

Essays

MANDATORY RULES IN THE LAW OF TRUSTS

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The law of trusts consists overwhelmingly of default rules that the settlor who creates the trust may alter or negate. There are, however, some mandatory rules, which the settlor is forbidden to vary.¹ In this Essay, I direct attention to important recent developments in American trust law that have clarified the mandatory rules, and I explore the rationale for these rules. I divide the mandatory rules into two groups: intent-defeating rules that restrict the settlor's autonomy, and intent-serving rules whose purpose is to discern and implement the settlor's true intent.

The intent-defeating rules, discussed in Part I of the Essay, serve an anti-dead-hand policy. They limit the power of a departed settlor to prescribe how the trustee must invest trust assets or how the beneficiaries are to order their lives or use the transferred wealth. I direct particular attention to the long-standing but recently reformulated rule that a trust must be for the benefit of its beneficiaries. I advance the view that in the future, the benefit-the-beneficiaries requirement will be especially consequential in the realm of trust-investment practice, where it will restrain the settlor from imposing value-impairing investment directions.

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¹ The topic of mandatory rules has not been addressed much in trust law, although it features prominently in the literature of other fields, especially corporations and contracts. See, e.g., Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *YALE L.J.* 87 (1989) (distinguishing default and "immutable" terms in contract); Bernard Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 *NW. U. L. REV.* 542 (1990); Jeffrey Gordon, *The Mandatory Structure of Corporate Law*, 89 *COLUM. L. REV.* 1549 (1989); Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 *COLUM. L. REV.* 1599 (1989). David Hayton has directed attention to the nonwaivable character of the duty to inform beneficiaries about the trust in English Law. David Hayton, *The Irreducible Core Content of Trusteeship*, in *TRENDS IN CONTEMPORARY TRUST LAW* 47 (A.J. Oakley ed., 1996).

Part II of this Essay explains the prevailingly intent-implementing character of the other rules of mandatory law. These are rules that channel and facilitate, rather than defeat, the settlor's purpose. Included are the rule that prevents the settlor from dispensing with fiduciary obligations; the rule that prevents the settlor from dispensing with good faith in trust administration; the rule that limits the permitted scope of exculpation clauses; and the rule that requires that the existence and terms of the trust be disclosed to the beneficiary. Such terms, were they allowed, would authorize the trustee to loot the trust. The mandatory rules do not forbid the settlor from naming the trustee as a beneficiary, but they do force the settlor to articulate that intent with clarity. Accordingly, these rules are cautionary and protective in character, guarding the settlor (and the truly intended beneficiaries) against misunderstanding or imposition.

The Code. The mandatory rules have gained new prominence as the result of a pair of coordinated law revision projects, both quite recently concluded. The Uniform Trust Code of 2000² ("the Code") is the first comprehensive national codification of the American law of trusts. The Code contains a novel provision, section 105, which is the centerpiece of this Essay. It subjects trust law to the classificatory rubric of default and mandatory rules.³ Section 105(a) provides that all trust law is default law, apart from the mandatory rules that are specially scheduled in section 105(b). Section 105(b) lists the mandatory rules in numbered subsections, usually cross-referencing the relevant provisions elsewhere in the Code. Section 105 is reproduced as an appendix to this article.

The Third Restatement. The other major development emphasized in this Essay is the refinement of the benefit-the-beneficiaries requirement in the Restatement (Third) of Trusts. Section 27 requires that "a private trust, its terms, and its administration must be for the benefit of its beneficiaries"⁴ The first volumes of the Third Restatement were published in final form in 2003,⁵ but circulated in draft for several years previously. The

² UNIF. TRUST CODE (2000), 7C U.L.A. 126 (Supp. 2003) [hereinafter UTC]. The UTC's drafters took as their starting point the Restatement (Second) of Trusts (1959), which they updated extensively to take account of the trends in later case law and legislation. I have discussed the Code's main substantive reforms, including the Code's effort to identify the mandatory rules, in an essay directed to English and Commonwealth trust lawyers. John H. Langbein, *The Uniform Trust Code: Codification of the Law of Trusts in the United States*, 15 TR. L. INT'L 69 (2001).

³ This terminology has spread through American law from the law-and-economics literature. See Ian Ayres, *Valuing Modern Contract Scholarship*, 112 YALE L.J. 881, 885 (2003) (discussing the provenance in law and economics). The distinction between default and mandatory rules does not, however, turn on economic analysis; it was prominent in the German pandectist literature of the later nineteenth century. See, e.g., BERNHARD WINDSCHEID & THEODOR KIPP, *LEHRBUCH DES PANDEKTENRECHTS* § 30, at 125-27 (9th ed. 1906) (1862) (distinguishing "zwingendes und nachgiebiges Recht"). (I owe this reference to Erich Schanze).

⁴ RESTATEMENT (THIRD) OF TRUSTS § 27 (2003). The measure appeared in draft form as RESTATEMENT (THIRD) OF TRUSTS § 27 (Tentative Draft No. 2, Mar. 10, 1999).

⁵ I speak of the project that is producing a complete Third Restatement, whose first two volumes

Code, which was prepared in close coordination with the drafting of the Third Restatement, absorbs this benefit-the-beneficiaries requirement.⁶

Rules of general application. Several of the mandatory rules rest on self-evident principles of legal process that are broadly shared with the rest of private law. The settlor may not, for example, interfere with the court's routine powers of judicial administration,⁷ nor may the settlor enlarge or diminish the rights of creditors or other third parties.⁸ I shall have nothing to say in this Essay about these familiar limits on private ordering. I shall also skip over the rule against trusts for illegal purposes,⁹ a principle shared with every branch of private and organizational law. A scheme to overthrow the government or to sell dope or to operate a bordello is no more enforceable as a trust than as a contract, a corporation, or a partnership.¹⁰

I. RESTRAINING THE DEAD HAND

A. Benefit the Beneficiaries

The rule that the trust and its terms must be for the benefit of the beneficiaries reworks an older doctrine, the rule against "capricious purposes."¹¹ Under that rubric, the treatises collect cases in which, for example, the

(covering sections 1–69) appeared in 2003. For present purposes, when referring to the Third Restatement, I exclude an earlier project that updated the trust-investment provisions of the Second Restatement and was titled Restatement (Third) of Trusts: Prudent Investor Rule (1992). That material is expected to be revised, renumbered, and updated in a forthcoming volume of the permanent Third Restatement.

⁶ UTC § 404 & cmt.

⁷ *E.g.*, *id.* § 105(b)(4) (referencing § 415, the court's power to reform a trust instrument to correct mistaken terms); *id.* § 105(b)(6) (court's power to require or waive bond); *id.* § 105(b)(12) (limitations periods); *id.* § 105(b)(13) (court's power to take action and exercise jurisdiction that is "necessary in the interests of justice"); *id.* § 105(b)(14) (rules of jurisdiction and venue).

⁸ *Id.* § 105(b)(5) (creditor rights); *id.* § 105(b)(11) (rights of a person other than trustee or beneficiary). The question remains quite contentious of whether various classes of privileged creditors (e.g., suppliers of necessities; former spouses and other holders of domestic relations awards; tort creditors; and governmental entities) should be excepted from the enforcement of spendthrift restraints in a trust instrument. What the mandatory rule of section 105(b)(5) provides is simply that once those matters are resolved as a matter of spendthrift law (in the case of the Code, under section 503), they are not subject to alteration by unilateral act of the settlor.

⁹ The second clause of UTC § 105(b)(3) lists "the requirement . . . that the trust have a purpose that is lawful, not contrary to public policy, and possible to achieve," which tracks the language of UTC § 404, which in turn follows RESTATEMENT (SECOND) OF TRUSTS §§ 60–65 (1959); *accord* RESTATEMENT (THIRD) OF TRUSTS § 29 (2003).

¹⁰ *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 178(1) (1981) (illegal term unenforceable); 8 DEL. CODE ANN. tit. 8, § 101(b) (2001) (corporation authorized for "lawful business or purposes"); REV. UNIF. P'SHIP ACT § 801(4) (1997), 6 U.L.A. 189 (2001) (dissolving unlawful partnership); UNIF. P'SHIP ACT § 31(d)(3) (1914), 6 U.L.A. (pt. 2) 370 (2001).

¹¹ RESTATEMENT (THIRD) OF TRUSTS § 29 cmt. h (2003) (preserving the old rule); *see also id.* § 47 cmt. e (charitable trusts). Case law on capricious purposes is collected in 2 AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 124.7, at 277–79 (4th ed. 1987).

courts have prevented a settlor from ordering her house bricked up¹² or refused to enforce trust terms calling for the erection of heroic statues of the settlor.¹³ In *Colonial Trust Co. v. Brown*, the Connecticut Supreme Court relieved against value-impairing restrictions that the settlor wanted to impose upon the development of commercial real estate, explaining that “the restrictions are opposed to the interests of the beneficiaries of the trust.”¹⁴

The rule against capricious purposes deals with the easy cases (“caprice” means whim or sudden fancy),¹⁵ but leaves the underlying policy unexpressed. By refashioning the rule to spell out that a valid trust must benefit the beneficiaries, the Third Restatement and the Code articulate the policy that has been at work in these cases. As the court said in *Colonial Trust Co. v. Brown*, a trust must advance “the interests of the beneficiaries of the trust.”¹⁶

In the realm of charitable trusts, the ancient charitable purpose doctrine¹⁷ serves a function comparable to the benefit-the-beneficiaries standard¹⁸ by requiring any purported charitable trust to satisfy standards of public benefit. Under the charitable purpose doctrine, a charitable trust must serve purposes “of such social interest or benefit to the community” that the trust merits the “special privileges that are typically allowed to charitable trusts,”¹⁹ most notably, exemption from the rule against perpetuities.²⁰ The courts police the requirement of charitable benefit by insisting on objective criteria for determining what constitutes public benefit,²¹ as well as by applying an anti-

¹² *Brown v. Burdett*, 21 Ch. D. 667 (1882).

¹³ *M’Caig v. Univ. of Glasgow*, 1907 Sess. Cas. 231 (Scot.) (trust to erect statues of the testator and other family members on lands devised by the testator); see also *Aitken’s Trs. v. Aitken*, 1927 Sess. Cas. 374 (Scot.) (trust to erect bronze equestrian statue of testator).

¹⁴ 135 A. 555, 564 (Conn. 1926) (holding void certain restrictions on the height and leasing terms of buildings to be erected on trust real estate; the court also found the restrictions harmful to “the parts of the city in which the lands in question are located”).

¹⁵ 1 SHORTER OXFORD ENGLISH DICTIONARY 262 (3d rev. ed. 1968).

¹⁶ 135 A. at 564.

¹⁷ UTC § 405(a); RESTATEMENT (THIRD) OF TRUSTS § 28 & cmt. a (2003). The modern authorities descend from the Statute of Charitable Uses, 43 Eliz. 1, c. 4 (1601).

¹⁸ Section 27(2) of the Third Restatement, the provision that establishes the benefit-the-beneficiaries requirement, cross-refers to the charitable purpose doctrine, signaling the comparability of the two rules. RESTATEMENT (THIRD) OF TRUSTS § 27(2) (2003) (citing *id.* § 28).

¹⁹ *Id.* § 28 cmt. a. Permitted charitable purposes include the relief of poverty, the advancement of education or religion, the promotion of health, governmental or municipal purposes, and other purposes that yield community benefit. *Id.*; UTC § 405(a).

²⁰ RESTATEMENT (SECOND) OF TRUSTS § 365 (1959).

²¹ For example, discussing trusts for the advancement of education, Scott collects references to cases in which the courts have determined that a particular scheme lacked sufficient educational merit. The courts refuse to enforce these trusts on the ground that they “would be of little or no value to the community.” 4A SCOTT & FRATCHER, *supra* note 11, § 370, at 160–61. A leading example is *In re Pinion*, [1965] Ch. 85, in which the settlor attempted to leave his home, bric-a-brac, and paintings in trust as a museum. The court took expert evidence that the purported collection was meritless (“one of the experts expresses his surprise that so voracious a collector should not by hazard have picked up even one meritorious object,” *id.* at 107), and it declined to enforce the trust.

inurement rule forbidding the use of charitable-trust assets for private gain.²²

Although the trust device has found important uses in commerce,²³ “[t]he normal private trust is essentially a gift, projected on the plane of time and so subjected to a management regime.”²⁴ The dominant substantive principle of the law of gratuitous transfers is to carry out the donor’s intent.²⁵ This deference to the wishes of the settlor presupposes that the settlor propounded the trust and its terms for the purpose of benefiting the beneficiaries. That presupposition is almost always justified, since the settlor has shown that he or she cared enough about the beneficiaries to give them the beneficial interest in the trust property. When, however, a settlor imposes manifestly value-impairing restrictions on the use or disposition of the trust property, the requirement that the trust terms be for the benefit of the beneficiaries places an outside limit upon the normal rule of deference to the settlor’s intent.

1. *Restraints on Marriage.*—Deciding whether some seemingly intrusive restriction runs afoul of this standard is not always easy. A particularly troublesome case, canvassed in the official comment and reporter’s notes to the Third Restatement,²⁶ arises when the settlor conditions the trust upon the beneficiary marrying within the faith. The cases²⁷ (and indeed the Restatements)²⁸ have divided about whether to sustain such a term. The settlor meant to have the beneficiary’s interest at heart by attempting to bind

²² See RESTATEMENT (SECOND) OF TRUSTS § 376 (1959).

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 Bernard Rudden, Review, *John P. Dawson, Gifts and Promises (1981)*, 44 MOD. L. REV. 610 (1981).

²⁵ “The controlling consideration in determining the meaning of a donative document is the donor’s intention. The donor’s intention is given effect to the maximum extent allowed by law.” RESTATEMENT (THIRD) OF PROPERTY: WILLS AND DONATIVE TRANSFERS §10.1 (2003).

²⁶ RESTATEMENT (THIRD) OF TRUSTS § 29 cmts. j, k (2003) (family relationships and religious freedom). The reporter, Professor Edward C. Halbach, Jr., covers this material in connection with the rule of section 29(b), invalidating a trust provision “contrary to public policy.”

²⁷ A leading modern case upholding such a restriction is *Shapira v. Union National Bank*, 315 N.E.2d 825 (Ohio Ct. Com. Pl. 1974). But see *Matter of Lieberman*, 18 N.E.2d 658 (N.Y. 1939). Many courts have strained to resolve such cases on constructional grounds, avoiding the policy question. See, e.g., *Clayton v. Ramsden*, [1943] A.C. 320 (House of Lords voided for purported uncertainty a restriction to persons “of Jewish parentage” and “of the Jewish faith.”).

²⁸ The Restatement (Third) of Trusts is hostile:

A trust provision is ordinarily invalid if its enforcement would tend to restrain the religious freedom of the beneficiary by offering a financial inducement to embrace or reject a particular faith or set of beliefs concerning religion. Illustrative is a provision granting or terminating a beneficial interest only of the beneficiary should adopt or abandon a particular religious faith.

RESTATEMENT (THIRD) OF TRUSTS § 29 cmt. k (2003). For previous versions, see RESTATEMENT (SECOND) OF TRUSTS § 62 cmt. i (1959), and RESTATEMENT (SECOND) OF PROPERTY: DONATIVE TRANSFERS §§ 6.2–6.3, 8.1 (1986) (approving such restraints), criticized in RESTATEMENT (THIRD) OF TRUSTS § 29 cmt. k, at 92–93 (2003).

the beneficiary to the faith. The argument against enforcing the condition is that it is too disruptive to the beneficiary's life to satisfy the benefit-the-beneficiaries standard. The Third Restatement follows²⁹ the view of Gareth Jones, voiced in a prominent essay, that conditioning a benefit under a trust upon the beneficiary's not "marry[ing] a person of a certain race or faith is wholly objectionable; to uphold the restraint is to endow the dead with an unjustifiable power of intruding themselves into the most personal aspects of human life."³⁰ But Jones does not tell us why the settlor's preference should be legally "objectionable" and "unjustifiable."

There is indeed a powerful argument for enforcing the settlor's wishes, no matter how intrusive, peculiar, or even harmful to the beneficiary. During his or her lifetime, the settlor has unfettered discretion, as owner of the property, to impose such conditions on an inter vivos gift. The owner who is competent to transfer property in trust would also be competent to do with the property the various things that the courts have refused to enforce as trust terms: to neglect or destroy the property; to use it to build statues of himself; to develop it in an economically suboptimal way; or to refuse to benefit the child who marries outside the faith.

2. *Justifying the Interference with Settlor Autonomy.*—The puzzle about the anti-dead-hand principle is this: Why should the owner of the property be forbidden from doing by trust that which he or she can do by inter vivos act? In Jones's arresting example, "[a] settlor may destroy his own Rembrandt.³¹ But he cannot establish a trust and order his trustees to destroy it."³² But why not? Various answers have been offered to that question.³³ The account³⁴ that I find persuasive, and that has found broad

²⁹ RESTATEMENT (THIRD) OF TRUSTS § 29 cmt. i, at 60-61 (2003).

³⁰ Gareth H. Jones, *The Dead Hand and the Law of Trusts*, in DEATH, TAXES AND FAMILY PROPERTY 119, 127 (E. Halbach ed., 1977); accord Jeffrey G. Sherman, *Posthumous Meddling: An Instrumentalist Theory of Testamentary Restraints on Conjugal and Religious Choices*, 1999 U. ILL. L. REV. 1273.

³¹ It is true that an owner with capacity to conduct his own affairs may destroy his Rembrandt, but destroying Rembrandts would be likely to cause capacity to be questioned.

³² Jones, *supra* note 30, at 126.

³³ Most discussion of the anti-dead-hand policy has centered on the rule against perpetuities and has emphasized the need to promote alienability of land. Simes rightly pointed out that this rationale does not explain why the rule should apply to trusts in which the trustee has the power of sale. LEWIS M. SIMES, PUBLIC POLICY AND THE DEAD HAND 40 (1955). Simes's alternative justification, "striking a fair balance between the desires of members of the present [and] succeeding generations," *id.* at 58, is a slogan, not an explanation. See T.P. Gallanis, *The Rule Against Perpetuities and the Law Commission's Flawed Philosophy*, 59 CAMBRIDGE L.J. 284 (2000) (critiquing Simes).

³⁴ For a succinct version, see RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 18.7 at 522-23 (6th ed. 2003). In a similar vein, Robert Sitkoff, commenting on an earlier draft of this Essay, observed that the owner's failure to destroy the Rembrandt during his lifetime may belie a sense of ambivalence or irresolution about ordering its destruction. By requiring that the settlor destroy the painting during lifetime if at all, the rule forces him to experience its destruction and thus to demonstrate his resolution. Letter from Robert Sitkoff, to John H. Langbein 2-3 (May 27, 2003).

acceptance,³⁵ is that the anti-dead-hand principle is fundamentally a change-of-circumstances doctrine. The distinctive attribute of a trust is that it can and commonly does perpetuate the settlor's autonomy after his or her death (hence the dead-hand label).³⁶ The living donor can always change his or her mind, as he or she observes the consequences of an unwise course of conduct, or as other circumstances change, but the settlor who is deceased or who, though living, occupies a decedent-like relationship to the trust by having made the trust's terms irrevocable cannot.³⁷

B. Investment Directions

The characteristic sphere for the application of the anti-dead-hand rule has been the fringe world of the eccentric settlor: the crackpot who wants to brick up her house, or build statues of himself, or dictate children's marital choices. In the future, however, I believe that the benefit-the-beneficiaries rule will set limits upon a more common form of settlor direction, the value-impairing investment instruction. The benefit-the-beneficiaries requirement will interact with the growing understanding of sound fiduciary investing practices to restrain the settlor's power to direct a course of investment imparting risk and return objectives contrary to the interests of the beneficiaries.

To take an extreme example, suppose that the settlor were to leave a modest trust fund for the support of his otherwise destitute widow and orphans and were to require that the fund be entirely invested in, say, shares of the bankrupt Enron Corporation. Suppose further that the settlor were to leave an account of his thinking, explaining that, depending upon the course of the bankruptcy proceeding, these shares have the potential to increase greatly in value. No court would enforce such a direction, even though the

³⁵ See, e.g., RESTATEMENT (THIRD) OF TRUSTS § 29 cmt. i, at 61 (2003) ("the 'rigor mortis' of deadhand control is not present while a property owner is able to respond to persuasion and evolving circumstances"); accord JESSE DUKEMINIER & STANLEY M. JOHANSON, WILLS, TRUSTS AND ESTATES 31 (6th ed. 2000); Gallanis, *supra* note 33, at 284. But see Gregory S. Alexander, *The Dead Hand and the Law of Trusts in the Nineteenth Century*, 37 STAN. L. REV. 1189, 1261–62 (1985).

³⁶ Sherman has pointed out that the movement in recent years to abolish the rule against perpetuities magnifies the reach of the settlors' terms. Sherman, *supra* note 30, at 1280. On the extent of the perpetuities repeal movement, see Note, *Dynasty Trusts and the Rule Against Perpetuities*, 116 HARV. L. REV. 2588, 2590–95 (2003).

³⁷ Traditionally, only the beneficiaries of a trust have standing to enforce the trust; the settlor does not. See RESTATEMENT (SECOND) OF TRUSTS § 200 & cmt. b (1959). I have criticized that rule in John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625, 664 (1995). The Uniform Trust Code softens the rule against settlor enforcement in two main respects. The Code allows the settlor to sue to enforce a charitable trust, and it allows the settlor of an irrevocable trust to petition for removal of the trustee. UTC §§ 405(c), 706(a). The Code also empowers the settlor and the beneficiaries of a private trust jointly to compel termination of the trust "even if the modification or termination is inconsistent with a material purpose of the trust." UTC § 411(a). I take from Edward C. Halbach, Jr. the insight that this provision is more in the nature of a power of release than a power to enforce the trust.

principles of trust investment law with which the direction conflicts (especially the duty to diversify trust investments³⁸ and, more generally, the duty of prudent investing³⁹) are default rules that the settlor may waive.⁴⁰ There are circumstances (discussed below) in which the settlor can abridge the diversification and prudent-investing norms without violating the benefit-the-beneficiaries requirement. However, in the example I have given (the direction to invest all the assets of a modest trust for impoverished beneficiaries in the common stock of a bankrupt firm), the resulting underdiversification and volatility levels would be so contrary to the risk-and-return profile of the beneficiaries that the direction could not satisfy an objective standard of benefit under the benefit-the-beneficiaries rule.

The deeper lesson from this example is that, even though most rules of trust law (such as the duties to diversify and to invest prudently) are default rules rather than mandatory rules, it does not follow that the settlor is free to authorize any conceivable departure from the default rules. A default rule is one that the settlor can abridge, but only to the extent that the settlor's term is "for the benefit of [the] beneficiaries."⁴¹ The requirement that there be benefit to the beneficiaries sets outer limits on the settlor's power to abridge the default law. Trust law's deference to the settlor's direction always presupposes that the direction is beneficiary-regarding.

1. *Blue Chips*.—What should happen in a case in which, instead of requiring the portfolio to be in Enron shares, the settlor requires it to be invested entirely in shares of a seasoned blue chip? In my view, such a direction should also be seen as a violation of the requirement that trust terms must be for the benefit of the beneficiaries. Some years before the Code was drafted, I raised this question by supposing the following case:

The settlor has worked all his life for, let us say, IBM. Through stock options and company sponsored investment plans, he has accumulated a large block of IBM common stock. He dies, leaving the block in trust with instructions not to sell it. The block is the only substantial asset of the trust, and because the settlor's death results in a stepped-up basis, selling the block incurs no tax cost. Suppose, further, that the settlor leaves a letter explaining his thinking. "I worked for IBM for 35 years, they were wonderful to me, they helped me

³⁸ "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." UNIF. PRUDENT INVESTOR ACT § 3 (1994) [hereinafter UPIA], *incorporated in* UTC art. 9.

³⁹ The substantive standard is UPIA § 2(b): "A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust."

⁴⁰ "The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust." *Id.* § 1(b).

⁴¹ UTC § 105(b)(3). This section tracks but does not expressly cross-refer to UTC § 404. Most provisions of § 105(b) do cross-refer to the relevant substantive provision; in this instance, the attribution to § 404 appears in the official comment to § 105(b)(3), but not in the statutory text.

buy the stock, and the stock zoomed in value throughout my career. You just cannot do better."⁴²

Modern portfolio theory instructs us that the investor who diversifies thoroughly virtually always improves the odds of doing better than a one-stock portfolio, regardless of what the stock is. Failure to diversify imposes upon the portfolio what is called uncompensated risk, risk that can be costlessly avoided by spreading the investment across many asset classes and many distinct security issues.⁴³

Even a blue chip can suffer catastrophic and wholly unpredictable losses—as happened, for example, to the shares of the Union Carbide Company in the wake of the 1984 Bhopal disaster⁴⁴ or to Texaco, then independent and one of the major international oil companies, when a fluke lawsuit forced it into bankruptcy in 1987.⁴⁵ Such changes of fortune can occur more slowly, but be equally catastrophic for a trust fund that is locked into a declining company. For example, in the 1970s and 1980s the mass merchant Kmart was a revered blue chip;⁴⁶ no one could have predicted that the success of an upstart Arkansas retailer called Wal-Mart would ultimately

⁴² John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 664 (1996). A version of the hypothesized case was reported a few years later. In *In re Saxton*, 712 N.Y.S.2d 225 (App. Div. 2000), a bank trustee was found liable for refusing to diversify the settlor's block of IBM stock. In *Saxton*, the settlor did not direct retention, but the remainder beneficiaries signed an agreement waiving diversification and immunizing the trustee in the event that the value of the IBM stock declined. The court refused to enforce the agreement against the remainder beneficiaries, on the grounds that (1) the agreement had not been adequately explained to them when they executed it, and (2) in any event, they had subsequently revoked it. 712 N.Y.S. 2d at 231.

⁴³ For discussion, see RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 cmts. e, g, at 19–24, 25–28 (1992); Langbein, *supra* note 42, at 646–49.

⁴⁴ The accident occurred on December 3, 1984. In the week following, Union Carbide stock lost over 20 percent of its value, declining from \$48.75 to \$38.75. Alexander R. Hammer, *Dow Declines 1.11 in Active Trading*, N.Y. TIMES, Dec. 7, 1984, at D8.

⁴⁵ In the week following the \$10.5 billion verdict against Texaco, the company's shares declined in value by more than 20 percent. See Lee A. Daniels, *Stock Falls on Texaco Statement*, N.Y. TIMES, Nov. 27, 1985, at D1. The litigation ultimately led Texaco to file for bankruptcy protection under Chapter 11 on April 12, 1987. The following day, Texaco stock fell by more than 10 percent; the shares of Pennzoil, the firm that won the Texaco verdict, lost more than 16 percent on news of the bankruptcy. See Thomas C. Hayes, *Pennzoil's Chances Unclear*, N.Y. TIMES, Apr. 14, 1987, at D1. For reflections on the events, see Robert Wilson & Robert Mnookin, *Rational Bargaining and Market Efficiency: Understanding Pennzoil v. Texaco*, 75 VA. L. REV. 295 (1989).

⁴⁶ *Fortune* selected Kmart CEO Harry Cunningham as a member of its Hall of Fame of Business Leadership in 1978. "No large retailer in the last fifteen years has a comparable record of growth." Max Ways, *The Hall of Fame of Business Leadership*, FORTUNE, Jan. 30, 1978. In 1979, *U.S. News & World Report* found that Kmart was one of the three most popular stocks owned by individual investment clubs. *Favorite Stocks*, U.S. NEWS & WORLD REP., Dec. 24, 1979, at 77. T. Rowe Price, the founder of the mutual fund firm, shared with readers of *Forbes* that he was buying Kmart for the portfolios he managed. T. Rowe Price, *Stocks to Buy*, FORBES, May 29, 1978, at 126. Investment professionals quoted in *Forbes*' "Streetwalker" column in 1979 were reported to think "that fast-growing Kmart Corp., riding its growing discount chain, has a good chance of passing Sears in retailing profits in the next two years." *K-mart's Fast Track*, FORBES, Apr. 30, 1979, at 97.

send Kmart into bankruptcy in the year 2002.⁴⁷ Across the last quarter of the twentieth century, a combination of technological and regulatory change transformed the American Telephone & Telegraph Company from the world's largest and most stable enterprise into an imperiled bit player, whose share value has declined precipitously.⁴⁸ We have lately seen accounting frauds reduce huge firms such as Enron and WorldCom to bankruptcy, frauds that sophisticated investment professionals failed to detect until the harm was done.

Because it is so hard to foresee the next Bhopal or WorldCom, the prudent fiduciary investor diversifies so broadly that if catastrophe befalls one of the holdings in the portfolio, the loss will be lessened (and often somewhat offset by the performance of other portfolio companies, because competitors commonly prosper when a rival falters). The advantages of diversifying an investment portfolio broadly are so great that it is usually folly not to do it, and folly is not how to benefit beneficiaries.

To be sure, there are circumstances that can make it prudent for a trust fund not to diversify, which is why the duty has been formulated as a default rule. When, for example, the trust in question is but one of many for the same beneficiaries, or when the trust otherwise represents only a small portion of the total wealth available to the beneficiaries, the trustee may appropriately take into account the beneficiaries' other trust and nontrust resources in deciding whether and how to diversify the trust.⁴⁹ Moreover, there will sometimes be cases in which the tax cost of diversifying a low-basis asset may outweigh the gain.⁵⁰ Yet another circumstance in which an underdiversified portfolio may be quite justified occurs when trust assets are not being held for investment (or not wholly for investment). Such

⁴⁷ Regarding the bankruptcy, see Danny Hakim & Leslie Kaufman, *Kmart Files Bankruptcy, Largest Ever for a Retailer*, N.Y. TIMES, Jan. 23, 2002, at C1; Michael Levy & Dhruv Grewal, *So Long, Kmart Shoppers*, WALL ST. J., Jan. 28, 2002, at A14. Regarding the rise of Wal-Mart, see RICHARD S. TEDLOW, *GIANTS OF ENTERPRISE: SEVEN BUSINESS INNOVATORS AND THE EMPIRES THEY BUILT* 315-66 (2001); SANDRA S. VANCE & ROY V. SCOTT, *WAL-MART: A HISTORY OF SAM WALTON'S RETAIL PHENOMENON* (1994).

⁴⁸ See Stephanie N. Metha, *Say Goodbye to AT&T*, FORTUNE, Oct. 1, 2001. AT&T has been conducting merger negotiations with one of the regional telecom companies that was split from it in the 1980s, heightening the prospect that AT&T will be absorbed by another firm. See Andrew Ross Sorkin, *BellSouth Said To Halt Talks With AT&T*, N.Y. TIMES, Oct. 29, 2003, at C4.

⁴⁹ The Uniform Prudent Investor Act includes "other resources of the beneficiaries" among the "circumstances that a trustee shall consider in investing and managing trust assets." UPIA § 2(c)(6).

⁵⁰ "If a tax-sensitive trust owns an underdiversified block of low-basis securities, the tax costs of recognizing the gain may outweigh the advantages of diversifying the holding." *Id.* § 3 cmt. I have elsewhere discussed other responses to the dilemma faced by the trustee of a trust that is subject to taxation, and that has an underdiversified holding with a low tax basis. See Langbein, *supra* note 42, at 661 (following George Crawford, *A Fiduciary Duty to Use Derivatives?*, 1 STAN. J.L. BUS. & FIN. 307 (1995) (explaining use of puts to hedge the risk of an undiversified holding)). The estate tax can also be an impediment to diversification, because I.R.C. §§ 2032A, 2057, and 6166, which provide lower rates for family businesses, also require recapture of the tax benefit if the business is sold within 10 or 15 years. (I acknowledge the kindness of Edward Zelinsky in bringing this point to my attention).

“programmatic” investing is common in certain kinds of charitable trusts— for example, in a trust that holds land as a bird sanctuary or nature preserve. There are analogues to programmatic investing in personal trusts, as when the settlor directs that the family residence be retained as a home for the widow or that vacation property be held for the recreational use of family members.

When, however, trust assets are held for investment, and are easily diversifiable at no cost or at acceptable cost, I believe that the courts will come to view the advantages of diversification as so overwhelming that the settlor’s interference with effective diversification will be treated as inconsistent with the requirement that the trust terms must be for the benefit of the beneficiaries. Settlor-directed underdiversification is an avoidable harm, akin to the harm that the courts have prevented by intervening against settlors’ directions to waste or destroy trust property.

2. *Family Enterprises.*—A recurrent setting in which we sometimes see a settlor impose a value-impairing investment restriction arises in connection with the disposition of a family enterprise. It is common for a trust to be used as part of the succession arrangements for a family firm. When the settlor directs the trustee to retain the firm, that direction brings the trust into tension not only with the duty to diversify,⁵¹ but also with the branch of the duty of prudent investing that forbids the “employment of trust property in the carrying on of trade or business”⁵² Trust law discourages investments that require trustees to engage in active entrepreneurship. Operating a business (or hiring and monitoring agents to operate the business) is far more challenging than conventional fiduciary investing in a portfolio of marketable securities, whose performance is easily monitored through market prices and benchmark portfolios such as the various market indexes.

The aversion to conducting entrepreneurship within a trust fund is mere default law, which the settlor can override. Sometimes the settlor has sound reasons for thinking that the beneficiaries will derive more benefit from retaining the family firm than from selling or dissolving it. For example, a family firm sometimes occupies a market niche that produces returns superior to those readily available to fiduciaries in the investment markets. There are circumstances in which a family firm that would not realize much if sold or liquidated can continue to be a profitable source of employment

⁵¹ “The wish to retain a family business is another situation in which the purposes of the trust sometimes override the conventional duty to diversify.” UPIA § 3 cmt.

⁵² RESTATEMENT (SECOND) OF TRUSTS § 227 cmt. f (1959). Bogert’s treatise explains that “the trustee would need special business talents which are not usually possessed or reasonably to be expected.” GEORGE G. BOGERT & GEORGE T. BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 676, at 56 (2d ed. 1977). This concern abides as a precept of good trust practice, although the modern law has eliminated all categorical prohibitions on types of investments. See RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 cmt. f, at 24 (1992); UPIA § 2(e) (allowing the trustee to “invest in any kind of property or type of investment” that is consistent with the prudence standards of the act).

and income for family members. Sometimes what motivates the settlor's direction to retain is the belief that operating the family firm can be the source of influence, prestige, and perquisites for family members that may outweigh the superior expected investment returns of a diversified portfolio. We see such thinking in the strategies that have been used to perpetuate family control of such prominent institutions as the *New York Times*⁵³ and the Ford Motor Company,⁵⁴ as well as many smaller and less storied firms.

Sometimes, however, what lurks behind a settlor's direction to retain a family firm is the settlor's aspiration to perpetuate his or her notions about the conduct of the enterprise and thus to steer the firm's and the family's affairs from the grave. The grave is not, however, a good place from which to adjust to the pace of modern commerce. The family business is sometimes the alter ego of the decedent, too dependent upon the decedent's entrepreneurial skills to be viable after his or her death, in which case the interests of the beneficiaries would be best served by selling or liquidating it.⁵⁵ When a family firm falls into a trust without any direction to retain it, the duty of prudence requires the trustee to investigate the alternatives with care, including such factors as the business prospects of the firm; the abilities of its management; and the abilities, relationships, and financial and other circumstances of the beneficiaries. The trustee's determination to retain a family firm is a fiduciary act that the trustee must continually revisit, because the balance of circumstances that initially supported the decision can change over time.

When, however, the trust instrument requires the trustee to retain the family firm, that course of conduct is potentially so risky that, in my view, the benefit-the-beneficiaries standard now requires a prudent trustee to examine closely whether to oblige. In the event that the trustee determines that the direction to retain the asset is not in the interests of the beneficiar-

⁵³ Regarding the Sulzberger family that controls the paper, see SUSAN E. TIFFT & ALEX S. JONES, TRUST: THE PRIVATE AND POWERFUL FAMILY BEHIND *THE NEW YORK TIMES* (1999) (using voting control to perpetuate editorial control in family hands); see also HARRISON E. SALISBURY, WITHOUT FEAR OR FAVOR: *THE NEW YORK TIMES* AND ITS TIMES 108-09 (1980) (discussing the trust that perpetuates family control of the newspaper). Family ownership has been uncommonly persistent in the newspaper business, probably because of the civic and political influence that these enterprises bestow upon the persons who control them. See Ken Auletta, *Family Business*, NEW YORKER, Nov. 3, 2003, at 54 (re-marking on family control of the *Wall Street Journal*, *New York Times*, and *Washington Post*).

⁵⁴ See DAVID HALBERSTAM, THE RECKONING 224-26 (discussing the Ford family's retention of the voting stock when Ford Motor Company shares were first offered to the public after World War II).

⁵⁵ Retaining a family enterprise is sometimes unavoidable, at least provisionally, as a transition measure when the firm cannot be easily marketed. The default rule governing the treatment of so-called inception assets gives trustees considerable flexibility to consider the alternatives.

Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of [the Uniform Prudent Investor Act].

UPIA § 4.

ies, the trustee has a duty to resist the direction. If the trustee adheres to the trust term in such circumstances, the trustee risks liability to the beneficiaries for breach of trust. Procedurally, the appropriate step would be for the trustee to petition the court to modify the direction, consistent with the benefit-the-beneficiaries standard.⁵⁶

C. *Modifying Trusts*

Having seen that the core policy that drives the benefit-the-beneficiary requirement is the concern with supervening change of circumstances,⁵⁷ we would expect the express change-of-circumstances doctrines of trust law to be mandatory as well. They are. The Code provides that the settlor may not preclude “the power of the court to modify or terminate a trust” under various provisions authorizing such steps.⁵⁸ Those provisions include the deviation doctrine, emphasized below;⁵⁹ the *cy pres* doctrine for charitable trusts;⁶⁰ and the court’s power to terminate a trust that becomes too small to be economic.⁶¹ In a similar vein, the court’s power to adjust trustee compensation to changed circumstances is mandatory.⁶²

In one dimension, these change-of-circumstance rules are intent-serving. They are imputed-intent doctrines, which empower the court to modify the trust as the settlor would have wished had the settlor known of the changed circumstance. The dimension that requires these doctrines to be grouped with the intent-defeating mandatory rules is that the settlor is forbidden to oust them. Trust terms that would prevent the court from responding to changed circumstances offend the anti-dead-hand policy.

The Code codifies the familiar deviation doctrine in section 412(a): “The court may modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not anticipated by the settlor, modification or termination will further the purposes of the trust.”⁶³

⁵⁶ See UTC § 410(b) (authorizing such proceedings). See generally RESTATEMENT (SECOND) OF TRUSTS § 259 (1959) (application to court for instructions). It is well settled that a trustee’s duty of prudent administration may require application to the court to seek trust modification in appropriate circumstances. See RESTATEMENT (SECOND) OF TRUSTS § 167(1) (1959) (deviation doctrine).

⁵⁷ See *supra* text accompanying notes 34–37.

⁵⁸ UTC § 105(b)(4).

⁵⁹ *Id.* § 412(a).

⁶⁰ *Id.* § 413.

⁶¹ *Id.* § 414.

⁶² Section 105(b)(7) makes mandatory “the power of the court under section 708(b) to adjust a trustee’s compensation specified in the terms of the trust which is unreasonably low or high.” Section 708(b) authorizes the court to alter compensation arrangements contained in the trust: “the court may allow more or less compensation if . . . (1) the duties of the trustee are substantially different from those contemplated when the trust was created; or (2) the compensation specified by the terms of the trust would be unreasonably low or high.” *Id.* § 708(b).

⁶³ *Id.* § 412(a). This provision expands the deviation doctrine of prior law, *e.g.*, RESTATEMENT (SECOND) OF TRUSTS § 167(1) (1959), which was limited to administrative matters such as investment, to include the “dispositive terms” of the trust. The court would thus be able to adjust the amounts or

The deviation doctrine is meant to be intent-serving, on an imputed intent standard (what the settlor would have wanted done had he or she known of the changed circumstances). The Code says: "To the extent practicable, the modification must be made in accordance with the settlor's probable intention."⁶⁴

The leading case applying the deviation doctrine arose from a trust created by Joseph Pulitzer for his children. He transferred to the trust his controlling interest in the *New York World* newspaper and forbade the trustees to sell it. When the paper became unprofitable, the trustees sought and received judicial approval to sell it anyhow.⁶⁵ The reasoning in such cases is that subsequent experience has revealed a conflict between the settlor's dominant purpose, to benefit the beneficiaries, and the settlor's subsidiary purpose, to benefit them in a particular way. In *Pulitzer*, keeping the *New York World* in the trust was the subsidiary purpose. "The dominant purpose of Mr. Pulitzer must have been the maintenance of a fair income for his children and the ultimate reception of an unimpaired corpus by the remaindermen."⁶⁶ Thus, the court disregarded the investment direction in order to carry out the settlor's imputed dominant intent, which was to benefit the beneficiaries.

Suppose, however, that the settlor in *Pulitzer* had foreseen and recited in the trust instrument the danger that the newspaper might become unprofitable, and he directed the trustees to continue operating it anyhow. In the actual case, the court refused to consider the possibility that a settlor of such "sagacity and business ability" could have intended "from mere vanity"⁶⁷ to keep the newspaper operating at the expense of the trust. But suppose he had. Suppose the settlor spelled out that he foresaw the possibility that the paper would cease to be economically viable, but he wanted it maintained regardless of the impairment of the interests of the beneficiaries. Such a restriction would not have been enforceable.⁶⁸ Attempting to prevent the

shares specified in the instrument in order "to carry out the purposes of the trust." *Id.* The change follows RESTATEMENT (THIRD) OF TRUSTS § 66(1) (2003) (the Code cites a superseded tentative draft of the section, *see* UTC § 412(a) cmt.).

⁶⁴ UTC § 412(a).

⁶⁵ *Matter of Pulitzer*, 249 N.Y.S. 87, 139 Misc. 575 (Surr. Ct. 1931), *aff'd mem.*, 260 N.Y.S. 975, 237 App. Div. 808 (1932).

⁶⁶ 249 N.Y.S. at 94, 139 Misc. at 580.

⁶⁷ *Id.* The suspicion abides that the court in *Pulitzer* was not candid in its characterization of the settlor's intent. *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS § 27 cmt. b, at 7 (2003) (remarking on the court's "dubious finding"). The court probably sensed that the settlor was attempting to do just what the court complimented him for having the sagacity not to do, which was to insist on keeping the newspaper in operation regardless of whether it benefited the beneficiaries or not. Relying on the sagacity that the court imputed to the settlor spared the court from having to confront and invalidate the term that the settlor may actually have intended.

⁶⁸ Such a trust could not succeed as a charitable trust for the operation of the newspaper, even were that construed to have been the settlor's intent, because the trust would have been for the benefit of a for-profit enterprise, and because operating a commercial newspaper falls outside the scope of the charitable purpose doctrine. *See supra* text accompanying notes 17-22.

court from modifying the trust in response to such materially worsened circumstances would offend the anti-dead-hand principle embodied in the rule that the trust must be for the benefit of the beneficiaries.⁶⁹

The Code's deviation doctrine, section 412(a), is a change-of-circumstances doctrine limited to cases in which the court modifies trust terms on account of "circumstances not anticipated by the settlor."⁷⁰ By contrast, section 412(b) of the Code authorizes the court to modify administrative terms (such as investment directions) even in circumstances that the settlor did anticipate, if the offending terms "would be impracticable or wasteful or impair the trust's administration."⁷¹ The Code's official comment explains this provision as "an application of the requirement in Section 404 that a trust and its terms must be for the benefit of its beneficiaries."⁷² The policy is further manifested in the Code's mandatory-law menu provision, section 105(b)(4), which prevents the settlor from precluding the court's power to modify trust terms. Forbidding the court to intervene when trust terms become harmful to the interest of the beneficiaries is no more defensible⁷³ than enforcing a provision that harms the beneficiaries *ab initio*, as in the case of the famous settlor who directed her house to be bricked up.⁷⁴ Trust terms must be for the benefit of the beneficiaries.

II. INTENT-SERVING MANDATORY LAW

The remaining rules of mandatory law invite partition into three groups: (1) rules governing the creation of trusts; (2) the good faith requirement, which has been particularly prominent in the treatment of exculpation clauses; and (3) rules requiring disclosure to the beneficiaries of the trust's existence and terms. The theme that unites these measures is their prevalently intent-implementing character, in contrast to the intent-

A trust to operate a newspaper today might be designed as a purpose trust to last no longer than twenty-one years under UTC §§ 405, 408–09. *Accord* RESTATEMENT (THIRD) OF TRUSTS § 47(2) (2003). These measures are innovations; such a purpose trust would not have been recognized at the time of the *Pulitzer* case. *See infra* note 80.

⁶⁹ For a discussion of the benefit-the-beneficiaries rule of UTC § 404, mandatory under UTC § 105(b)(3), see *supra* text accompanying notes 4, 11–16.

⁷⁰ UTC § 412(a); *accord* RESTATEMENT (THIRD) OF TRUSTS § 66(1) (2003).

⁷¹ UTC § 412(b).

⁷² *Id.* cmt. (citing the tentative draft of what is now RESTATEMENT (THIRD) OF TRUSTS § 27(2) & cmt. b (2003) (requiring that "a private trust, its terms, and its administration must be for the benefit of the beneficiaries")).

⁷³ In *Thomson's Trustees v. Davidson*, 1947 Sess. Cas. 654 (Scot.), discussed in 2A SCOTT & FRATCHER, *supra* note 11, § 166, at 267, the court refused to enforce a provision preventing trustees from selling certain securities until the securities could be sold at a profit over what the settlor had paid for them. The trustees petitioned for instructions, and the court allowed the shares to be sold contrary to the trust term. The court said that it was not "legitimate" for the settlor "to prohibit these trustees from exercising the most characteristic function which falls to be discharged by every trustee,—the preservation of the trust estate." *Id.* at 658.

⁷⁴ *Brown v. Burdett*, 21 Ch. D. 667 (1882); see *supra* text accompanying note 12.

defeating purpose of the anti-dead-hand rules. Even when these rules interfere with an expressed intention of the settlor, they do so for the purpose of implementing the settlor's dominant intent.

A. Trust Creation

The Code carries forward from the common law of trusts⁷⁵ the familiar requirements for creating a valid trust:⁷⁶ there must be trust property;⁷⁷ the settlor must have the capacity⁷⁸ and the intent⁷⁹ to create the trust; the trust must identify definite beneficiaries;⁸⁰ and the trust must have enforceable duties.⁸¹

1. *Categorization.*—The question of whether a purported transfer did or did not take the trust form raises an issue of categorization. Distinguishing between trust and other legal forms (contract, gift, bailment, agency, corporation) keeps order among juridical concepts. The process of legal categorization is, therefore, a matter of positive law, removed from private

⁷⁵ E.g., PAUL TODD & SARAH LOWRIE, TEXTBOOK ON TRUSTS 109–18 (5th ed. 2000).

⁷⁶ UTC § 105(b)(1). Unlike most of the other mandatory rules scheduled in section 105(b), the quoted provision respecting the requirements for trust creation is not well drafted, because it supplies no cross-reference to the rules being invoked. The cross-reference in the official comment is overbroad. It says: “For the requirements for creating a trust, see Sections 401–409.” I explain above in text that sections 401–02 contain the traditional rules for trust creation. Sections 403–09 deal with qualifications such as choice of law (§ 403); trusts for illegal or fraudulent purposes (§§ 404, 406); charitable and purpose trusts (§§ 405, 408–09); and oral trusts (allowed under § 407).

⁷⁷ *Id.* § 401.

⁷⁸ *Id.* § 402(a)(1).

⁷⁹ *Id.* § 402(a)(2).

⁸⁰ *Id.* § 402(a)(3)(A) (trust must have definite beneficiaries or be a charitable trust). In charitable trusts, the beneficiaries must be sufficiently indefinite to constitute the requisite public interest under the doctrine of charitable purposes, which is codified in UTC section 405(a). As at common law, the attorney general has standing to enforcement a charitable trust; the Code accords. *Id.* § 110(c). In a departure from the common law, the Code allows the settlor to enforce a charitable trust. *Id.* § 405(c).

The Code also departs from the common law in allowing so-called “purpose” or “honorary” trusts, for the support of pet animals who lack juridical capacity, or for causes that do not qualify as charitable under section 405(a), but subject to duration constraints. *Id.* §§ 408–09. Regarding the difficulty still experienced in English law in validating such trusts, see Geraint Thomas, *Purpose Trusts*, in THE INTERNATIONAL TRUST 237 (John Glasson ed., 2002); regarding the American development, see Adam J. Hirsch, *Bequests for Purposes: A Unified Theory*, 56 WASH. & LEE L. REV. 33 (1999); Adam J. Hirsch, *Trusts for Purposes: Policy, Ambiguity, and Anomaly in the Uniform Laws*, 26 FLA. ST. U. L. REV. 913 (1999) (criticizing the Uniform Probate Code provisions foreshadowing UTC §§ 408–09). Because a purpose trust lacks conventional beneficiaries, the question arises of how the benefit-the-beneficiaries standard of UTC § 404 and section 27 of the Restatement (Third) of Trusts, see *supra* text accompanying notes 4, 11–16, would apply to such a trust. Purpose trusts are relatively new, and there has been no experience on the question. I would expect a court confronting that question to treat the purpose of a particular purpose trust as a close substitute for the beneficiaries of a conventional trust, hence to adapt the benefit-the-beneficiaries rule into a benefit-the-purposes standard.

⁸¹ UTC § 402(a)(4).

autonomy.⁸² The settlor can choose to proceed by trust or by outright gift, but the settlor cannot make the courts call the one the other.

The rules of trust creation facilitate rather than restrain. Although mandatory, the requirements for trust creation do not seriously restrict the settlor's autonomy over the disposition of the property; rather, they tell the settlor how to go about making an effective transfer in trust. When a trust fails for violation of the trust creation rules, it is usually because the settlor (or an advisor) blundered in attempting to comply with the rules, not because the settlor attempted to achieve a forbidden end.

Complying with the trust creation rules allows the court to be confident that the settlor did indeed transfer the property to a trustee for the benefit of the beneficiaries, and hence that the settlor (or more commonly the settlor's estate) no longer owns the property.⁸³ Failure to insist on cogent evidence that the settlor intended the trust would, Lord Nottingham warned, allow "the Lord Chancellor to construe or presume any man in England out of his estate"⁸⁴ The trust creation rules protect the purported transferor (and especially his or her estate) against false or mistaken claims that he or she had transferred the property away in trust. Insisting on minimal levels of clarity in the use of juridical concepts also produces a systemic gain: It promotes the reliance of outsiders, such as lenders and other creditors.⁸⁵

2. *Enforceable Duties.*—Explaining the Code's requirement that a trust must create enforceable duties,⁸⁶ the official comment explains: "A settlor may not so negate the responsibilities of a trustee that the trustee would no longer be acting in a fiduciary capacity."⁸⁷ If the trustee has no

⁸² See Thomas W. Merrill & Henry E. Smith, *The Property/Contract Interface*, 101 COLUM. L. REV. 773, 843–49 (2001) [hereinafter Merrill & Smith, *Interface*]; Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The Numerus Clausus Principle*, 110 YALE L.J. 1, 18, 57–59 (2000) [hereinafter Merrill & Smith, *Standardization*].

⁸³ TODD & LOWRIE, *supra* note 75, at 109 (rationale "is to ensure that the property is correctly identified and is dealt with in accordance with the wishes of the settlor").

⁸⁴ *Cook v. Fountain*, 3 Swanston App. 585, 592, 36 Eng. Rep. 984, 987 (Ch. 1676), discussed in D.E.C. Yale, *Introduction to 2 LORD NOTTINGHAM'S CHANCERY CASES 101* (Selden Soc. Vol. 79) (1961).

⁸⁵ Merrill & Smith, *Interface*, *supra* note 82, at 799–809, 833–43; Merrill & Smith, *Standardization*, *supra* note 82, at 27–34. For the suggestion that mislabeling may disadvantage third parties, such as creditors of the trustee, see Robert Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 641–46 (2004). Sitkoff has observed that, to the extent that the rules of trust creation serve such third-party interests, the rationale for making them mandatory is broader than the intent-serving function that I emphasize in text. Letter from Robert Sitkoff to John H. Langbein, *supra* note 34, at 5.

⁸⁶ "A trust is created only if . . . the trustee has duties to perform." UTC § 402(a)(4); accord RESTATEMENT (THIRD) OF TRUSTS § 2 (2003). To the same effect is the rule that merger of legal and equitable estates defeats a trust, which is codified as UTC § 402(a)(5).

⁸⁷ UTC § 105(b)(1) cmt. The Restatement's discussion of the requirements for trust creation points to a pair of cases in which fiduciary duty is scant: "Fiduciary duties may, in the circumstances of certain trust relationships, technically exist but not be effectively enforceable; the situation arises to the extent the trustee holds a power of revocation or a presently exercisable general power of appointment or with-

enforceable duties, the beneficiary would have no enforceable interest.

It is important to see how the rule mandating fiduciary obligation fits within the larger structure of trust fiduciary law. The starting point is that each of the fiduciary duties is a default rule, including the core duties of loyalty (the duty to administer the trust solely in the interests of the beneficiaries),⁸⁸ impartiality (the duty of due regard to the interests of all the beneficiaries of a trust),⁸⁹ and the duty of prudence in the conduct of trust administration (the care norm, requiring the exercise of reasonable care, skill, and caution).⁹⁰ None of these fiduciary duties appears on the Code's list of mandatory rules, hence none is protected from settlor modification.

The recognition of the default character of trust fiduciary law is longstanding. Speaking of the duty of loyalty, the Second Restatement provides: "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."⁹¹

Hence, even the duty of loyalty, the "most fundamental"⁹² rule of trust fiduciary law, yields to contrary terms of the settlor.⁹³ Trust law allows the settlor to conclude that particular fiduciary rules would overprotect or otherwise complicate the particular trust and its purposes; hence, the beneficiaries would be better served by abridging them.

Oddly, however, although the various fiduciary rules are default rules, the settlor may not abrogate them in their entirety, because eliminating all fiduciary duties would make the trust illusory. To illustrate: If I am the owner of Blackacre, I am allowed to give Blackacre to *T*, or to make *T* the beneficiary of a trust of Blackacre. What the rule forbids me from doing is effecting that transfer by means of an illusory trust, a trust nominally for the benefit of *B*, rather than *T*. A purported trust to *T* as trustee for *B*, pursuant

drawal." RESTATEMENT (THIRD) OF TRUSTS § 2 cmt. b, at 18 (2003). I have elsewhere explained that the revocable inter vivos trust with life estate retained is in some circumstances "a way station to the creation of a true . . . trust, and . . . in other settings . . . a label that is used to validate transfers that are not in function trusts." Langbein, *supra* note 37, at 645; *see also id.* at 672-75.

⁸⁸ UTC § 802(a); RESTATEMENT (SECOND) OF TRUSTS § 170(1) (1959).

⁸⁹ UTC § 803; RESTATEMENT (SECOND) OF TRUSTS §§ 183, 232 (1959).

⁹⁰ UTC § 804; RESTATEMENT (SECOND) OF TRUSTS § 174 (1959).

⁹¹ RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. t (1959); *accord* UTC § 802(b)(1). The Restatement passage quoted in text continues: "The trustee violates his duty to the beneficiary, however, if he acts in bad faith, no matter how broad may be the provisions of the terms of the trust in conferring power upon him to deal with the trust property on his own account." RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. t (1959). I deal with the good faith requirement elsewhere, *see infra* text accompanying notes 95-105.

⁹² "The most fundamental duty owed by the trustee to the beneficiaries of the trust is the duty of loyalty . . ." 2A SCOTT & FRATCHER, *supra* note 11, § 170, at 311.

⁹³ Prominent decisional authority on the point includes *In re Estate of Halas*, 568 N.E.2d 170, 178 (Ill. App. Ct. 1991); *Estate of McCredy*, 470 A.2d 585, 596-601 (Pa. Super. 1983); and *In re Krause Estate*, 172 N.W.2d 468 (Mich. Ct. App. 1969).

to trust terms providing that *T* shall owe *B* no fiduciary duties, would be illusory because *B* could not enforce a trust that is shorn of fiduciary duties. *T* could, therefore, deal with the trust property as though it had been transferred to *T* beneficially.

The requirement that a trust have enforceable duties speaks to means, not to ends; hence, it is intent-implementing as opposed to intent-defeating. Nothing in my example prevents me from making *T* the beneficiary of my trust rather than *B*. What the mandatory rule forces me to do is to spell out that my intent is to allow *T* to take beneficially. The concern is I may not understand that, by eliminating all fiduciary duties, I am effectively making *T*, rather than *B*, the donee. By forbidding me from eliminating all fiduciary duties, the rule protects me and my intended beneficiary (whether *T* or *B*) by requiring me to make my transfer in a forthright manner.

In this way, the requirement that a trust must have enforceable duties has the consequence of placing aggregate limits on the manner and the extent to which a settlor can oust the default law.⁹⁴

B. Good Faith; Exculpation Clauses

Code section 801, requiring the trustee to “administer the trust in good faith, in accordance with its terms and purposes and the interests of the beneficiaries,” is among the rules of mandatory law scheduled in section 105(b).⁹⁵

The Code’s most visible application of the good faith⁹⁶ requirement occurs in its treatment of exculpation clauses. Clauses relieving trustees of liability for breach of trust are most commonly employed in circumstances in which family members or other nonprofessionals are being induced to serve as trustees. The Code allows the settlor to insert such a clause, but not to relieve against liability for a breach “committed in bad faith or with reckless indifference to the purposes of the trust or the interests of the beneficiaries.”⁹⁷ This good faith limitation on exculpation clauses is well-established in the case law;⁹⁸ the Code’s version derives from the Second Restatement.⁹⁹

⁹⁴ The benefit-the-beneficiaries rule has a similar effect. See *supra* text accompanying note 41.

⁹⁵ UTC §§ 105(b)(2), 801. English law accords. “The duty to act in good faith . . . cannot, of course, be excluded.” Hayton, *supra* note 1, at 57 (citing *Re Jeffrey*, [1984] 4 DLR 704, 710).

⁹⁶ The Code does not define “good faith.” For a succinct account of the nuances developed in contract law, but emphasizing the core notion of honest dealing, see Robert S. Summers, *The Conceptualization of Good Faith in American Contract Law: A General Account*, in GOOD FAITH IN EUROPEAN CONTRACT LAW 118 (Reinhard Zimmermann & Simon Whittaker eds., 2000).

⁹⁷ UTC § 1008. UTC § 105(b)(10) schedules this measure among the Code’s mandatory rules. The comment to section 1008 links that section’s prohibition on bad faith to the requirements of good faith and benefit to the beneficiary.

⁹⁸ See generally 3 SCOTT & FRATCHER, *supra* note 11, § 222, at 384–87; *id.* § 222.3 & n. 1, at 391–93. In a prominent recent English case, the Court of Appeal validated a clause excusing all trustee liability except for fraud. In recognizing that such a clause effectively exonerated even gross negligence, the court rejected the beneficiary’s claim “that it is contrary to public policy to exclude the liability of a trustee for gross negligence . . .” *Nurse v. Armitage*, [1998] Ch. 241, 254 (1997). Lord Justice Millett

The good faith requirement is mandatory for essentially the same reasons that trust law removes the standards for trust creation from party control. A trust whose terms authorize bad faith performance, like a trust that denies enforceable duties, would be illusory. In a recent case in which it refused to enforce an exculpation clause that would have authorized bad faith trusteeship, the Delaware Supreme Court observed: "A trust in which there is no legally binding obligation on a trustee is a trust in name only and more in the nature of an absolute estate or fee simple grant of property"¹⁰⁰ to the trustee.

The good faith requirement serves a truth-in-labeling policy similar to the rules of trust creation. A settlor who wishes to benefit *T*, the trustee, may do so. For example, the settlor may grant *T*, the trustee, a general power of appointment, which would allow *T* to appoint some or all of the trust property to *T* personally,¹⁰¹ but the settlor must identify the interest in that way. The settlor may not get that result by dispensing with good faith administration of the trust,¹⁰² thereby allowing the trustee to loot the trust. This insistence on correct labeling, in addition to promoting efficient judicial administration, serves protective and cautionary functions. The suspicion is ever present that a term dispensing with good faith trust administration may not have been properly disclosed to the settlor, or that the settlor may not have understood its effect. The question of what a settlor really knew or intended is difficult to resolve, because the settlor is almost always dead when the issue arises, and cogent evidence of the settlor's intent is seldom obtainable. The mandatory rule against bad faith trusteeship can be understood to operate as a presumption that trust terms authorizing bad faith must have been improperly concealed from the settlor or otherwise misunderstood by the settlor when propounded, because no settlor seeking to benefit the beneficiary would expose the beneficiary to the hazards of bad faith trusteeship.

The rule governing exculpation clauses has a second branch that is directed not towards problems of good faith application, but towards the danger of imposition in the drafting or inclusion of such clauses. Following the Second Restatement, the Code provides that an exculpation clause is ineffective when "inserted as the result of an abuse by the trustee of a fiduciary or confidential relationship to the settlor."¹⁰³ The Code has intensified this prohibition by adding a further safeguard, which provides: "An exculpatory

said: "The duty of the trustees [that the clause did not negate] to perform the trusts honestly and in good faith for the benefit of the beneficiaries is the minimum necessary to give substance to the trusts, but in my opinion it is sufficient." *Id.* at 253-54.

⁹⁹ RESTATEMENT (SECOND) OF TRUSTS § 222 (1959).

¹⁰⁰ *McNeil v. McNeil*, 798 A.2d 503, 509 (Del. 2002) (rejecting a term making decisions of the trustees "not subject to review by any court").

¹⁰¹ RESTATEMENT (SECOND) OF PROPERTY: DONATIVE TRANSFERS § 11.1 cmt. d, § 11.4(1) (1986).

¹⁰² *Id.* § 12.1.

¹⁰³ UTC § 1008(a)(2).

term drafted or caused to be drafted by the trustee is invalid as an abuse of a fiduciary or confidential relationship unless the trustee proves that the exculpatory term is fair under the circumstances and that its existence and contents were adequately communicated to the settlor.¹⁰⁴ This measure effectively presumes abuse when the trustee's hand is found in the creation of the clause, shifting the burden of disproof to the trustee.¹⁰⁵ By making this regime mandatory, the Code prevents the wrongdoing trustee from defeating the safeguard by arranging to have it drafted out of the instrument. Because this branch of the rule is an anti-fraud measure, it is unambiguously intent-serving, preventing enforcement of a clause that the settlor probably did not intend or understand.

C. Disclosure to the Beneficiaries

The default regime of the Uniform Trust Code requires extensive reporting by the trustee to the beneficiaries,¹⁰⁶ amplifying the duty to inform (or account)¹⁰⁷ under the common law of trusts.¹⁰⁸ Following the case law,¹⁰⁹ the Code makes some of its disclosure rules mandatory. Under section 105(b)(8), the settlor of an irrevocable trust may not dispense with the trustee's duty to notify the beneficiaries "of the existence of the trust, of the identity of the trustee, and of their right to request trustee's reports"¹¹⁰ Section 105(b)(9) makes mandatory the trustee's duty "to respond to the re-

¹⁰⁴ *Id.* § 1008(b). The comment remarks that section 1008(b)'s requirements are "satisfied if the settlor was represented by independent counsel." *Id.* § 1008(b) cmt.

¹⁰⁵ Section 1008(b) was the Code's response to *Marsman v. Nasca*, 573 N.E.2d 1025 (Mass. App. Ct. 1991), which the provision would overrule. See UTC § 1008 cmt. (disapproving of the case).

¹⁰⁶ *Id.* § 813.

¹⁰⁷ The Code carefully avoids using the word "account." See *id.* § 813(c) cmt. (explaining that the Code "employs the term 'report' instead of 'accounting'"). In trust practice and parlance, the term "accounting" has been used to refer to five distinct doctrines or remedies: (1) the trustee's duty to keep appropriate internal financial records respecting the trust property, RESTATEMENT (SECOND) OF TRUSTS § 172 (1959); (2) financial reporting to the beneficiary about the trust assets, *id.* § 173; (3) financial reporting to the court for purposes of obtaining a judicial decree with preclusive effect approving the accounts, *id.* § 260; (4) so-called "accounting for profits," a restitutionary remedy to recoup from a trustee a profit that the trustee has made from the trust in circumstances that do not constitute breach of trust, *id.* § 203; and (5) the equitable remedy of account, which arises from equity's power of discovery, and which commonly entails the use of a master or referee to examine and offset financial records and prepare consolidated accounts, see 1 DAN DOBBS, LAW OF REMEDIES § 4.3(5), at 609, 610 (1993).

¹⁰⁸ RESTATEMENT (SECOND) OF TRUSTS § 173 (1959).

¹⁰⁹ *E.g.*, *Briggs v. Cowley*, 224 N.E.2d 417, 421 (Mass. 1967) (holding that "the clauses in the trust instrument purporting to relieve the trustees of the duty imposed by law to account are invalid as against public policy in so far as they purport to deprive the Probate Court of jurisdiction and the [beneficiary] of her standing to maintain this proceeding").

¹¹⁰ UTC § 105(b)(8) (cross-referencing *id.* § 813(b)(2)–(3)). The provision contains an exception, allowing the settlor to direct that the existence or terms of the trust be concealed from a beneficiary who is under age twenty-five. This measure defers to the settlor's concern that early disclosure of unearned wealth may harm a young person's character. Commonly, but not necessarily, such a trust would have other beneficiaries above the age of mandatory disclosure who would be able to enforce the trust.

quest of a beneficiary of an irrevocable trust for trustee's reports and other information reasonably related to the administration of a trust"¹¹¹

Like a trust term purporting to abrogate all fiduciary duties, or a term authorizing the trustee to act in bad faith, a term that prevents the beneficiary from obtaining the information needed to enforce the trust entails the risk of making the trust unenforceable and hence illusory. The policy of mandatory disclosure is protective. Behind the Code's prohibition on complete nondisclosure of the trust and its terms is the intuition that the settlor is not likely to have understood that the true effect of such a term resembles a transfer of the beneficial interest to the trustee, because the term places the trustee's misuse of the trust property beyond effective remedy. As we have seen in connection with the good faith requirement, so with disclosure: The mandatory rules do not prevent the settlor from making a beneficial gift to the trustee, but they do force the settlor to clarify the intent to make such an improbable transfer by doing it in a different and unambiguous fashion.

CONCLUSION

I have sounded three main themes on this tour through the mandatory rules of trust law:

The primacy of default law. Trust law consists almost entirely of default rules. The mandatory rules barely intrude on ordinary practice. Aside from the rule against illegal purposes, which is universal in private and organizational law, the only mandatory rules of trust law that materially interfere with the settlor's intention are the anti-dead-hand rules. The two main variants of such rules are the benefit-the-beneficiaries requirement and the rules allowing courts to modify trusts in response to changed circumstances.

Limiting unsound investment directions. In the realm of trust investing and managing trust assets, the recognition of modern portfolio theory as the basis of trust investment law has rendered the standard of benefit to the beneficiaries much more objective and measurable than in the past. Because the gains from broad diversification are large and virtually costless to obtain, the benefit-the-beneficiaries requirement has the potential to relieve against value-impairing investment directions.

Implementing settlor's intent. Apart from the anti-dead-hand rules, the mandatory rules of trust law have a prevaingly intent-serving purpose. They facilitate rather than prohibit; their policy is cautionary and protective. These rules force the settlor to be precise about the tradeoffs between benefiting the trustee and benefiting the beneficiary; hence they aim to clarify and channel, rather than to defeat the settlor's intent. Trust terms that would excuse bad faith, or dispense with fiduciary obligation, or conceal the trust from its beneficiaries would make the trust obligation illusory, effectively allowing the trustee to loot the trust. Because, however, the settlor

¹¹¹ *Id.* § 105(b)(9) (cross-referencing *id.* § 813(a)).

has named the beneficiary and not the trustee as the ostensible beneficiary of the trust, the inference is ordinarily compelling that the settlor did not intend to displace the beneficiary and substitute the trustee as beneficiary. The intent-serving mandatory rules merely require a settlor who has such an improbable intent to articulate it unambiguously, in order to prevent the settlor from stumbling into that result through misunderstanding or imposition. Accordingly, apart from the anti-dead-hand rules, the mandatory rules of trust law have only the modest aspiration of truth in labeling.

APPENDIX

UNIFORM TRUST CODE § 105
(with 2003 technical amendment)

SECTION 105. DEFAULT AND MANDATORY RULES.

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

(b) The terms of a trust prevail over any provision of this [Code] except:

- (1) the requirements for creating a trust;
- (2) the duty of a trustee to act in good faith and in accordance with the purposes of the trust;
- (3) the requirement that a trust and its terms be for the benefit of its beneficiaries, and that the trust have a purpose that is lawful, not contrary to public policy, and possible to achieve;
- (4) the power of the court to modify or terminate a trust under Sections 410 through 416;
- (5) the effect of a spendthrift provision and the rights of certain creditors and assignees to reach a trust as provided in [Article] 5;
- (6) the power of the court under Section 702 to require, dispense with, or modify or terminate a bond;
- (7) the power of the court under Section 708(b) to adjust a trustee's compensation specified in the terms of the trust which is unreasonably low or high;
- (8) the duty under Section 813(b)(2) and (3) to notify the qualified beneficiaries of an irrevocable trust who have attained 25 years of age of the existence of the trust, of the identity of the trustee, and of their right to request trustee's reports;
- (9) the duty under Section 813(a) to respond to the request of a beneficiary of an irrevocable trust for trustee's reports and other information reasonably related to the administration of a trust;
- (10) the effect of an exculpatory term under Section 1008;
- (11) the rights under Sections 1010 through 1013 of a person other than a trustee or beneficiary;
- (12) periods of limitation for commencing a judicial proceeding; [and]
- (13) the power of the court to take such action and exercise such jurisdiction as may be necessary in the interests of justice [; and]
- (14) the subject-matter jurisdiction of the court and venue for commencing a proceeding as provided in Sections 203 and 204].