. Cases are collected in 3 SCOTT & FRATCHER, *supra* note 2, § 188.4, at 67 n.8, 68 n.11.

143. 3 *id.* § 188.4, at 68 & n.12.

144. I discuss the advance-approval doctrine *infra* Subsection II.A.3, regarding situations in which it would be prudent for the trustee not to seek advance approval because of weighty concerns about publicity, delay, or expense.

voidable at the option of the corporation.¹⁴⁵ Across the late nineteenth and twentieth centuries, however, the law of corporations changed course, rejected the trust law solution, and developed a regime for accommodating such conflicts to the interests of the corporation.¹⁴⁶ The American Law Institute's *Principles of Corporate Governance* now pointedly "avoids the use of the term 'duty of loyalty,' . . . and instead uses the term 'duty of fair dealing.'"¹⁴⁷

The modern corporate regime emphasizes three principles for dealing with conflicted-director transactions: disclosure, delegation, and fairness.

(1) The conflicted director must disclose the conflict and all the material circumstances to his or her fellow directors.¹⁴⁸

(2) The decision whether to approve the conflicted transaction is delegated to the nonconflicted directors.¹⁴⁹

(3) In making their decision, the participating directors are required to test the transaction against a standard of fairness to the corporation.¹⁵⁰

In addition, some jurisdictions follow the rule, endorsed by the ALI's *Principles*,¹⁵¹ that when these procedures have not been followed, the conflicted director bears the burden of proof regarding fairness in any resulting litigation.¹⁵²

1. *Mutual Advantage*

Overlaps or conflicts are endemic in corporate activity. A board of directors will often contain persons who transact with the firm as suppliers, lenders, customers, or venture partners. Likewise, with corporate officers, a

145. Harold Marsh, Jr., *Are Directors Trustees?: Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 36-39 (1966).

146. For the historical development, see MODEL BUS. CORP. ACT § 8.60 annot. (History), at 8-389 (2002); 1 ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS pt. V introductory note, at 200 (1994); and ROBERT C. CLARK, CORPORATE LAW § 5.1, at 160-66 (1986) (following Marsh, *supra* note 145, at 36-43). *But see* Norwood P. Beveridge, Jr., *The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction*, 41 DEPAUL L. REV. 655, 659-62 (1992) (pointing to evidence that movement toward the fairness standard began earlier than indicated by Marsh).

147. 1 ALI, *supra* note 146, pt. V introductory note, at 200.

148. MODEL BUS. CORP. ACT § 8.60(4); 1 ALI, *supra* note 146, § 5.02(a)(1), at 277.

149. MODEL BUS. CORP. ACT §§ 8.61(b)(1), 8.62(a), (d); 1 ALI, *supra* note 146, § 5.02(a)(2)(B), at 277. Thirty-four states with MBCA-type statutes provide that "a conflict-of-interest [transaction] is not automatically void or voidable by the corporation if it has been ratified by an informed board of directors, excluding the interested directors." MODEL BUS. CORP. ACT § 8.61 annot. (Statutory Comparison), at 8-406.

150. MODEL BUS. CORP. ACT § 8.61(b)(3); 1 ALI, *supra* note 146, § 5.02(a)(2)(A), at 277.

151. 1 ALI, *supra* note 146, § 5.02(b) & cmt., at 278, 306-08.

152. Case law is collected in MODEL BUS. CORP. ACT § 8.61 annot. (Selected Cases), at 8-408 to -424.

rule prohibiting conflicts “would frustrate many mutually beneficial transactions, from management buy-outs to profit sharing when corporate employees make inventions.”¹⁵³ In such circumstances the interest of the corporation is often better served by promoting than by prohibiting transactions that offer mutual advantage. Reflecting on the causes of the abandonment of the sole interest rule in twentieth-century corporate law, Robert Clark observes that “the increasing use of the corporate form inevitably caused the courts to be exposed to a greater number and variety of self-dealing transactions.”¹⁵⁴ With this familiarity came the realization that “certain self-dealing transactions might be not only normal and virtually unpreventable but also positively” advantageous to the corporation, hence the movement to “more selective rules” that would “allow the nonabusive self-dealing transactions to occur.”¹⁵⁵

In traditional trust administration, especially before the rise of institutional trustees, there was much less justification for trustees to develop comparable patterns of personal involvement with trust assets, and thus it was less costly simply to forbid conflicts.¹⁵⁶ Recall Sanders, writing in the eighteenth century that “courts of equity look upon trusts as *honorary*, and . . . not undertaken upon mercenary motives.”¹⁵⁷ When trusteeship was rooted in honor rather than commerce, the trustee had no reason for personal entanglement with trust property. Because the business corporation is by nature “mercenary,” it was easier for the law to defer to the decision of its nonconflicted directors that they found compensating mercenary advantage (“fairness”) for the corporation in transacting with a director.

2. *Multiple Fiduciaries*

The central procedural device of the corporate regime for dealing with conflicts is delegation to and approval by the nonconflicted directors. Corporate boards of directors commonly have several members, and thus a relatively impartial¹⁵⁸ decisionmaker is already in place for deciding whether a conflicted transaction is nevertheless advantageous to the

153. Easterbrook & Fischel, *supra* note 116, at 442.

154. CLARK, *supra* note 146, § 5.1, at 164.

155. *Id.* Clark considers and rejects as improbable two interest-group-based explanations for the rule, pressure from corporate managers or from legal professionals. *Id.* § 5.1, at 162-63.

156. *See supra* text accompanying note 24.

157. SANDERS, *supra* note 44, at 256.

158. Eisenberg has cautioned that “directors, by virtue of their collegial relationships, are unlikely to treat one of their number with the degree of wariness with which they would approach a transaction with a third party.” Melvin Aron Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. L. 997, 1002 (1988).

corporation. By contrast, collegial trusteeship, that is, cotrusteeship,¹⁵⁹ is not the norm in American trust practice.¹⁶⁰ We presuppose that a single individual or entity will serve as trustee. Accordingly, trust law has no reliable analogue to the central institutional mechanism of the modern corporate regime of routine delegation to nonconflicted cofiduciaries. Indeed, under the nondelegation rule of trust fiduciary law, it is unclear whether a conflicted trustee is allowed to delegate approval of a major transaction to cotrustees.¹⁶¹

3. *Exit*

As a practical matter, trusts do (and commonly are meant to) restrict the ability of trust beneficiaries to dispose of trust property or to escape the managerial authority of the trustee. The shareholder of a publicly traded company can disengage from a mismanaged corporation by selling the shares (although often at material cost, because would-be buyers are likely

159. Cotrusteeship is, of course, authorized. *See, e.g.*, RESTATEMENT (SECOND) OF TRUSTS § 184 (1959) (duties of cotrustees); *accord* UNIF. TRUST CODE § 703 (2000), 7C U.L.A. 217 (Supp. 2004) (same).

160. In England, by contrast, where the use of trust companies is less common than in the United States, professionally drafted trust instruments commonly make provision for multiple trustees, often combining a solicitor or an accountant with family members. In such cases it is becoming common to countermand the sole interest rule in favor of a procedure that replicates the core features of the American corporate rule, that is, empowering the nonconflicted trustee(s) to approve a conflict that the conflicted trustee discloses fully. *See, e.g.*, THE SOCIETY OF TRUST & ESTATE PRACTITIONERS, STANDARD PROVISIONS OF THE SOCIETY OF TRUST AND ESTATE PRACTITIONERS § 9(2)(c), at 6 (6th ed. 2003), *available at* <http://www.step.org/attach.pl/28/211/STEP%20Standard%20Provisions.doc> (allowing nonconflicted trustees to validate a transaction if the conflicted trustee discloses “the nature and extent of any material [conflict]” and the nonconflicted trustee(s) determine “that the transaction . . . is not contrary to the general interest of the [beneficiaries]”). (I owe this reference to Richard Nolan and Lionel Smith.)

161. The rule of the Uniform Trust Code is that “[a] trustee may not delegate to a cotrustee the performance of a function the settlor reasonably expected the trustees to perform jointly.” UNIF. TRUST CODE § 703(e), 7C U.L.A. 217 (Supp.), but that begs the question of what is reasonably expected in such circumstances. As a general matter, there are two main reasons that a trust is designed with cotrustees: (1) to obtain the benefit of multiple decisionmakers, including the salutary process advantages of group deliberation, and (2) as a protection against the eccentricity or misbehavior of any one trustee. Accordingly, a trustee’s delegation of important decisions to cotrustees runs counter to the settlor’s purposes in requiring cotrustees. When, however, a trustee is conflicted, so that his or her interest is potentially adverse to the interest of the beneficiary, that trustee may be too compromised to perform effectively, in which case the trustee may better serve the interest of the beneficiary by not participating in the transaction.

An alternative to delegation—when the conflicted trustee determines that nonparticipation might be undesirable, for example, because there is reason to fear that the cotrustees might misbehave in the absence of the conflicted trustee—would be for the conflicted trustee to seek appointment of a trustee *ad litem* to serve in his or her stead. For authority, see RESTATEMENT (SECOND) OF TRUSTS § 199(d). *Accord* UNIF. TRUST CODE § 1001(b)(5), 7C U.L.A. 251 (Supp.). Because, however, this step would entail court proceedings, it has no particular advantage over petitioning for advance court approval of the conflicted transaction, the procedure discussed *infra* text accompanying notes 181-193.

to discount the shares accordingly). There is no counterpart in trusteeship to the market for corporate control, no takeover bid for a mismanaged trusteeship.¹⁶² Interests in trusts are commonly inalienable, both on account of legal restrictions¹⁶³ and because of practical impediments to valuing and marketing contingent interests. Trustees are removable only for cause,¹⁶⁴ unless the trust instrument provides otherwise. These characteristic difficulties of exit from trust relations bear on the more protective character of both the care¹⁶⁵ and the loyalty norms of trust law.

The abandonment of the sole interest rule in corporate law provides an important comparison for trust law. Corporate law, recognizing that some conflicts benefit the corporation, has replaced prohibition with regulation. Although there are enough differences between the two fields that success in one does not resolve whether the other should follow, trust and corporation law are closely related historically;¹⁶⁶ each has become a regime for intermediating managers between owners and their property, hence each is a field of fiduciary obligation; and each is a functional competitor of the other for many uses.¹⁶⁷ Accordingly, the successful experience with ridding corporation law of the sole interest rule is highly instructive for trust law.

162. See Fischel & Langbein, *supra* note 110, at 1116 (noting the absence of a “takeover market for trustees” and suggesting that the “stricter rules” of trust fiduciary law “substitute for the weaker private or market-type constraints”); Sitkoff, *Efficiency*, *supra* note 18, at 571.

163. In American trust law the beneficiaries may not terminate a trust if continuing it “is necessary to carry out a material purpose of the trust.” RESTATEMENT (SECOND) OF TRUSTS § 337(2); *accord* UNIF. TRUST CODE § 411(b), 7C U.L.A. 189 (Supp.). American trust law also allows the settlor to make beneficial interests inalienable, either expressly, by means of a spendthrift clause, or as a practical matter, by giving the trustee discretion regarding whether and how much to distribute. RESTATEMENT (THIRD) OF TRUSTS §§ 50, 58, 60 (2003); RESTATEMENT (SECOND) OF TRUSTS §§ 152-153, 155; *accord* UNIF. TRUST CODE §§ 502, 504, 7C U.L.A. 200, 202 (Supp.).

164. RESTATEMENT (THIRD) OF TRUSTS § 37; *accord* UNIF. TRUST CODE § 706, 7C U.L.A. 221-22 (Supp.), *discussed in* Sitkoff, *Agency*, *supra* note 18, at 663-66.

165. The care norm of trust law, the duty of prudent administration, is at least nominally more protective than the business judgment rule of corporate law. See Sitkoff, *Agency*, *supra* note 18, at 656-57; Sitkoff, *Efficiency*, *supra* note 18, at 574-76. One explanation that has been suggested is that the trust beneficiary cannot diversify his or her holding in the trust, whereas an investor in corporate shares can. See Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. REV. 52, 95-96 (1987). On the other hand, trust law now requires diversification of the trust portfolio unless the instrument contraindicates. See *infra* text accompanying note 205. A leading authority on nonprofit law has questioned whether in actual application there is any material difference between prudence and business judgment. Harvey P. Dale, *Nonprofit Directors and Officers—Duties and Liabilities for Investment Decisions*, in TWENTY-SECOND CONFERENCE ON TAX PLANNING FOR 501(C)(3) ORGANIZATIONS § 4.03, at 4-13 (1994).

166. See, e.g., RON HARRIS, *INDUSTRIALIZING ENGLISH LAW: ENTREPRENEURSHIP AND BUSINESS ORGANIZATION, 1720-1844*, at 147-59 (2000).

167. I have discussed the competition between trust and corporation in John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165 (1997). It is the subject of economic analysis in Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 N.Y.U. L. REV. 434 (1998).

II. ESCAPING THE SOLE INTEREST RULE

How could a rule as harsh as the sole interest rule have survived across the past two centuries of mushrooming growth in both the use of trusts and the assets subject to trusteeship? The answer is simple: For the well-counseled trustee, the mischief of the sole interest rule is severely bounded by doctrines of exclusion, treated next, and by a further set of categorical exceptions, discussed thereafter. Thus, the brunt of the rule is borne by the typical fall guys of Anglo-American private law, those persons who are too unsophisticated to hire lawyers or who happen to find their way into the hands of bad lawyers.¹⁶⁸

A. *The Exclusions*

Three doctrines of exclusion, long established in the common law of trusts, are settlor authorization, beneficiary consent, and advance judicial approval.

1. *Settlor Authorization*

The sole interest rule is default law that the settlor can alter or abridge, as previously discussed.¹⁶⁹ When the settlor selects a conflicted person to serve as trustee, such as a family member who is also a beneficiary, the court infers that the settlor intended a commensurate waiver of the sole interest rule, even if the trust instrument does not spell out that term.¹⁷⁰ “It is well established that a trustee may occupy conflicting positions in handling the trust where the trust instrument contemplates, creates, or sanctions the conflict of interest.”¹⁷¹

The authorization doctrine also applies to excuse conflicted transactions in the law of agency, the other major field of modern fiduciary law to which the sole interest rule pertains.¹⁷² The sole interest rule has been less problematic in agency than in trust because agency is mostly a two-party

168. The most prominent American loyalty case, *In re Estate of Rothko*, 379 N.Y.S.2d 923 (Sur. Ct. 1975), *aff'd as modified*, 372 N.E.2d 291 (N.Y. 1977), was caused in part by the blunder of the lawyers for the fiduciaries, who advised them—wrongly—that the court would not entertain a petition for instructions about whether their projected conduct would violate the duty of loyalty. *See id.* at 936-37.

169. *See* RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. t (1959); *accord* UNIF. TRUST CODE § 802(b)(1), 7C U.L.A. 229 (Supp.).

170. *E.g.*, *Estate of McCredy*, 470 A.2d 585, 600 (Pa. Super. Ct. 1983) (stating that a settlor can waive the sole interest rule “by implication, where he knowingly places his trustee in a position which might conflict with the interest of the trust or its beneficiaries”).

171. *Dick v. Peoples Mid-Ill. Corp.*, 609 N.E.2d 997, 1002 (Ill. App. Ct. 1993).

172. RESTATEMENT (SECOND) OF AGENCY § 387 (1958).

relationship (principal-agent), in contrast to the three-party relationship (settlor-trustee-beneficiary) of trust. Unless otherwise agreed by contract, the principal may alter or terminate an agent's authority at will.¹⁷³ Accordingly, if at any point the principal decides that the sole interest rule, which is meant for the principal's protection, is impinging on a beneficial transaction, he or she may abridge it. An agent who wants to proceed with a conflicted transaction need only persuade the principal to authorize it (which, of course, the principal will resist, unless he or she determines the transaction to be in his or her best interest). A trustee operating under an irrevocable trust, which in most cases will have been created by a now-deceased settlor, cannot return for authorization to obtain a transaction not foreseen when the trust was created.

2. *Beneficiary Consent*

"[A] beneficiary cannot hold the trustee liable for an act or omission of the trustee as a breach of trust if the beneficiary . . . consented to it."¹⁷⁴ Of course, consent is ineffective if, when consenting, the beneficiary "did not know of his rights and of the material facts which the trustee knew or should have known and which the trustee did not reasonably believe that the beneficiary knew."¹⁷⁵ Moreover, as I have previously mentioned in discussing trust law disclosure standards,¹⁷⁶ the fairness requirement supplies a further safeguard against imposition when the trustee seeks to rely upon the beneficiary's consent in conflict settings. If the trustee has "an adverse interest in the transaction," the terms of the transaction must be objectively "fair and reasonable."¹⁷⁷

Enforcing beneficiary consent to a conflicted transaction (subject to these safeguards of voluntariness and fairness) is directly responsive to the policy that underlies the loyalty rule, which is to maximize the best interest of the beneficiary. A beneficiary who is competent and well informed and who consents to a transaction that is objectively fair is taken to know and to act in his or her own best interest. This insight is what allowed the law of corporations to free itself from the sole interest rule. "The fundamental move . . . was to analogize the disinterested members of the corporate board

173. *Id.* § 118.

174. RESTATEMENT (SECOND) OF TRUSTS § 216(1); *accord* UNIF. TRUST CODE § 802(b)(4), 7C U.L.A. 229 (Supp.).

175. RESTATEMENT (SECOND) OF TRUSTS § 216(2)(b); *accord* UNIF. TRUST CODE § 1009(2), 7C U.L.A. 258 (Supp.).

176. *See supra* note 31 (reproducing RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. t, which facilitates settlor authorization).

177. RESTATEMENT (SECOND) OF TRUSTS § 216(3); *accord id.* § 170(2). Case law is collected in 3 SCOTT & FRATCHER, *supra* note 2, § 216, at 330 n.6.

of directors to the [consenting] beneficiary” of trust law.¹⁷⁸ The key principles are the same both in the modern corporate rule governing transactions with conflicted directors and in the trust law rule governing transactions with a conflicted trustee when the beneficiary consents: substantive fairness plus thorough disclosure to persons who are competent to evaluate the transaction.

Estoppel values are also at stake in protecting a trustee’s justified reliance on beneficiary consent. In the words of a Victorian judge, it would be “revolting to one’s common understanding that a person should desire his trustee to do a particular act . . . and then afterwards file a bill against him for having done that which he desired him to do.”¹⁷⁹

Beneficiary consent is likely to be even more used in the future as a consequence of the modern trend, strongly endorsed in the Uniform Trust Code, toward liberalizing the standards for representation. Under that doctrine, parents and other ancestors may in some circumstances consent for and bind minor and unborn beneficiaries.¹⁸⁰

3. *Advance Judicial Approval*

The most revealing of the excusing doctrines is the rule allowing a conflicted transaction if the trustee first obtains judicial approval. The *Restatement* says, “The trustee can properly purchase trust property for himself with the approval of the court.”¹⁸¹ This doctrine is an application of the familiar equitable remedy, the petition for instructions, which permits a trustee “to apply to the court for instructions as to the administration of the trust if there is reasonable doubt as to his duties or powers as trustee.”¹⁸²

178. Edward Rock & Michael Wachter, *Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 NW. U. L. REV. 651, 669 (2002) (citing Marsh, *supra* note 145, at 39-40).

179. Lockhart v. Reilly, 25 L.J. Eq. 697, 701 (Eng. Ch. 1856).

180. UNIF. TRUST CODE §§ 301-304, 7C U.L.A. 174-77 (Supp.).

181. RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. f. Although the doctrine originated in case law, it has been codified in various states, *see* 2A SCOTT & FRATCHER, *supra* note 2, § 170.7, at 340 n.13, and now in the Uniform Trust Code, *see* UNIF. TRUST CODE § 802(b)(2), 7C U.L.A. 229 (Supp.). The Uniform Trustees’ Powers Act (UTPA) contained a provision that requires the trustee to seek advance approval in certain conflict-of-interest transactions. UNIF. TRS.’ POWERS ACT § 5(b) (1964), 7C U.L.A. 426 (2000). The Uniform Trust Code, which supersedes the UTPA, UNIF. TRUST CODE § 1105(1), 7C U.L.A. 266 (Supp.), does not reenact this provision.

182. RESTATEMENT (SECOND) OF TRUSTS § 259; *see also id.* cmt. a (stating when the trustee is “entitled to instructions”).

The procedure for securing advance¹⁸³ judicial approval of a conflicted transaction resembles the conflict-of-interest regime of the law of corporations,¹⁸⁴ because it interposes an impartial decisionmaker (there the disinterested directors, here the court) between the conflicted fiduciary and the transaction. The trust law procedure is more protective than the corporate rule because it provides beneficiaries with notice and opportunity to be heard judicially.¹⁸⁵ The thinking, in the words of the Massachusetts court, is that “under the supervision and control of” the appropriate court, “the danger of a fiduciary taking advantage of his position for his personal benefit is eliminated.”¹⁸⁶

Such judicial proceedings are directly responsive to the concern that motivated the framers of the “no further inquiry” rule, that the conflicted trustee might conceal the real circumstances of the transaction. In *Davoue v. Fanning*, the 1816 case in which Chancellor Kent adopted the English sole interest rule, he pointed out that a trustee could still “safely” purchase trust property “by filing a bill” for approval; “the Court will then examine into the case, and judge whether it be advisable to let the trustee bid.”¹⁸⁷ In place of the “no further inquiry” rule, the advance-approval doctrine substitutes judicial inquiry.

The substantive standard for the court’s inquiry under the advance-approval doctrine is “the best interest of the beneficiary.”¹⁸⁸ That standard expresses the policy value underlying the duty of loyalty. Instead of treating the issue of benefit to the beneficiary as beyond investigation, the advance-approval procedure enables the court to decide on the merits whether the

183. Both Bogert and Scott cite a few cases for the proposition that judicial approval may sometimes occur after the sale. BOGERT & BOGERT, *supra* note 2, § 543(A), at 284 n.20; 2A SCOTT & FRATCHER, *supra* note 2, § 170.7, at 339. My reading of the cited cases is that none actually rests on the stated ground; all involve some distinguishing factor, such as collateral estoppel, language of authorization in the trust instrument, or a fiduciary beneficially interested in the property as an heir or devisee. Ratifying a conflicted transaction already concluded would be irreconcilable with the “no further inquiry” branch of the sole interest rule. The only plausible ground of distinction in such a case—that the trustee might have won the race to the courthouse door by petitioning for approval before the beneficiary sued—is immaterial from the standpoint of the rationale for the rule.

184. *See supra* text accompanying notes 149, 158-161.

185. *See* RESTATEMENT (SECOND) OF TRUSTS § 220 & cmt. d (preclusive effect of proper decree).

186. *Terry v. Terry*, 25 N.E.2d 205, 207 (Mass. 1940) (sustaining probate court decree allowing estate administrator to buy realty from the estate). The fiduciary standards for estate administration are those of trust law. *See supra* text accompanying note 15.

187. 2 Johns. Ch. 252, 261 (N.Y. Ch. 1816); *see supra* text accompanying note 63.

188. RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. f (“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.”). Scott collects some case law deciding whether such transactions are “for the best interest of the trust estate.” 2A SCOTT & FRATCHER, *supra* note 2, § 170.7, at 340 & n.11.

transaction is in the beneficiary's best interest.¹⁸⁹ Thus, the change in procedure results in a different and more refined substantive standard: Best interest replaces sole interest.

Advance approval is a safe harbor but not a panacea. There are circumstances in which the advantages of proceeding in this way would be so overwhelming to the trust that it would be a breach of the duty of prudence for a trustee, especially a professional trustee,¹⁹⁰ to act in a conflict-of-interest setting without seeking advance approval. On the other hand, because the procedure entails judicial decisionmaking, it has three worrisome features characteristic of litigation: publicity, delay, and expense. (Concern about just these traits is what led to the movement in the law of estate administration, previously mentioned,¹⁹¹ to make court-supervised procedures optional.)

For persons seeking to avoid the public gaze in matters of family wealth transmission, an important attraction of the inter vivos trust is that trust administration is conducted in private,¹⁹² unless litigation arises. A trustee's petition for instructions, being a species of litigation, is public business. Furthermore, quite apart from concerns about family privacy, commercial and regulatory considerations can sometimes make a transaction so sensitive that premature public disclosure would impair or kill the deal.

Litigation also takes time: for notice to beneficiaries; for the appointment of a guardian ad litem in a case in which the interests of minor beneficiaries require it; for pretrial discovery; for party submissions; for hearing, deliberation, and decree; and, on occasion, for appellate review. It is often the case that a transactional opportunity (for example, an offer to purchase a trust-held asset such as a piece of real estate or a close corporation interest) will be too time bound to permit such delay.

The expense of advance-approval proceedings may also discourage a trustee from using the device. As an application of the duties of prudence and loyalty, a trustee operates under a duty of cost sensitivity when incurring expenses of any sort.¹⁹³ For transactions of smaller value, the cost of instruction proceedings would outweigh the gain.

189. *E.g.*, *In re Estate of Klein v. Ware*, 229 N.W.2d 753, 755 (Iowa 1975) (claiming that "no loss was occasioned" by executors' court-approved purchase of estate property at court-conducted auction).

190. Regarding the higher standard of care of the professional trustee, see *supra* note 96.

191. See *supra* text accompanying notes 49-50.

192. See A. James Casner, *Estate Planning—Avoidance of Probate*, 60 COLUM. L. REV. 108, 123-24 (1960).

193. See RESTATEMENT (SECOND) OF TRUSTS § 188 & cmt. f (identifying duty to limit trust expenses to those "necessary or appropriate to carry out the purposes of the trust"); accord UNIF. TRUST CODE § 805 (2000), 7C U.L.A. 234 (Supp. 2004) ("[T]he trustee may incur only costs that are reasonable in relation to the trust property, the purposes of the trust, and the skills of the

B. *Attrition: The Burgeoning of Categorical Exceptions*

Across the twentieth century courts and legislatures have been whittling away at the scope of the sole interest rule, creating an ever-growing set of exceptions to the rule. These categorical exceptions invite comparison with the technique of advance judicial approval just discussed, which also limits the reach of the sole interest rule. Judicial approval is case specific and requires litigation to establish to the satisfaction of the court that the particular transaction is indeed in “the best interest of the beneficiary.”¹⁹⁴ The categorical exceptions, by contrast, represent legislative or judicial determinations that a class of conflict-of-interest transactions is so likely to be beneficial to the beneficiary that the sole interest rule should be abrogated without case-specific advance approval.

Under the categorical exceptions the duty of loyalty abides, and the trustee, even though conflicted, continues to be obliged to act in the best interest of the beneficiary in exercising the power to engage in such a transaction.¹⁹⁵ What these doctrines achieve, therefore, is to replace the “no further inquiry” rule with a standard allowing inquiry into whether a conflict-tinged transaction was undertaken in the best interest of the beneficiary.

1. *Financial Services*

Several of the exceptions are measures that enable institutional trustees to provide financial services for trust accounts. These exceptions reflect the trend across the twentieth century to locate trusteeship services within large organizations that provide a variety of other financial services, such as banking, brokerage, investment advising, and the sponsoring or servicing of mutual funds. Integration and consolidation of such services for trust accounts can result in economies of scale and other synergies that work to the advantage of the trust beneficiary, but there is also a dimension of self-interest on the part of the providers of these financial services. Integrated financial service firms are not charities; they derive fee income from their services. Ordinarily, the more services the provider supplies to a trust account, the greater the fee income.

trustee.”); UNIF. PRUDENT INVESTOR ACT § 7 (1994), 7B U.L.A. 301 (2000) (applying the same rule to “investing and managing” trust assets).

194. RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. f.

195. For example, the official comment to the Uniform Trust Code provision allowing the trustee to invest in an affiliated mutual fund, discussed *infra* note 234, emphasizes that the measure “does not otherwise waive or lessen a trustee’s fiduciary obligations. The trustee, in deciding whether to invest in a mutual fund, must not place its own interests ahead of those of the beneficiaries.” UNIF. TRUST CODE § 802(f) cmt., 7C U.L.A. 231 (Supp.).

Were the sole interest rule to apply unabated, it would prevent such firms from deploying their full range of services for their trust accounts, even though “horizontal disintegration means lost economies of scope and higher prices.”¹⁹⁶ In response, legislation and case law have developed categorical exceptions to permit various of these overlaps. The exceptions are premised on the notion that the trust beneficiary will be better off if the law promotes the mutual advantage of trustee and beneficiary, in the fashion of other commercial relationships, than if it insists that only the beneficiary can benefit.

a. *Self-Deposit*

Does Citicorp, when serving as trustee, have to do the trust’s banking at the Chase? If so, the trustee is put to nuisance¹⁹⁷ and expense, which will be reflected in the cost of trust administration. Nevertheless, because self-deposit would violate the sole interest rule, a “corporate trustee is affected by conflicting interests in choosing a bank for deposit for trust funds if it may consider its own commercial department.”¹⁹⁸ Likewise, because a demand deposit creates a form of debt, the trustee would effectively be borrowing money from the trust account, in violation of the branch of the sole interest rule that forbids the trustee to “use trust money in his business[] or lend trust money to himself.”¹⁹⁹ Thus, the *Restatement (Second)* still treats self-deposit as “a breach of trust,” because the trustee is “dealing as an individual [that is, in its commercial department] with itself as a trustee.”²⁰⁰ The path of the future was, however, already visible to the *Restatement* writers, who observed that in some states legislation authorized self-deposit.²⁰¹ Indeed, back in the 1930s in the deliberations that led to the *Restatement (First)*, there was considerable support for allowing self-deposit, subject to the trustee’s duty to determine that such a deposit was in the best interest of the beneficiary.²⁰² The Uniform Trust Code now follows

196. Easterbrook & Fischel, *supra* note 116, at 428 (discussing the consequences of forcing a separation of brokerage and trading activities).

197. Bogert speaks of the “great convenience in corporate trust administration in allowing deposits to be made within a single institution.” BOGERT & BOGERT, *supra* note 2, § 543(K), at 359.

198. *Id.* § 543(K), at 356.

199. RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. *l.* Scott collects extensive case law supporting the proposition that “[a] trustee cannot properly lend trust funds to himself.” 2A SCOTT & FRATCHER, *supra* note 2, § 170.17, at 385 & n.6.

200. RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. *m.*

201. *Id.* Scott collects statutory citations. 2A SCOTT & FRATCHER, *supra* note 2, § 170.18, at 394-97 nn.11-15.

202. According to Scott, who served as the reporter, those who favored departing from the sole interest rule wished to allow self-deposit when “under all the circumstances it was reasonable and prudent to make the deposit,” but not when “the trust company did not act for the interest of

the trend of the state legislation and exempts from the sole interest rule the “deposit of trust money in a regulated financial-service institution operated by the trustee.”²⁰³ The effect of such legislation is to prefer the best interest of the beneficiary over the sole interest rule.

b. *Pooled Investment Vehicles*

Across the twentieth century the trust developed its characteristic modern form as a management regime for a portfolio of financial assets,²⁰⁴ often professionally administered by a bank trust department or other institutional trustee. As diversification came to be a central precept of modern investment practice,²⁰⁵ trust law absorbed it into fiduciary obligation. The duty to diversify trust investments appeared in the later nineteenth century²⁰⁶ and was recognized in the *Restatement (First)*.²⁰⁷ In 1992 the *Restatement (Third)* revised the standards for trust investment to intensify the duty to diversify.²⁰⁸ The Uniform Prudent Investor Act of 1994, which codifies the duty,²⁰⁹ is in force in forty states;²¹⁰ there are nonuniform variants in most of the rest. Because a trust fund rarely contains sufficient assets “to diversify thoroughly by constructing its own portfolio of individually selected investments,”²¹¹ the Act promotes the use of pooled investment vehicles, which “have become the main mechanism for facilitating diversification for the investment needs of smaller trusts.”²¹²

the beneficiaries in making the deposit,” for example, if the bank were known to be in danger of failing, or if the trustee “left the money on deposit for an unreasonably long time.” 2A SCOTT & FRATCHER, *supra* note 2, § 170.18, at 392 (discussing RESTATEMENT OF TRUSTS § 165 cmt. m (Proposed Final Draft 1935)). In more recent times, the advent of federal insurance for bank deposits has reduced the risk of loss in such cases. Furthermore, with the spread of interest-bearing demand-deposit accounts and money market funds, the fiduciary duty to make even short-term funds productive has largely eliminated the danger that a self-serving trustee might deposit trust funds in non-interest-bearing demand accounts in order to skim the forgone interest. That danger was still acute a generation ago. See EDWARD S. HERMAN, CONFLICTS OF INTEREST: COMMERCIAL BANK TRUST DEPARTMENTS 107-21 (1975) (discussing uninvested trust cash).

203. UNIF. TRUST CODE § 802(h)(4) (2000), 7C U.L.A. 230 (Supp. 2004). By regulation, the Comptroller of the Currency permits national banks to engage in self-deposit of fiduciary funds when state or other governing law permits. 12 C.F.R. § 9.10(b) (2004).

204. See *supra* text accompanying notes 41-46.

205. Regarding the large and costless gains resulting from diversification, see John H. Langbein, *Mandatory Rules in the Law of Trusts*, 98 NW. U. L. REV. 1105, 1112-15 (2004); and John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 649 (1996) [hereinafter Langbein, *Investing*].

206. See, e.g., *In re Dickinson*, 25 N.E. 99 (Mass. 1890).

207. RESTATEMENT OF TRUSTS § 228 (1935).

208. RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227(b) (1992).

209. UNIF. PRUDENT INVESTOR ACT § 3 (1994), 7B U.L.A. 296 (2000) (providing that a “trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying”).

210. 7B U.L.A. 84 (Supp. 2004) (enactment table).

211. UNIF. PRUDENT INVESTOR ACT § 3 cmt., 7B U.L.A. 297 (2000).

212. *Id.*

Three main pooling devices emerged in the practice of institutional trustees, more or less in succession: the mortgage participation, the common trust fund, and the mutual fund.

Mortgage participations. In the early decades of the twentieth century, when the well-secured first mortgage was still the prototypical trust investment,²¹³ institutional trustees developed the technique of dividing a mortgage into pieces, certificating the pieces (which are called mortgage participations), and allocating them as investments among several trusts.²¹⁴ This practice enabled each trust to diversify the risks of mortgage investing (default risk; maturity or interest rate risk), by spreading the funds available across different mortgage investments. Mortgage participations are no longer common because superior forms of diversifying mortgage investments, such as mortgage-backed securities, have come to prevail.²¹⁵

Although the mortgage participation was developed to benefit trust beneficiaries, the mechanism had overtones of trustee self-dealing. Typically, the trustee had to make the mortgage loan for its own account before it could divide the investment into smaller shares for its trust accounts. The trustee then sold the participation certificates from its own account to the several trusts. The question arose “whether this is not in effect a sale of its individual property to itself as trustee,”²¹⁶ hence in violation of the branch of the sole interest rule that forbids a trustee from selling its own property to the trust.²¹⁷ Under the sole interest rule, “[i]t is immaterial that the trustee acts in good faith”²¹⁸ when selling its own property to the trust, nor is it a defense that the consideration is fair.²¹⁹ Thus, a trust’s investment in such a mortgage participation would have been voidable by the beneficiary. Were a default to occur, or some other event that caused the investment to fall in value through no fault of the trustee, the beneficiary would have had the option to disaffirm the transaction, forcing the trustee to bear the loss. Had trustees been exposed to that risk, they would have ceased to arrange mortgage participations (or charged more for the service, having been transformed into mortgage insurers), which would have left trust beneficiaries worse off as a class.

213. This practice is discussed in Langbein, *Investing*, *supra* note 205, at 643-44.

214. *See, e.g.*, BOGERT & BOGERT, *supra* note 2, § 543(F), at 327-29; 2A SCOTT & FRATCHER, *supra* note 2, § 170.14, at 364-66.

215. Regarding the principal modern variety, the collateralized mortgage obligation (CMO), see Chris Ames & Jeffrey K. Mudrick, Lehman Bros., *Collateralized Mortgage Obligations*, in THE HANDBOOK OF FIXED INCOME SECURITIES 619 (Frank J. Fabozzi ed., 6th ed. 2001). The authors report that \$111 billion in mortgage-backed securities was outstanding at year-end 1980, \$2.2 trillion at year-end 1999. *Id.* at 619.

216. 2A SCOTT & FRATCHER, *supra* note 2, § 170.14, at 365.

217. RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. h (1959).

218. *Id.*

219. *Id.*

When such cases were brought, however, the courts mostly refused to apply the sole interest rule.²²⁰ The courts looked at the merits of this mode of trust investing and preferred the trust beneficiary's best interest over his or her sole interest. The cases sometimes say that the trustee did not profit from the transaction, when there was no markup or transactional fee on the sale into the trust,²²¹ but that excuse does not confront the incentives of the trust business. An institutional trustee that develops a reputation for investment success in its trust accounts has a competitive advantage over rivals and a basis for pricing its trust services more aggressively (within the limits of the reasonableness norm²²²). Moreover, once the bank made a mortgage investment, because the bank was at risk until it allocated all the interests into its trust accounts, it had an incentive to place those interests, which was potentially adverse to the trust accounts into which it assigned them. The real explanation for allowing the conflict is that *ex ante* the trust beneficiary was better off even though the trustee was conflicted. Mutual benefit was better than allowing the sole interest rule to prevent this class of transaction.

Common trust funds. The characteristic pooling device for trust investing in the middle decades²²³ of the twentieth century was the common trust fund, a sort of in-house mutual fund operated by the trustee for investing smaller trust accounts.

Legislation was needed to validate these funds because the pooling mechanism conflicted with the rule forbidding the trustee from commingling trust assets, either with the trustee's personal assets or with the assets of other trusts.²²⁴ The rule against commingling reinforces the duty of loyalty, by denying the trustee the opportunity to favor the trustee's own account over that of the trust—for example, by subsequently allocating winning investments to the trustee's personal account and losers to the trust. Similarly, the rule against commingling multiple trust accounts means to preclude the trustee from playing favorites among them.

220. Cases are collected in BOGERT & BOGERT, *supra* note 2, § 543(F), at 328 n.11; and 2A SCOTT & FRATCHER, *supra* note 2, § 170.14, at 365 n.3.

221. *E.g.*, First Nat'l Bank of Birmingham v. Basham, 191 So. 873 (Ala. 1939); *In re Nuese's Estate*, 96 A.2d 298 (N.J. Super. Ct. Prob. Div. 1953), *aff'd*, 104 A.2d 281 (N.J. 1954); accord BOGERT & BOGERT, *supra* note 2, § 543(F), at 327 ("The bank or trust company obtains no profit from the sale.").

222. *See supra* note 35; *infra* note 252.

223. "The first common trust fund was organized in 1927, and such funds were expressly authorized by the Federal Reserve Board" in regulations promulgated in 1937. *Inv. Co. Inst. v. Camp*, 401 U.S. 617, 624 (1971). Following a trickle of common trust fund activity in the 1930s, the Internal Revenue Code was amended in 1936 to exempt such funds from entity-level taxation. James J. Saxon & Dean E. Miller, *Common Trust Funds*, 53 GEO. L.J. 994, 995-1006 (1965). The exemption is now codified at I.R.C. § 584(b).

224. RESTATEMENT (SECOND) OF TRUSTS § 179 & cmts. a-c; accord UNIF. TRUST CODE § 810(b)-(c) (2000), 7C U.L.A. 237 (Supp. 2004).

The Uniform Common Trust Fund Act,²²⁵ which is widely adopted,²²⁶ as well as comparable nonuniform legislation in other states, overcomes the rule against commingling. The official comment to the Uniform Act explains that “a common trust fund cannot legally be operated without statutory sanction, because its operation involves a mixture of trust funds.”²²⁷ The Act authorizes a trust company to “establish common trust funds for the purpose of furnishing investments to itself as fiduciary.”²²⁸ The drafters point to “the great utility of these common trust funds,”²²⁹ which is to say, the benefit to trust beneficiaries. Once again, trust law was altered to prefer best interest over sole interest.

*Mutual funds.*²³⁰ Over the past quarter-century, mutual funds have been supplanting common trust funds as the pooling vehicle of choice for trust investing. Mutual funds have significant advantages over common trust funds,²³¹ and in 1996 Congress facilitated the spread of mutual funds for trust investing by allowing tax-free conversion of existing common trust funds to mutual funds.²³²

225. UNIF. COMMON TRUST FUND ACT (1938), 7 U.L.A. pt. II, at 183 (2002).

226. In thirty-four states and the District of Columbia. *See* 7 U.L.A. pt. II, at 175.

227. *Id.* prefatory note, 7 U.L.A. pt. II, at 176.

228. *Id.* § 1, 7 U.L.A. pt. II, at 183.

229. *Id.* prefatory note, 7 U.L.A. pt II, at 176.

230. In an Article devoted to conflicts of interest, I should disclose that I have served episodically as a consultant to a large mutual fund organization on various fiduciary investing issues. I had no role in the drafting or enactment of the state mutual fund statutes discussed *infra* text accompanying note 233. As a Uniform Law Commissioner and member of the drafting committee for the Uniform Trust Code, I participated in the drafting of section 802(f), which codified the state statutes.

231. Among them:

(1) The mutual fund allows both fiduciary and nonfiduciary accounts to be pooled in the same fund, which enables mutual funds to be larger than common trust funds, hence to enjoy greater diversification and economies of scale. Bank common trust funds are limited to fiduciary accounts. *See* 12 C.F.R. § 9.18(a)(1) (2004).

(2) The vastly greater size of the mutual fund industry results in an array of fund types that are more varied than those characteristic of common trust funds, permitting a trustee to achieve more precise asset allocation for the trust portfolio.

(3) Open-end mutual funds are priced daily and are commonly quoted in the financial press and on the electronic services, which promotes transparency for beneficiaries and others.

(4) The mutual fund has a material tax advantage when the trustee makes distributions to beneficiaries. Mutual fund shares may be distributed in kind (that is, in shares of the mutual fund); distributions from a common trust fund must be liquidated when distributed, which triggers the recognition and taxation of any gains. I.R.C. § 584(e) (2000).

(5) In some states, especially New York, common trust funds are required to undergo periodic judicial accountings, a form of make-work that provides ample opportunity for the court to appoint politically well-connected guardians ad litem to litigate imaginary grievances at the expense of the fund and its underlying trust beneficiaries. *See* N.Y. BANKING LAW § 100-c(6) (McKinney 2001). Litigation under the New York statute gave rise to the leading American constitutional case on personal jurisdiction and notice, *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306 (1950).

232. *See* I.R.C. § 584(h).

Investing trust proceeds in a mutual fund operated and serviced entirely by entities unrelated to the trustee—for example, Morgan Stanley as trustee investing trust accounts in Vanguard funds—raises no loyalty concern. When, however, the trustee invests trust proceeds in mutual funds operated or serviced by an entity that is commercially affiliated with the trust company (Morgan Stanley as trustee investing trust accounts in Morgan Stanley-sponsored mutual funds), the sole interest rule is implicated. Accordingly, legislation has been required to validate the use of affiliated mutual funds. Without legislative authorization, the sole interest rule would have confronted the trustee with a choice between forgoing the advantages of mutual fund investing, or else abandoning to outsiders the traditional trustee's responsibility for conducting investment.

Virtually all states have intervened to exempt affiliated mutual funds from the sole interest rule,²³³ and the Uniform Trust Code has now codified the exception. Section 802(f) provides that a trustee's investment in such a mutual fund "is not presumed to be affected by a conflict between [the trustee's] personal and fiduciary interests," although the trustee is still subject to the norms of prudent investing.²³⁴ The official comment points out that the duty of loyalty still requires that the trustee "not place its own interests ahead of those of the beneficiaries."²³⁵ Thus, even though the statute eliminates the sole interest rule, the trustee still has the duty to act in the best interest of the beneficiary when deciding whether to use affiliated funds. Although the trustee derives fee income both from the mutual fund and the trust, the trustee's duty of cost sensitivity²³⁶ requires that the aggregate expenses be appropriate and reasonable. The duty of monitoring²³⁷ incident to the use of pooled investment vehicles requires constant attention to the costs and the comparative performance of competing funds.²³⁸ Accordingly, fiduciary obligation still suffuses the use of affiliated mutual funds.

233. *E.g.*, CAL. PROB. CODE § 16015 (West 1991); 760 ILL. COMP. STAT. 5/5.2 (2004); N.Y. EST. POWERS & TRUSTS LAW § 11-2.2(6) (McKinney 2001). The drafters of the Uniform Trust Code noted in 2000 that "[n]early all of the states have enacted statutes authorizing trustees to invest in funds from which the trustee might derive additional compensation." UNIF. TRUST CODE § 802(f) cmt. (2000), 7C U.L.A. 229 (Supp. 2004).

234. UNIF. TRUST CODE § 802(f), 7C U.L.A. 229 (Supp.). The measure also requires regular annual disclosure to trust beneficiaries of certain compensation arrangements between trustee and mutual fund.

235. *Id.* cmt.

236. *See supra* text accompanying note 193.

237. UNIF. PRUDENT INVESTOR ACT § 9(a)(3) (1994), 7B U.L.A. 303 (2000).

238. The *Restatement of Trusts*, which was revised in 1992 to address the spread of investment practices based on modern portfolio theory, emphasizes that "[c]oncerns over sales charges, compensation, and other charges are not an obstacle to a reasonable course of action using mutual funds and other pooling arrangements, but they do require . . . trustees to make careful cost comparisons, particularly among similar products of a specific type being considered for a trust portfolio." RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 cmt. m (1992); *see also* UNIF. PRUDENT INVESTOR ACT § 9 cmt., 7B U.L.A. 306 (cautioning that

The ostensible judgment that underlies the statutes authorizing the trustee to use affiliated funds is that the beneficiaries are likely to be better off with the trustee investing the trust in mutual funds rather than constructing a less diversified portfolio of individual securities. Prohibiting affiliated providers would discourage that trend by requiring a trustee who wished to use mutual funds to delegate the investment function to outsiders, even though the settlor chose the trustee for that function as well as the other aspects of the trusteeship. Furthermore, prohibiting the use of affiliated funds would interfere with the ability of the trustee or financial services provider to achieve economies of scale and integration of function. The legislative judgment is that although the trustee's parent firm may benefit from enhanced fee income, allowing the use of affiliated funds promotes the best interest of the beneficiary. Again, best interest prevails over sole interest.

It is possible to take a dimmer view of the merits of trustee-provided mutual funds, by supposing that the authorizing legislation reflects the success of a powerful interest group in using the political process to secure self-serving advantage. On this view, the authorizing statutes constitute an unprincipled special interest incursion into the protective zone of the sole interest rule, hence they are an embarrassment rather than part of a welcome trend.²³⁹

There is no doubt that the financial services industry promoted the authorizing legislation and has benefited from the resulting fee income. The question is whether that is a sufficient explanation for the enactment of the statutes. The difficulty with that account is that it does not explain why this particular abridgement of the sole interest rule has prevailed so widely, whereas other rules of trust law adverse to the interests of institutional fiduciaries remain in full force, for example, the higher standard of care for professionals,²⁴⁰ the capital requirements for trust banks,²⁴¹ or the recent spread of punitive damages in trust matters.²⁴² Institutional trustees do not own state legislatures.

“[t]he trustee must be alert to protect the beneficiary from ‘double dipping,’” and hence that when “the trustee’s regular compensation schedule presupposes that the trustee will conduct the investment management function, it should ordinarily follow that the trustee will lower its fee when delegating the investment function to an outside manager”).

239. Clark examines and dismisses similar arguments about the movement away from the sole interest rule in the law of corporations. See CLARK, *supra* note 146, § 5.1, at 162-64 (discussing “managerial influence theory” and “lawyers’ influence theory”).

240. See RESTATEMENT (SECOND) OF TRUSTS § 174 (1959). The Uniform Trust Code codified the rule in section 806 without a peep from the industry.

241. *E.g.*, CAL. FIN. CODE § 1540 (West 1999) (requiring a security deposit with the state treasurer); 205 ILL. COMP. STAT. 620/2-7 (2004) (requiring the commissioner to set minimum capital requirements).

242. In the mid-1970s, there was scant authority for punitive damages in trust matters, but punitive damages have since spread to many states. The point is discussed in the majority opinion

It is also noteworthy that, in administering ERISA fiduciary law, the Department of Labor, which is not subject to the influence of the financial services industry to the extent that state legislators are, has followed a similar policy. Since 1977 the Department has exempted from ERISA's prohibited-transactions regime plan transactions in mutual fund shares in which the fund's investment advisor is also a fiduciary of the ERISA-covered plan.²⁴³ Another reason for thinking that the statutes authorizing the use of affiliated mutual funds are understood to be advantageous to beneficiaries as well as trustees is that there has been no trend of which I am aware among trust drafters to countermand the default regime of the statutes.

Accordingly, the spread of authorizing legislation for affiliated mutual funds instances more than mere trust company self-interest. The providers' version of the events, which I regard as persuasive, is that their easy victory on affiliated mutual funds reflects easy merits. Once the advantages of mutual funds over other forms of pooled investment became manifest, the legislatures had no option consistent with the interests of trust beneficiaries other than to facilitate the spread of the affiliated mutual fund, unless they were prepared to order a divorce between trust administration and trust investment that has never before characterized the trust industry.

2. *Professional Services*

I have previously directed attention to the most pervasive of the exceptions to the sole interest rule, the American rule allowing reasonable trustee compensation.²⁴⁴ Only by allowing compensation has it been possible to create and deliver to trust beneficiaries the professional skills and financial resources of the modern trust industry. The rationale for the American rule is that the trust beneficiary is better off by allowing the trustee to profit in this way from the trust, contrary to the insistence of the sole interest rule that the trustee have no financial interest in the trust.

The incentives of trustee compensation are not always aligned with the interest of the trust beneficiary. Every fee increase comes at the expense of the beneficiary. A trustee's interest in perpetuating fee income may on occasion affect decisions about whether to make discretionary distributions (which, by diminishing assets under management, erode the base upon which most fee schedules are set) or whether to resist a beneficiary's effort

in *Mertens v. Hewitt Associates*, 508 U.S. 248, 257 n.7 (1993), as well as in the dissenting opinion, *id.* at 270-72 & n.6 (White, J., dissenting). See generally Jay M. Zitter, Annotation, *Punitive Damages: Power of Equity Court To Award*, 58 A.L.R.4TH 844 (1987 & Supp. 2004).

243. See Donald J. Myers & Michael B. Richman, *Class Exemptions from Prohibited Transactions*, in ERISA FIDUCIARY LAW 267, 287-90 (Susan P. Serota ed., 1995) (discussing Prohibited Transaction Exemption 77-4, 42 Fed. Reg. 18,732 (Apr. 8, 1977)).

244. See *supra* text accompanying notes 35-47.

to change trustees or to terminate a trust. Nevertheless, the American rule is premised on the view that the interest of trust beneficiaries as a class in obtaining the benefits of compensated trust services will more often be served by allowing the intrinsic conflict. The function of the reasonableness standard is to limit compensation to an amount that bears an appropriate relationship to the best interest of the beneficiary.²⁴⁵

The American rule allowing trustee compensation has been extended beyond core trustee functions to a variety of settings in which the trustee is allowed to obtain extra compensation for nontraditional services, for example, when the trustee also serves as an executor, lawyer, real estate agent, or insurance agent. This application of the American rule is in some tension with the basic anti-kickback rule, which also derives from the duty of loyalty. The *Restatement (Second)* version provides: "The trustee violates his duty to the beneficiary if he accepts for himself from a third person any bonus or commission for any act done by him in connection with the administration of the trust."²⁴⁶ Thus, a trustee who is also an insurance agent and receives from the insurer "a commission for placing the insurance . . . is accountable for the commission."²⁴⁷ Were the agent allowed to keep it, "he would be tempted to place the insurance with the company which employs him, even though that might not be for the best interest of the beneficiary."²⁴⁸

When, however, the trust itself, as opposed to an outside transactional party, pays the trustee a commission or other extra compensation, American law mostly reverses course and allows the trustee to collect. "[A] trustee who renders professional or other services not usually rendered by trustees in the administration of the trust, as for example services as attorney or as real estate agent, may be awarded extra compensation for such services."²⁴⁹ Because, however, the trustee's temptation to hire himself or herself, "even though that might not be for the best interest of the

245. For that reason the rule has developed that the court has discretion to reduce or deny compensation to a trustee who has committed a breach of trust. RESTATEMENT (SECOND) OF TRUSTS § 243. The official comment explains that such a "reduction or denial is not in the nature of an additional penalty for the breach of trust but is based upon the fact that the trustee has not rendered or has not properly rendered the services for which compensation is given." *Id.* cmt. a. The trustee who has not delivered benefit does not get paid.

246. *Id.* § 170(1) cmt. o.

247. *Id.*

248. *Id.* For supporting case law, see 2A SCOTT & FRATCHER, *supra* note 2, § 170.22, at 416 & n.5.

249. RESTATEMENT (SECOND) OF TRUSTS § 242 cmt. d; *see also id.* § 170(1) cmt. o (authorizing "a trustee to receive compensation as an officer of a corporation, shares of which he holds in trust, even though the shares represent a controlling interest in the corporation, if he performs necessary services as such officer, and receives no more than proper compensation for such services").

beneficiary,”²⁵⁰ is no different depending on whether the commission is paid by the trust or by a third party, the question arises of why the two situations are treated oppositely. The longstanding concern about concealment of improper payments, discussed above,²⁵¹ may motivate some suspicion of commissions paid by third parties, who do not operate under fiduciary duties of recordkeeping and disclosure. Likewise, under the rule allowing the trustee extra compensation from the trust for extra services, the trustee operates under the fiduciary duty of reasonableness in claiming or setting such extra compensation,²⁵² in contrast to a third-party transactional payor who is not a fiduciary for the trust.

The tenuousness of these distinctions may provide grounds for questioning some applications of the ban on payments from third parties, but the rule allowing extra compensation for trustee-provided professional services rests on a firm footing, resembling strongly the rationale for allowing an institutional trustee to supply its own compensated financial services: Integration promotes economies of scale and other synergies. The sheer informational advantage possessed by a trustee or executor who has already mastered the affairs of the trust or estate for purposes of routine administration often makes that person better suited than a newcomer to provide legal, accounting, real estate brokerage, or other needed services.

Bogert’s treatise is hostile to the rule allowing the trustee to receive extra compensation, fearing that the trustee “may be tempted to employ himself for special duties when there is no real need and to exaggerate the value of the work he performs.”²⁵³ Bogert would prefer to treat such payments as violations of the sole interest rule, hence voidable at the option of the trust beneficiary.²⁵⁴ But Bogert leaves unmentioned the argument from mutual advantage that has prevailed in these cases, that the benefits of allowing the trustee to be the service provider outweigh the dangers. Scott’s treatise, on the other hand, has been more sensitive to the rationale for the exception.²⁵⁵

3. *Affiliated Persons*

The Uniform Trustees’ Powers Act of 1964 began a legislative movement that has been strengthened in the Uniform Trust Code to soften

250. *Id.* § 170(1) cmt. o.

251. *See supra* text accompanying notes 61-67.

252. RESTATEMENT (SECOND) OF TRUSTS § 188 & cmt. f; *accord* UNIF. TRUST CODE § 805 (2000), 7C U.L.A. 234 (Supp. 2004); *see also* UNIF. PRUDENT INVESTOR ACT § 7 (1994), 7B U.L.A. 301 (2000).

253. BOGERT & BOGERT, *supra* note 2, § 543(M), at 362.

254. *Id.*

255. Scott finds “sufficient protection” for the trust in the court’s power to review extra compensation paid to the trustee. 3A SCOTT & FRATCHER, *supra* note 2, § 242.2, at 286.

the sole interest rule in its application to persons affiliated with the trustee. The 1964 Act authorizes the trustee “to employ persons, including attorneys, auditors, investment advisors, or agents, even if they are associated with the trustee.”²⁵⁶ That provision reflects the judgment that the benefits to the beneficiaries from integrating these functions within a corporate fiduciary or other such institutional trustee justify allowing the work to be done in-house. The Uniform Trust Code resolves this tradeoff somewhat differently. Section 802(c) modifies the duty of loyalty when “an agent or attorney of the trustee,” or a corporation or other person “that owns a significant interest in the trustee,” transacts with trust property. Such a transaction is “presumed to be affected by a conflict between personal and fiduciary interests”;²⁵⁷ however, that presumption can, according to the Code’s official comment, be “rebutted if the trustee establishes that the transaction was not affected by a conflict between personal and fiduciary interests.”²⁵⁸ Yet again we see retreat from the sole interest rule in favor of a standard that recognizes circumstances in which the overlap of interest may benefit the beneficiary. In this instance, the suggested mechanism of accommodation, retaining the presumption of invalidity but making it rebuttable, is the solution that I would apply in all conflict cases.

4. *Intrafamilial Transactions*

Situations in which the trustee transacts with a family member instance yet another sphere in which the sole interest rule is commonly not applied. The case law has been divided on whether the sole interest rule should apply to a transaction with the trustee’s spouse,²⁵⁹ but in cases involving a transaction with a blood relative, the conflict is commonly exempted from the sole interest rule.²⁶⁰ “The majority of decisions accede to the view that the relationship is merely one factor to be considered. They hold for the fiduciary where the transaction is found to be fair”²⁶¹ Under the

256. UNIF. TRS.’ POWERS ACT § 3(24) (1964), 7C U.L.A. 402 (2000). The provision is criticized on conventional sole interest grounds in Hallgring, *supra* note 66, at 819-23.

257. UNIF. TRUST CODE § 802(c), 7C U.L.A. 229 (Supp. 2004). Some of the language of section 802(c) is said to derive from the Comptroller of the Currency’s regulations for national banks. See Karen E. Boxx, *Of Punctilios and Paybacks: The Duty of Loyalty Under the Uniform Trust Code*, 67 MO. L. REV. 279, 298-99 & nn.171-72 (2002) (citing 12 C.F.R. § 9.12 (2002), and UNIF. TRUST CODE § 802 cmt., 7C U.L.A. 230-32 (Supp.)). For case law support, see, for example, *Estate of Coulter*, 108 A.2d 681 (Pa. 1954) (sustaining a sale for fair consideration to persons who were officers of a bank of which the trustee was chairman).

258. UNIF. TRUST CODE § 802 cmt., 7C U.L.A. 230 (Supp.). That inquiry, the comment says, is likely to turn on “whether the consideration was fair.” *Id.*

259. See 2A SCOTT & FRATCHER, *supra* note 2, § 170.6, at 333-35 & nn.7-9.

260. See 2A *id.* § 170.6, at 334-35 & nn.10-11.

261. *Culbertson v. McCann*, 664 P.2d 388, 391 (Okla. 1983). In that case, involving a sale to the fiduciary’s sister, the court reasoned that although the “relation of affection between [siblings]

Uniform Trust Code, the presumption of invalidity in these cases involving a spouse or relative is rebuttable, not conclusive.²⁶² Thus, although there is potential conflict, the solution is inquiry, not the “no further inquiry” rule.

C. *Repairing the Rule*

In their totality, the exclusions and the categorical exemptions from the sole interest rule that I have just reviewed range so broadly across contemporary American trust administration that they make it increasingly fictional to continue to treat the sole interest rule as the baseline norm. Across vast swaths of trust practice, especially when professional trustees are serving, the sole interest rule no longer accurately describes our law and practice.²⁶³

1. *Best Interest*

Fixing²⁶⁴ the sole interest rule is not hard. Change the force of the presumption of invalidity that presently attaches to a conflicted transaction

. . . alone does not raise a presumption of fraud,” the transaction should be subjected to “closer scrutiny” but not “automatic prohibition.” *Id.*

262. See UNIF. TRUST CODE § 802(c)(1)-(2) & cmt., 7C U.L.A. 229 (Supp.).

263. Indeed, perhaps because modern trust practice now legitimates so many conflicts of interest under the doctrines of exclusion and exception previously discussed, awareness has declined that the “no further inquiry” rule pertains equally to conflict-of-interest cases as well as outright self-dealing. For example, two current law school casebooks misstate the point. See JOEL C. DOBRIS ET AL., *ESTATES AND TRUSTS: CASES AND MATERIALS* 1043 (2d ed. 2003) (claiming that the *Rothko* case, discussed *supra* note 168, demonstrates that “where self-dealing is not involved, . . . [t]here is no flat prohibition, but the fiduciary has the burden of showing that the transaction was completely fair to the beneficiaries”); JESSE DUKEMINIER & STANLEY M. JOHANSON, *WILLS, TRUSTS, AND ESTATES* 905 (6th ed. 2000) (distinguishing “self-dealing (to which the no-further-inquiry rule applies)” from conflict of interest). Authority explaining that the “no further inquiry” rule applies to both is cited *supra* text accompanying notes 5-8, 19-20, 218-219. Bogert’s treatise, which so strongly endorses the sole interest rule, see *supra* text accompanying notes 5, 9, 16, 19, links the spread of the exceptions to a trend that “in recent years the courts appear to have been more willing to consider all facts and circumstances before determining whether the trustee should be held liable for breach of his duty of loyalty,” BOGERT & BOGERT, *supra* note 2, § 543, at 248.

264. The suggestion is sometimes heard that there is nothing to fix, because the courts presently have the power to excuse the well-intentioned trustee who has committed an innocuous breach of the sole interest rule. A general dispensing power, that is, one not limited to loyalty issues, has long been part of English law. Section 61 of the Trustee Act of 1925 allows the court to relieve from liability a breaching trustee who “has acted honestly and reasonably, and ought fairly to be excused for the breach of trust and for omitting to obtain the directions of the court in the matter.” 15 & 16 Geo. 5, c. 19, § 61 (Eng.). There is scant American authority for such a doctrine, see 3 SCOTT & FRATCHER, *supra* note 2, § 205.2, at 249-50 nn.5-6, and the English courts have rarely applied their statutory authority apart from cases of good faith mistaken payment, see 3 *id.* § 205.2, at 249 n.4. “There is no reported English decision in which trustees have successfully relied upon section 61 to gain relief for breach of their core fiduciary obligations.” John Lowry & Rod Edmunds, *Excuses*, in *BREACH OF TRUST* 269, 290 (Peter Birks & Arianna Pretto eds., 2002). Neither in England nor in the United States have the courts invoked an excusing doctrine to trump the “no further inquiry” rule in such hardship cases as those

from conclusive to rebuttable. In place of “no further inquiry,” allow inquiry. Allow a trustee who is sued for a breach of the duty of loyalty to prove that the conflicted transaction was prudently undertaken in the best interest of the beneficiary. That step would recast the trust law duty of loyalty from the sole interest rule to the best interest rule. Precisely that step has now been taken in section 802(c) of the Uniform Trust Code, just discussed, regarding affiliated providers and intrafamilial transactions.

I have emphasized in this Article that the courts already have deep experience applying the best interest standard because that standard governs cases in which the trustee petitions for advance approval. “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.”²⁶⁵ If the presumption of invalidity arising under the sole interest rule were made rebuttable, a trustee who had not sought advance approval would be allowed to plead the same substantive standard by way of defense to an action alleging breach of the duty of loyalty—that is, the trustee would be allowed to prove that the conflict was in the best interest of the beneficiary.

Recognizing a best interest defense would have the effect of clarifying the duty of loyalty, identifying the primacy of the best interest standard. Recall that the present *Restatement (Second)* rule provides: “The trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary.”²⁶⁶ Allowing the defense would effectively rework the rule as follows:

discussed *supra* text accompanying notes 117-137. Moreover, the excusing power as exemplified in the English statute would be troublesome with respect to the duty of loyalty, because it is standardless—that is, it is not conditioned on the trustee having acted in the best interest of the beneficiary in a conflicted transaction. In that regard, comparison with the American excusing doctrine for Wills Act execution errors, discussed *infra* text accompanying notes 282-288, is instructive. A court that excuses noncompliance with one of the Wills Act formal requirements must find that the defectively executed instrument fulfills the purpose of the Act. *See* RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 3.3 (1999) (requiring “clear and convincing evidence that the decedent adopted the document as his or her will”).

265. RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. f (1959).

266. *Id.* § 170(1). In the leading case applying ERISA’s duty of loyalty, Judge Friendly “accept[ed]” that “despite the words ‘sole’ and ‘exclusive’” in ERISA’s version of the duty, the conflicted persons whom the statute allows but does not require to be selected as the plan fiduciaries “do not violate their duties by following a course of action with respect to the [ERISA-covered] plan which benefits the corporation as well as the beneficiaries.” *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir. 1983). Rather, the ERISA duty should be read to allow such fiduciaries to “tak[e] action which, after careful and impartial investigation, they reasonably conclude best to promote the interests of [the ERISA plan’s] participants and beneficiaries, [even though the action] incidentally benefits the corporation or, indeed, themselves,” so long as they act “with an eye single to the interests of the participants and beneficiaries.” *Id.* Once again we see courts substituting best interest for sole interest. *United Steelworkers, Local 2116 v. Cyclops Corp.*, 860 F.2d 189, 200-01 (6th Cir. 1988).

(1) The trustee is under a duty to administer the trust in the best interest of the beneficiaries.

(2) A trustee who does not administer the trust in the sole interest of the beneficiaries is presumed not to have administered it in their best interest. The trustee may rebut the presumption by showing that a transaction not in the sole interest of the beneficiaries was prudently undertaken in the best interest of the beneficiaries.

By comparison with the sole interest rule, a best interest rule would more accurately identify the policy that the sole interest rule has been meant to serve. The better focused a rule is on its true purpose, the greater the likelihood that those who work with the rule (in this instance, trustees and their legal advisers and the courts) will apply the rule in a fashion that carries out the purpose.²⁶⁷

I have previously indicated why it would be appropriate to adjust the allocation of litigation expenses under this standard,²⁶⁸ to require the trustee to bear the reasonable expenses of a plaintiff beneficiary who contests a conflicted transaction, in circumstances in which the trustee could prudently have sought advance judicial instruction. I have also emphasized that the duty of loyalty is default law that the settlor may alter when creating the instrument.²⁶⁹ Accordingly, a settlor who preferred the sole interest rule could insist upon it.

2. *Proof*

The trustee asserting a best interest defense would bear the burden of proving it, echoing practice under the advance-approval doctrine and under those versions of the corporate rule that assign the burden of justifying fairness to the conflicted director who failed to seek and obtain advance approval.²⁷⁰ The fear has been voiced that inquiring into the merits of the transaction would require ventilating the allegedly subjective issue of what the trustee's motivations were.²⁷¹ Actually, most matters bearing on the trustee's motive for a transaction turn on objective criteria, for example, the need to raise proceeds for taxes or for distribution. It is true that the shift

267. The point stated in text presupposes, as almost all fiduciary lawyers would, that there is no merit to the suggestion that lack of clarity is a virtue in fiduciary law. To be sure, the contrary view has been voiced. Charles Black, for example, once asserted that "fiduciary obligation," among other concepts, has "been carefully isolated from exact definition, because such exact definition would simply point out safe ways of immunity." CHARLES L. BLACK, JR., *THE HUMANE IMAGINATION* 33 (1986). (I owe this reference to Dan Kahan.) The weakness in this reasoning is that concealing the true standard from the potential wrongdoer also conceals it from the conscientious fiduciary who is seeking to comply with it.

268. *See supra* text accompanying note 144.

269. *See supra* text accompanying note 169.

270. *See supra* text accompanying note 152.

271. Davis, *supra* note 18, at 26, 42-43.

from prospective to retrospective inquiry would, in the event of a transaction that did not work out well, raise the question of the trustee's knowledge at the time, on account of the anti-hindsight norm of trust law.²⁷² Even when an investment does not benefit the beneficiary, the trustee who prudently sought the best interest of the beneficiary would be protected. Although the prudence of the trustee's conduct is judged according to the circumstances pertaining at the time of the transaction, the standard is nevertheless objective, not subjective. The question is not simply whether the particular trustee thought that the transaction would benefit the beneficiary, but whether in the circumstances of the transaction a prudent trustee similarly situated would have thought that it would.²⁷³

Experience under the advance-approval doctrine strongly suggests that inquiring into the merits of a questioned transaction under the best interest standard would not present proof problems of particular intractability. In negotiated-sale transactions for real estate or family business interests (the two types of trust assets commonly involved in loyalty litigation), good practice calls for the involvement of outside professionals such as brokers, lenders, investment bankers, appraisers, and transactional counsel.²⁷⁴ A professional or professionally counseled trustee who had a reasonable basis for defending a loyalty case would typically have engaged such intermediaries and would be able to draw upon their evidence about the circumstances of the transaction, as well as the trustee's own testimony and transactional documents.

3. *Litigation Effects*

There is considerable reason for thinking that allowing a best interest defense in loyalty cases would not materially affect litigation levels. The altered rule would still leave the trustee who contemplates a conflicted transaction under the onerous burden of having to disprove the presumption of disloyalty, strongly discouraging such conduct. Trust law already exempts the quantitatively significant conflicts of interest, that is, trustee compensation and trustee-provided financial and professional services. For

272. That norm is exemplified for investment matters in the Uniform Prudent Investor Act, which provides: "Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight." UNIF. PRUDENT INVESTOR ACT § 8 (1994), 7B U.L.A. 302 (2000).

273. "A prudent trustee behaves as other trustees similarly situated would behave. The standard is, therefore, objective rather than subjective." *Id.* § 1 cmt., 7B U.L.A. 287.

274. *See, e.g., In re Green Charitable Trust*, 431 N.W.2d 492, 500 (Mich. Ct. App. 1988) (noting that a factor in "determining whether adequate efforts were taken" is consultation with local real estate brokers and appraisers and transactional counsel).

these classes of transactions, the legislatures and the courts have resolved to permit such conflicts in order to promote the best interests of beneficiaries.

I have emphasized that the trustee who acts under such a conflict still owes a fiduciary duty to the beneficiary to determine that the particular transaction is in the beneficiary's best interest.²⁷⁵ For example, the trustee who engages in self-deposit knowing that the bank is at risk of failing,²⁷⁶ or the trustee who invests trust proceeds in an affiliated mutual fund whose performance and expense ratios are persistently and materially unfavorable when compared to similar funds offered by competitors,²⁷⁷ still breaches the duties of loyalty and prudence, notwithstanding that the "no further inquiry" rule no longer pertains.²⁷⁸

a. *Amateurs*

It seems likely that the best interest defense would mostly be invoked by amateur trustees, persons too ignorant or ill advised to have known that advance approval was available.²⁷⁹ To be sure, as I have said,²⁸⁰ there would be cases in which even a well-counseled professional trustee would find it valuable to be able to undertake a conflicted transaction without advance approval, when the trustee determines that prudently evaluated factors of publicity, delay, or expense outweigh the benefits of advance approval. In general, however, the professional trustee, with its deep pockets always exposed, craves the security of a judicial decree and will avoid acting at its peril.

275. See *supra* text accompanying notes 195, 235-238.

276. E.g., *In re Culhane's Estate*, 256 N.W. 807 (Mich. 1934). Bogert points out that since the advent of federal deposit insurance, the risk of bank failure to small trust accounts has been largely transferred to the FDIC. BOGERT & BOGERT, *supra* note 2, § 598, at 486-87. Some states permit self-deposit only in an FDIC-insured bank. 2A SCOTT & FRATCHER, *supra* note 2, § 170.18, at 396-97.

277. The official comment to section 802(f) of the Uniform Trust Code notes that although the use of an affiliated mutual fund is "not automatically presumed to involve a conflict between the trustee's personal and fiduciary interests," the provision "does not otherwise waive or lessen a trustee's fiduciary obligations. The trustee, in deciding whether to invest in a mutual fund, must not place its own interests ahead of those of the beneficiaries." UNIF. TRUST CODE § 802(f) cmt. (2000), 7C U.L.A. 231 (Supp. 2004).

278. Cases in which bank trust departments are alleged to have converted common trust fund accounts into affiliated mutual funds without due regard for the interests of trust beneficiaries have led to class action litigation that has resulted in significant payments by the bank defendants. See "*Prepping and Broken Promises*" *Cost First Union \$23 Million*, TR. REG. NEWS, Oct. 2003, at 1 (discussing cases against Bank One and First Union).

279. I have also indicated above that the enhancements in trust recordkeeping and record retention are more characteristic of professional trustees than of amateurs. See *supra* text accompanying note 96. Deficient recordkeeping respecting a conflicted transaction would inevitably undermine the ability of any trustee, amateur as well as professional, to overcome the presumption of disloyalty that would continue to pertain under a best-interest-style loyalty rule.

280. See *supra* text accompanying notes 191-193.

Anglo-American trust law has made the fundamental policy decision to allow family members and other amateurs to serve as trustees—unlike, for example, in Japan, where trusteeship is restricted to a handful of regulated financial institutions.²⁸¹ In consequence, our legal system must reckon with trustees who make mistakes, including the mistake of not seeking advance approval for a conflicted transaction in circumstances in which competent counsel would recommend it. Under the sole interest rule, we consign that trustee to the mercies of the greediest beneficiary, by subjecting the transaction to rescission or surcharge on the beneficiary's demand, no matter how beneficial the transaction may have been. The best interest standard would make trusteeship less perilous for the amateur trustee who (commonly although not necessarily in ignorance of the often counterintuitive sole interest rule) prudently undertook a conflicted transaction for the benefit of the beneficiary.

b. *Incentives*

There is little reason to fear that the existence of a best interest defense would cause a trustee who was contemplating seeking advance approval of a conflicted transaction to refrain from doing so. Anticipatory 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 of whether the trustee's self-serving conduct was in the beneficiary's best interest.

By way of analogy, it is instructive to recall that a crucial consideration in the thinking that has led in recent years to the spread of a harmless error doctrine²⁸² for remedying Wills Act execution errors has been the understanding that reducing the force of the presumption of invalidity in those cases from conclusive to rebuttable would not affect incentives for due compliance. Because relief for harmless error still requires litigation, and because no testator sets out to throw his or her estate into avoidable litigation, the inference is compelling that remedying execution blunders does not encourage more of them. Anyone who knows that the harmless error doctrine exists knows enough not to want to rely upon it.²⁸³ Similar

281. Until 1985, only seven authorized trust banks were permitted to offer trust services. In recent years the system has been liberalized to permit foreign banks and some additional Japanese banks to serve. Makoto Arai & Koichi Kimura, *Financial Revolution and Trust Banks in Japan: Challenges in the Deregulation and Internationalisation Process*, 4 J. INT'L TR. & CORP. PLAN. 67 (1995).

282. E.g., UNIF. PROBATE CODE § 2-503 (1990), 8 U.L.A. pt. I, at 146 (1998); RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 3.3 (1999).

283. See John H. Langbein, *Substantial Compliance with the Wills Act*, 88 HARV. L. REV. 489, 524 (1975). On the absence of a litigation menace in Australia after more than a decade of experience with the reform, see John H. Langbein, *Excusing Harmless Errors in the Execution of*

reasoning underlies the movement to allow reformation of a mistake in the contents of a will.²⁸⁴

Another important insight that emerged from the movement to excuse harmless execution errors in the law of wills has been the understanding that softening a conclusive presumption that works injustice might actually reduce rather than increase litigation. The old rule requiring strict compliance with the Wills Act execution formalities was notoriously litigation breeding, both because it encouraged contestants to try to prove that harmless technical violations had occurred and because the courts were sometimes willing to stretch commonsense notions of what constituted literal compliance in sympathetic cases.²⁸⁵ When promulgating their versions of the harmless error rule, both the Uniform Law Commission and the American Law Institute pointed to the report of an Israeli judge, prepared for the British Columbia Law Reform Commission, which explained that the Israeli version of the harmless error rule had actually reduced litigation. The plaintiff loses the incentive to prove a merely technical defect because the court will validate the instrument anyhow.²⁸⁶

I would expect that litigation-reducing dynamic to carry over to the trust law duty of loyalty if the rule were modified to eliminate the present incentive to prove up harmless conflicts of interest. As with execution error, so with innocuous violations of the trust law duty of loyalty, a straightforward excusing doctrine would align the letter of the law with the underlying equities. That modification would eliminate much of the present temptation to bend the rules, exemplified in cases in which courts sustain the defense of implied settlor authorization even though the trust language hardly supports it.²⁸⁷

Wills: A Report on Australia's Tranquil Revolution in Probate Law, 87 COLUM. L. REV. 1, 37-41 (1987).

284. See RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 12.1 (allowing reformation). The reporter's notes canvass supporting decisional authority. *Id.* § 12.1 reporter's notes 2-4, 7-11. The effect of the reformation doctrine is to reduce from conclusive to rebuttable the inference that a will is complete and correct as written. The decision to allow reformation rests in part on the confident assumption that donors and their drafters will not be encouraged to become sloppy because litigation might thereafter succeed in persuading a court to restore a mistakenly omitted or misrendered devise.

285. This theme is developed in Melanie B. Leslie, *The Myth of Testamentary Freedom*, 38 ARIZ. L. REV. 235 (1996). I do not find Leslie persuasive in her suggestion that, because courts sometimes are responding to sympathetic equities when voiding a will for an error in complying with the execution formalities, the harmless error rule is misguided, *see id.* at 236-37, 258-68. For every case in which a court is able to manipulate the literal compliance standard to aid a sympathetic party (assuming that is desirable), there are dozens of cases (for example, in which attestation is missing in whole or in part) in which the old requirement of literal compliance strips the court of any ability to respond to sympathetic equities.

286. Letter from Judge I.S. Shiloh to the British Columbia Law Reform Commission (Oct. 18, 1979), *discussed in* RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 3.3 reporter's note 2; *see also* UNIF. PROBATE CODE § 2-503 cmt., 8 U.L.A. pt. I, at 147.

287. A notorious example is Holmes's opinion in *Turnbull v. Pomeroy*, 3 N.E. 15 (Mass. 1885). Another instructive example is *In re Steele's Estate*, 103 A.2d 409 (Pa. 1954).

c. *Clear and Convincing?*

In both the harmless error rule for Wills Act execution errors²⁸⁸ and in the reformation doctrine for mistaken contents in wills (and other donative instruments),²⁸⁹ a higher-than-ordinary standard of proof, the clear-and-convincing-evidence standard, has been imposed. The Supreme Court has observed that such a standard of proof “instruct[s] the factfinder concerning the degree of confidence our society thinks he should have in the correctness of factual conclusions for a particular type of adjudication.”²⁹⁰ A court or a legislature could conclude that a higher-than-ordinary standard should be imposed on a reformed trust law duty of loyalty, and thus require the trustee to prove by clear and convincing evidence that the conflicted transaction was prudently undertaken in the best interest of the beneficiary.

Against that suggestion are important grounds of distinction between the trust law sole interest rule and the settings in which the clear-and-convincing-evidence standard has been required. That standard has not been imposed in any of the excusing doctrines or the categorical exceptions to the sole interest rule reviewed above, nor has trust fiduciary law otherwise resorted to that standard in the past.²⁹¹ The particular circumstance to which the clear-and-convincing-evidence requirement responds in cases of execution error and mistaken content in wills is that the testator whose donative intent is in question is dead and unable to testify about what the intent really was. By contrast, the trustee who has violated the trust law sole interest rule in circumstances in which the purpose was to benefit the beneficiary will routinely be alive and able to testify about those circumstances.

CONCLUSION

Because the trust relationship places the beneficiary’s property under the control of the trustee, the danger inheres that the trustee will misappropriate the property for personal advantage. The duty of loyalty, which forbids that behavior, is an essential principle of trust fiduciary law.

288. RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 3.3; UNIF. PROBATE CODE § 2-503, 8 U.L.A. pt. I, at 146.

289. RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 12.1 & cmt. e.

290. *In re Winship*, 397 U.S. 358, 370 (1970) (Harlan, J., concurring).

291. The Uniform Trust Code requires clear and convincing evidence in only three settings: (1) to prove an oral trust, under section 407, as required in many states; (2) to reform mistaken terms in a trust, under section 415, which codifies the reformation doctrine of RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 12.1; and (3) to invoke the harmless error doctrine, under section 602(c), which enforces a settlor’s well-proven intent to revoke a trust even if the mode of revocation is not that called for by the terms of the trust instrument.

The question raised in this Article is not whether to retain the duty of loyalty but how best to formulate it. What is wrong with the duty as presently formulated in the sole interest rule is that it emphasizes a particular enforcement technique (avoiding all conflict or overlap of interest between trustee and trust property), as opposed to the underlying purpose that the technique is meant to serve, which is to maximize the beneficiary's best interest.

So long as there is no divergence between sole interest and best interest, and often there is none, nothing turns on the distinction. However, by refusing to allow the trustee to defend a particular conflict on the ground that it was prudently undertaken in the best interest of the beneficiaries, the sole interest rule conclusively presumes that all overlap or conflict of interest between trustee and trust entails misappropriation. I have explained in this Article why the law should allow inquiry into the merits of a trustee's defense that the conduct in question served the best interest of the beneficiary. In recommending that change, I have emphasized four profound historical changes over the past two centuries in the circumstances of trusteeship that have undermined the original premises of the sole interest rule:

(1) The revolution in civil procedure associated with fusion has provided trust-enforcing courts with an adequate system of fact-finding, casting doubt upon the early-nineteenth-century preference for prophylaxis over cure that is embodied in the sole interest rule. What previously had to be done by crude overdeterrence can now be done by rational inquiry into the circumstances of a transaction.

(2) As the trust has changed function, from a device for holding and transferring family real estate into its characteristic modern role as a management regime for a portfolio of financial assets, trusteeship has changed character. The gentleman amateur, serving as a matter of honor, with few duties, few powers, and no particular skills, has largely given way to the fee-paid professional, who brings managerial resources commensurate with the investment and administrative challenges of the modern trust.

(3) The professionalization of trust administration, together with the data processing revolution, has led to large improvements in trust recordkeeping and record retention. Those changes are now reflected in the standards of trust fiduciary law and are reinforced by an expanded duty of disclosure to the trust beneficiary. Thus, routine trust administration now greatly reduces the danger that so motivated the sole interest rule, the fear that without a prohibitory rule a conflicted trustee could easily conceal evidence of misappropriation.

(4) Professionalization has transformed trusteeship into a commercial relationship, now centered in the financial services industry, typically in

bank trust departments. Like any other professional services industry, the trust industry is based on patterns of mutual benefit that the sole interest paradigm does not accurately capture. Professional trustees do not serve for honor, they serve for hire; accordingly, they serve not in the sole interest of the beneficiary but also to make money for themselves and their shareholders. The first great breach in the sole interest rule was the American rule allowing reasonable compensation to trustees. Thereafter, pressure to allow the economies of integration associated with in-house financial services has resulted in case law and legislation further diminishing the scope of the sole interest rule, as evidenced in the exceptions for self-deposit on the trustee's banking side, for common trust funds, and now for affiliated mutual funds. What has driven these waves of reduction in the ambit of the sole interest rule is the realization that each advances the best interest of the beneficiary. In such circumstances, a rule recognizing mutual benefit is better than insisting upon the sole interest rule. Quite similar thinking underlies the movement to permit extra compensation for trustee-provided professional services.

The central thesis of this Article is that these great changes in the character and practice of modern trusteeship make the sole interest rule outmoded. The reform urged here is to allow a conflicted trustee to defend on the ground that the particular transaction was prudently undertaken in the best interest of the beneficiaries. Permitting this defense would effectively turn the sole interest rule into a best interest rule. I have explained that, procedurally, the way to implement the change is to reduce the presumption of wrongdoing that now attaches to a conflict-tinged transaction from conclusive to rebuttable, allowing the trustee to show that the conflict was harmless or beneficial.

This Article points to the successful experience that trust law has acquired in applying the best interest standard under the long-established advance-approval doctrine. When the trustee petitions the court to authorize a conflicted transaction, the court applies the best interest test. I have also emphasized the experience in the law of corporations, where the trust law sole interest rule has been abandoned in favor of the modern corporate regime for conflicted directors' transactions, under which mutually beneficial conflicts are permitted when evaluated under appropriate safeguards for the corporation. I have pointed to a variety of reasons for thinking that the reform would be unlikely to increase, and might in fact decrease, litigation levels about loyalty matters.

The sole interest rule works needless harm on trust beneficiaries and trustees. Cases like *Boardman v. Phipps* and doctrines such as the rule that the trustee cannot bid on trust property at a public auction deter trustee conduct that would be manifestly beneficial to the trust beneficiary, on the

ground that the law must inflict such harm in order to prevent trustees from misappropriating trust property in quite different cases. Allowing a best interest defense would cut back on the mischief worked under the sole interest rule while still maintaining the deterrent to trustee disloyalty. In a case such as *Boardman v. Phipps* or in the most embarrassing of the auction cases, the sole interest rule takes away a benefit from the trustee who earned it and awards it to the trust beneficiary. In these cases trust law works unjust enrichment, in ugly tension with the equity tradition of preventing unjust enrichment. Adjusting the duty of loyalty as suggested would eliminate that stain on our fundamentally sound tradition of encouraging faithful trusteeship.