



John H. Langbein on the Rise of the Management Trust / 52

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Rise of the Management Trust

During the past century, the trust changed from a means of holding and transferring land to a device for managing financial assets

Although the trust comes with a long historical pedigree, it has undergone a radical transformation in the past century. The core function of the trust has changed, giving rise both to the modern trust industry and to a profoundly altered legal regime that was necessary to support and govern the industry.

FROM CONVEYANCING TO FINANCIAL MANAGEMENT

The trust first developed for an age in which real estate was the principal form of wealth. We can trace the Lord Chancellor enforcing trusts (then called "uses") as far back as the 14th century. Until the later 17th century, the owner of freehold land was not allowed to pass the land by will and, thus, on the owner's death, the land had to descend by intestacy. The trust was a conveyancing device that defeated both the rigidities of intestacy (which still included primogeniture) and the burdensome taxes (called feudal incidents) that pertained when land passed on intestacy. The owner of land (the settlor) transferred the land to trustees to hold for the settlor for life and, on his death, to transfer the land to those survivors and in those shares specified in the terms of the trust. Then, as now, the trust served as a will substitute. In this way, landowners could use the trust "to make decent provision for their wives, daughters, and younger sons and

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to prevent escheat (when the landholder was not survived by descendants).¹

Late into the 19th century, the trust remained primarily a branch of the law of conveyancing. Early treatises on trusts—such as those by Geoffrey Gilbert (three editions from 1734 to 1811)² and Francis Sanders (five editions from 1791 to 1844)³—are completely devoted to land transfer and landed estates. These books are all but untouched by the law of fiduciary administration.

Today's trust has ceased to be a conveyancing device for land and has become, instead, a management device for holding a portfolio of financial assets.⁴ The management trust is a response to the radical change away from family real estate as the dominant form of personal wealth. As the jurist Roscoe Pound observed in an arresting epigram, "Wealth in a commercial age is made up largely of promises."⁵ Most modern wealth takes the form of financial assets: equities, bonds, mutual fund shares, insurance contracts, pension and annuity interests, and bank accounts. Today's trust typically holds a portfolio of these complex financial assets, which are contract rights against the issuers. Such a portfolio requires skilled and active management. Investment decisions must be made and monitored, the portfolio rebalanced and proxies voted. Unusual assets, such as close corporation or partnership interests, commonly require even more active and specialized administration. By contrast, under the old conveyancing trust that held ancestral land, the beneficiaries commonly lived on the land and managed it. The trustees were, in truth, more stakeholders than managers; they were, in effect, nominees, with no serious powers or duties.

FROM AMATEUR TO PROFESSIONAL TRUSTEESHIP

The transformation in the nature of wealth that led to the management trust brought about a parallel transformation in trusteeship.

Trustees of old were unpaid amateurs, that is, family and community statesmen who lent their names and honor to a conveyancing dodge. Writing in the last years of the 19th

century, the great legal scholar Frederic W. Maitland could still observe that "[a]lmost every well-to-do-man was a trustee."⁶

Private trustees still abound, but the prototypical modern trustee is the fee-paid professional whose business is to enter into and carry out trust agreements. These entities thrive on their expertise in investment management, trust accounting, taxation, regulation and fiduciary administration. Indeed, the founding of *Trusts & Estates* magazine 100 years ago, to serve trust professionals and their legal advisors, evidences the growth of the new profession that arose to conduct trust management. Amateurs do not need to read professional literature.

In the days when amateur trusteeship prevailed, and trustees had little to do, the rule was settled that they should serve without compensation (unless the settlor made special provisions for compensation in the terms of the trust). Sanders, the late-18th-century English treatise writer, explained: "[C]ourts 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."⁷ The rise of professional trust management made that rule untenable. American courts and legislatures led the way towards reversing the rule, substituting the modern standard of reasonable compensation.⁸ Today's characteristic trustee is a fee-paid professional service provider.

OVERCOMING TRUSTEE DISEMPOWERMENT

Another profound transformation that was essential to bring about the modern management trust was a reorientation in the way trust law went about the task of protecting trust beneficiaries. Because the trustee nominally owns the trust property, the trust relationship, by necessity, puts the beneficiaries of a trust at the peril of trustee misbehavior; a trustee could, for example, misappropriate or mismanage the trust's assets.

Protecting the beneficiary against those dangers has always been the central concern of trust law. In the early centuries of the trust, when

The modern trustee requires extensive discretion to meet changing market forces.

trustees were mostly stakeholders of ancestral land, it was relatively easy to keep them in check, simply by disabling them from doing much with the trust property. Thus, trust default law deliberately supplied no trustee powers. The trustee had only those powers that the trust instrument expressly granted, which were typically few, as the trustee's job was usually just to hold and convey to the remainderpersons. Stakeholder trustees did not need to transact. Joseph Story summarized American law in his treatise of 1836: "[T]he trustee has no right (unless express power is given) to change the nature of the estate, as by converting land into money, or money into land."⁵

Trustee disempowerment was, therefore, the original system of beneficiary safeguard in the law of trusts, and it worked well enough as long as trustees had nothing much to do beyond standing as nominee owners of family land. But when the portfolio of financial assets displaced family land as the characteristic form of family wealth held in trust, disempowerment became quite counterproductive. The modern trustee conducts a program of investing and managing financial assets that requires extensive discretion to respond to changing market forces.

Two great steps were needed to adapt trust law to the rise of the management trust: Disempowerment had to be abandoned, and a new system of beneficiary safeguard had to be devised.

Broad empowerment legislation, such as the Uniform Trustees' Powers Act (1964), is now widespread. Such statutes authorize trustees to engage in every conceivable transaction that might enhance the value of trust assets (and professionally drafted instruments commonly contain such powers). The Uniform Trust Code (2000) completes this development, reversing the common law rule and providing the trustee with "all powers over the trust property which an

unmarried competent owner has over individually owned property."¹⁰

THE RISE OF FIDUCIARY LAW

Equipping trustees with transactional powers was only half the job of adapting the law to the needs of the management trust. The other half was the development of a substitute system of beneficiary safeguard. Trustees with transactional powers necessarily have the power to abuse

Enhancing the management powers of trustees required the development of fiduciary law.

as well as to advance the interests of beneficiaries. To prevent abuse, trustees were subject to duties, protective in nature, which were elaborated into a new body of law that we now recognize as trust fiduciary law.

All trust fiduciary law rests on two core principles, the care norm (the duty of prudent administration) and the loyalty norm (the duty to administer the trust for the benefit of the beneficiary). The many subrules—for example, the duties to keep and disclose records; to collect, segregate, earmark and protect trust property; to enforce and defend claims; to be impartial among multiple beneficiaries—are all applications of prudence and loyalty.

The modern law of trust administration is so centered on fiduciary law that we tend not to remember how recently that body of law has developed. Once again, a quick look at the classical treatises tells the story. Neither Gilbert nor Sanders nor Story covers trust fiduciary law. Not until treatises by Thomas Lewin (16 editions

from 1837 to 1964)¹¹ in England, and John N. Pomeroy (five editions, from 1881 to 1941)¹² in the United States do we find coverage of what we now recognize as fiduciary issues, although still in a cramped fashion, somewhat as an afterthought. The success of mid-century treatises by George G. Bogert and Austin W. Scott in running Pomeroy off the American market results from their extensive coverage of the new trust law, that is, of trust fiduciary law.

To be sure, principles of trust fiduciary law can be traced well back to the 18th century. *Keech v. Sandford*,¹³ the foundational case on what we now generalize as the duty of loyalty, was decided in 1726. The outline of early trust investment law also was articulated in the 18th and early 19th centuries.¹⁴ But these doctrinal impulses were not matters of great consequence until the last century or so.

Only when financial assets came to displace ancestral land from the typical trust, and when empowerment triumphed over disempowerment, did trustees come routinely to exercise the levels of discretion over trust property that bring the fiduciary standards of care and loyalty into operation. As a practical matter, therefore, trust fiduciary law has been 20th-century and, now, 21st-century law.

FROM LEGAL LIST TO PRUDENT INVESTOR

The last great building block that was needed to create the modern management trust was what we might call the deregulation or privatization of trust investment law. When the courts first confronted trust investment issues in the early 18th century, they developed a preoccupation with low-risk, low-return investments, especially government bonds and well-secured first mortgages. Legislation in England, and in many American states¹⁵ in the 18th and 19th centuries,

tended to prescribe a narrow range of the so-called "legal lists."

As the capital markets developed an ever-increasing range of investment alternatives, the extreme conservatism of the legal lists began to chafe. In the United States, professional trustees led the campaign¹⁶ to spread a more permissive standard for trust investment, the duty of prudent investing, which ultimately came to prevail in most states. In the late 20th century, as knowledge spread, both about the efficiency of the securities markets and about the large and costless rewards for effective diversification, the duty of prudent investing was revised.¹⁷ The law absorbed the lessons of modern portfolio theory, especially the total portfolio standard of care, the strong duty to diversify trust investments and the legitimation of pooled investment vehicles.¹⁸ The Uniform Prudent Investor Act of 1994, implementing these principles, is now in force in 40 states,¹⁹ and comparable non-uniform legislation has

been enacted in most of the rest.

The spread of the prudence norm represents a notable endorsement of the trust industry by the legal system. The Uniform Prudent Investor Act says, in its official comment: "A prudent trustee behaves as other trustees similarly situated would behave."²⁰ The prudence norm is an industry standard of care, protecting trustees from liability if they follow good investment practices.

The trust industry is having greater trouble living with its responsibilities under the duty of loyalty. Professional trustees are increasingly part of large financial services organizations, which rightly view trusteeship as a profit center. The duty of loyalty has been abridged in most states to allow the use of trustee-affiliated mutual funds,²¹ but trustees remain under a fiduciary duty of loyalty not to invest trust accounts in these in-house products unless doing so serves the best interests of beneficiaries. Highly publicized recent cases about improper con-

versions of common trust funds into mutual funds are a reminder of the liability that financial services organizations face if they do not recognize and adhere to the limitations on self-interested fiduciary behavior that trust law continues to insist upon.

FROM CASE LAW TO LEGISLATION

The rise of the management trust has been accompanied by a steady transformation in the sources of trust law, from case law to statute law, often uniform acts. This process has now culminated in the promulgation of the Uniform Trust Code, the first comprehensive national codification of the law of trusts.

Many factors have influenced the trend towards legislation. The American Law Institute's enormously influential Restatements of Trusts (first, 1935; second, 1959; third, ongoing since 1992) are code-like in character. They helped prepare the way to statute, by articulating the principles of trust law with great precision. Thus, the California Trust Code, which the drafters of the Uniform Trust Code took as their starting point, was heavily based on the second Restatement of Trusts. Professional trustees, especially corporate fiduciaries whose deep pockets put them at risk in litigation, much prefer the precision of legislation to the disorder of case law, and they have been influential in promoting much of the trust legislation.

The movement to give trust law a legislative base also has had the effect of making the law more uniform or national in character. Much of the legislation has been the work of the Uniform Law Commission, an organization of the state governments. The concern to promote uniformity among the states in probate and trust law, exemplified in the Uniform Probate Code (1969, revised 1990) and the Uniform Trust Code, responds not only to the growth of trusts and estates having multi-state contacts, (that is, prop-

erty or beneficiaries in more than one state), but also the spread of multi-state trust companies. Thus, as the rise of management trusts has brought about a trust industry that is becoming ever more national in character, trust law is also becoming ever more national.

BEYOND FAMILY WEALTH

The central features of the management trust are professional asset management, conducted under fiduciary safeguards, in a segregated vehicle, which is bankruptcy-remote from the manager. The management trust has proven to be so attractive and adaptable that it has spread from its core function of family wealth transmission to a host of other uses, most importantly pension trusts²² and mutual funds, as well as asset securitization trusts. Federal and state law now facilitate or require a host of regulatory compliance trusts, for example, nuclear plant decommissioning trusts or prepaid funeral expense trusts. The aggregate assets of these commercial trusts now dwarf the assets held in personal trusts by a ratio of something like 20-to-1.²³

The attractions of the management trust, especially its commercial uses, have led to the absorption of the trust in legal systems that until recent times never knew it. Countries as remote from the Anglo-American trust tradition as Italy²⁴ and Japan²⁵ have been importing the management trust.

The rise of the management trust, the trust industry and the modern Anglo-American law of trusts during the last century has been an event of historic importance, whose implications continue to unfold, as the management trust expands from its stronghold in Anglo-American family wealth transmission and spreads to commercial practice worldwide. |

Endnotes

1. William F. Fratcher, Trust, in 6 *International Encyclopedia of Comparative Law*, Section 9, at 12 (1972).
2. Geoffrey Gilbert, *The Law of Uses and Trusts with a Treatise of Dower* (London, 1734).
3. Francis W. Sanders, *An Essay on the Nature and Laws of Uses and Trusts, Including a Treatise on Conveyances at Common Law* (London, 1791).
4. This phenomenon is a theme of John H. Langbein, "The Contractarian Basis of the Law of Trusts," 105 *Yale L.J.* 625 (1995), from which some of the discussion above in text derives.
5. Roscoe Pound, *An Introduction to the Philosophy of Law*, 236 (1922).
6. Frederic W. Maitland, "Trust and Corporation," reprinted in 3 *The Collected Papers* 321,323 (H.A.L. Fisher ed., 1911).
7. Sanders, *supra* note 3, at 256.
8. Restatement of Trusts (Second), Section 242 (1959); accord, Uniform Trust Code Section 708 (2000).
9. See 2 Joseph Story, *Commentaries on Equity Jurisprudence as Administered in England and America*, 242 (1836).
10. UTC Section 815(a)(2)(A)(2000). UTC Section 816 carries forward a long list of transactional powers derived from the Uniform Trustee Powers Act (1964), even though UTC Section 815 makes the detailed enumeration redundant, because explicit transactional authority has been found to facilitate trustee dealings with third parties.
11. Regarding self-dealing, see, for example, Thomas Lewin, *A Practical Treatise on the Law of Trusts and Trustees*, at 394 (2d. American ed. from 3d. London ed., Philadelphia 1858).
12. See 4 John N. Pomeroy, *A Treatise on Equity Jurisprudence as Administered in the United States of America*, Sections 1071-74 (investment), 1075-78 (self-dealing) (5th ed. 1941).
13. 2 Eq. Cas. Abr. 741, Sel. Cas. Ch. 61, 25 Eng. Rep. 223 (1726). On the origins see Walter G. Hart, "The Development of the Rule in *Keech v. Sandford*," 21 *Law Q.R.* 258 (1905).
14. A useful account of the history of trust-investment law in England appears in A.H. Oosterhoff, *Trustees' Powers of Investment: A Study Prepared at the Direction of the Ontario Law Review Commission*, 6-50 (1970).
15. Apart from Massachusetts, the most important U.S. jurisdictions still had legal lists in effect at the start of the 20th century. See Mayo A. Shattuck, "The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century," 12 *Ohio St. L.J.* 491, 499 (1951).
16. In the early 1940s, the American Bankers Association developed and sponsored the widely enacted Model Prudent Man Act (1940). See Shattuck, *supra* note 15, at 501-03.
17. I have discussed these developments in John H. Langbein, "The Uniform Prudent Investor Act and the Future of Trust Investing," 81 *Iowa L. Rev.* 641 (1996).
18. The themes of the Restatement (Third) of Trusts: Prudent Investor Rule (1992) and the Uniform Prudent Investor Act (1994).
19. 7B Uniform Laws Ann., 2004 Supp., at 82.
20. Uniform Prudent Investor Act Section 1, cmt. (1994).
21. For example, Uniform Trust Code Section 802(f) (2000).
22. ERISA requires that plan assets be held in trust. Employee Retirement Income Security Act (ERISA) Section 403, 29 U.S.C. Section 1053.
23. See John H. Langbein, "The Secret Life of the Trust: The Trust as an Instrument of Commerce," 107 *Yale L.J.* 165 (1997).
24. Andrea Moja, *Il codice del trust e del trustee* (2002); Maurizio Lupoi, *Trusts: A Comparative Study*, 368 ff. (2000).
25. The trust "was introduced [into Japan] in 1900 or thereabouts from the United States primarily to provide a business framework for investment management by trust companies." Makoto Arai and Koichi Kimura, "Financial Revolution and Trust Banks in Japan: Challenges in the Deregulation and Internationalisation Process," 4 *J. Int'l Trust & Corp. Planning* 67, 68 (1995).