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Trust Protectors, Agency Costs, and Fiduciary Duty

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TRUST PROTECTORS, AGENCY COSTS, AND FIDUCIARY DUTY

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In recent years, fiduciary duty scholarship has focused on the agency cost problems that afflict private trusts.[1] Robert Sitkoff has demonstrated that a number of familiar fiduciary duties—including the duty of impartiality, the duty to invest for total return, and the duty of care—operate to align the interests of the trustee with those of the settlor and the beneficiaries.[2] Melanie Leslie, in arguing that settlor and trustee should not enjoy unlimited freedom to vary the content of fiduciary duties, has emphasized that information asymmetries undermine the assumption that the trust agreement will provide optimal control of agency costs.[3] Both Sitkoff and Leslie have focused on the difficulties inherent in relying on the market to monitor trustee behavior, and thus control agency costs.[4] And even John Langbein, in the course of his controversial proposal to jettison the no-further-inquiry rule, concedes that the "difficulty of beneficiary monitoring underscores the importance of the duty of loyalty."[5]

Agency cost analysis of private trusts, however, confronts an immediate difficulty: who is the principal? Two candidates emerge: the trust beneficiaries, who are often treated as the "equitable owners" of the trust property, and the trust settlor, without whose property (and

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1 "Agency costs" refer to the losses suffered by a principal because her agent's interests—and hence incentives to act—diverge from those of the principal. The principal can reduce those costs by monitoring the agent's activities or by bonding the agent. Hence, Jensen and Meckling have defined agency costs as the sum of the principal's monitoring expenditures, the principal's bonding expenditures, and the principal's residual loss—the remaining reduction in the principal's welfare as a result of the divergence of the interests of the principal and the agent. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

2 Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 650-57 (2004).

3 Melanie B. Leslie, *Trusting Trustees: Fiduciary Duties and the Limits of Default Rules*, 94 GEO. L.J. 67 (2005).

4 Sitkoff, *supra* note 2, at 645-46; Leslie, *supra* note 3, at 82-84.

5 John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929, 957 (2005).

without whose consent) there would be no trust.[6] Existing trust doctrine equivocates on who serves as the trustee's principal: the trust settlor may impose a variety of enforceable obligations on the trustee, but those restrictions are enforceable only by the trust beneficiaries, not by the trust settlor.[7]

Often, this equivocal answer presents few practical difficulties. On many issues, the interests of the settlor and the interests of the beneficiary are aligned; the settlor's primary objective is to benefit the beneficiaries, and if the trustee is serving the beneficiaries, the trustee is also serving the settlor. But to conclude that a trustee who serves the beneficiaries also serves the settlor does not address the basic agency cost problem: how do we assure that the trustee provides the care and loyalty the settlor and the beneficiaries expect?

Moreover, on some issues, equivocation about identifying the trustee's principal presents more significant difficulties. Suppose, for instance, the settlor wishes to control trust distributions in ways that the beneficiaries (or some subset of beneficiaries) do not like. Treating the beneficiaries as the trustee's principal is inconsistent with much traditional doctrine,[8] and particularly with the emerging contractarian theory of the trust.[9] But treating the settlor as the principal also creates a significant practical and conceptual problem: the settlor will typically be dead for much of the trust's duration. Practically, the settlor's demise often makes it impossible to determine whether the trustee is faithfully representing the wishes of the dead settlor. Even if the settlor left explicit instructions on some matters, the settlor could not possibly have anticipated all of the decisions a trustee would face. And that

[6] Robert Sitkoff has argued that because the joint intent of contracting parties carries with it a presumption of Pareto optimality, the settlor should generally be treated as the trustee's principal. Sitkoff, *supra* note 2, at 644-48. For another recent exploration of some of the issues, see Alan Newman, *The Intention of the Settlor Under the Uniform Trust Code: Whose Property Is It, Anyway?*, 38 AKRON L. REV. 649 (2005).

[7] Moreover, there are subtle differences between the predominant approaches in the United States and England. As one court has put it:

> The American cases recognize primarily the privilege of the donor to qualify his gift as he pleases within legal limits. *Cujus est dare ejus est disponere*. The English courts concentrate their predominant attention upon the situation of the beneficiary who being substantially the owner of the trust estate should be permitted in their judgment to deal with it as he wishes.

Speth v. Speth, 74 A.2d 344, 347 (N.J. 1950). *See generally* Sitkoff, *supra* note 2, at 662-63 (discussing differences between the American approach and the English approach, which tends to treat beneficiaries as the trustee's principals).

[8] For instance, traditional doctrine restricts the power of the trust beneficiaries to compel modification or termination of the trust when termination would frustrate a material purpose of the settlor. *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS § 65 (Tentative Draft No. 3, 2001).

[9] *See, e.g.*, John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625 (1995); Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 N.Y.U. L. REV. 434, 447-49 (1998).

problem—the settlor's lack of foresight—becomes more serious as the duration of the trust increases.[10] Conceptually, treating the dead settlor as the principal raises a time-honored question in the law of trusts and estates: for how long should current decisions be controlled by the dead hand of a settlor who has long since met his maker?[11]

Suppose now that we superimpose on the traditional trust framework a "trust protector"—a person selected by the settlor to represent the settlor's interests in making specified trust decisions that the settlor will be unable to make. As the living embodiment of the dead settlor, the protector has the potential to mitigate the foresight problems associated with dead hand control. At the same time, the protector has the potential to serve as a monitor of the trustee's performance, reducing agency costs in that respect as well.

To be sure, the office of trust protector did not develop to "solve" the agency cost problems associated with private express trusts. Instead, as Part I of this Article demonstrates, the trust protector emerged in the context of offshore trusts, where trust settlors have sought to maintain as much control over trust assets as possible while shielding those assets from creditors. But lawyers have recognized the potential of the office and have quickly adapted the trust protector to serve other functions.

Appointment of a trust protector, however, provides at best a modest amelioration of the agency cost problem, not a complete solution. The trust protector, too, is only an agent. The settlor did not choose to relinquish title to the protector but chose instead to give the protector limited powers to guide trustee behavior. As a result, the emergence of trust protectors raises a new set of agency cost problems: first, do protectors owe any enforceable duties to the trust beneficiaries, or to anyone else; second, how, if at all, do the powers conferred on the trust protector affect the responsibilities of the trustee?

The emergence of the trust protector is so new that current doctrine has not yet answered these questions. And the answers may differ depending on the purposes for which the protector was appointed and the powers the settlor has conferred on the protector. This Article attempts to situate the trust protector in the web of relationships that surround the private express trust, exploring the agency costs avoided—and created—with the advent of trust protectors, and examining the ramifications for fiduciary duty law.

10 *See generally* Robert C. Ellickson, *Adverse Possession and Perpetuities Law: Two Dents in the Libertarian Model of Property Rights*, 64 WASH. U. L.Q. 723, 734-35 (1986).

11 *See generally* LEWIS M. SIMES, PUBLIC POLICY AND THE DEAD HAND (1955).

I. THE EMERGENCE OF THE TRUST PROTECTOR

A. *Origins in the Growth of the Asset Protection Trust*

Trust protectors are not indigenous to American trust law. Even before the last two decades, some English trusts used protectors to reassure settlors uneasy about the powers conferred on the trustee.[12] But protectors were imported into the United States from offshore jurisdictions seeking to attract asset protection business. The typical offshore asset protection trust names as a trustee a person or institution beyond the personal jurisdiction of American courts. The reason for this practice is evident: if the trustee were subject to the jurisdiction of American courts, an American court could order the trustee to make trust assets available to American creditors, and could impose sanctions on the trustee for failure to comply with the court order.[13]

Despite their strong desire to protect their assets from creditors, American settlors of offshore trusts have often been reluctant to relinquish all control over their assets to a foreign entity. As a result, trust instruments have frequently named a "trust protector" with various powers over the trust and the trustee. Sometimes, the settlor named himself as protector,[14] but the settlor who named himself as protector increased the risk that an American court would order him to compel the trustee to make the money available to trust creditors—defeating the purpose of the asset protection trust.[15] Many settlors, therefore, opted to name a third party as protector.

In determining what powers to confer on the trust protector, settlors had to weigh competing risks. By conferring broad affirmative powers on the protector—even if the protector was not the settlor-beneficiary—the trust settlor would increase the risk that an American court with personal jurisdiction over the protector would pierce the trust at the behest of the settlor's creditors. The settlor could minimize that risk by leaving the protector only with power to veto the trustee's

[12] *See* Antony Duckworth, *Protectors—Fish or Fowl?*, 4 J. INT'L TR. & CORP. PLAN. 137, 168 (1995).

[13] *Cf.* Hardy v. Hardy, 5 Cal. Rptr. 110 (Dist. Ct. App. 1960) (a court with jurisdiction over a trustee can compel the trustee to account for or dispose of trust property located in another state).

[14] *See, e.g.*, FTC v. Affordable Media, LLC, 179 F.3d 1228, 1242-43 (9th Cir. 1999).

[15] *Id.* at 1242.

decisions;[16] an American court would find it difficult to order the protector to veto a decision the trustee had never made.[17]

On the other hand, limiting the protector to veto powers would reduce the protector's value for other purposes. For instance, the settlor might want to confer on the protector power to change the situs of the trust to take advantage of the enactment of more trust-friendly laws, or to escape political or legal instability in the original situs. The trustee, who might have strong ties to the original situs, might be reluctant to make such a change. Moreover, the settlor might want to give the protector power to remove the trustee upon suspicion or evidence of malfeasance. But to accomplish these objectives, the settlor would have to accept increased risk of intervention by an American court.[18] Quite naturally, various settlors have balanced these objectives differently, resulting in wide variety among the powers conferred on protectors of offshore trusts.

Use of protectors in offshore trusts originated out of the creativity of lawyers, not out of express statutory authorization. But as the use of protectors became more prevalent, a number of offshore jurisdictions did enact legislation authorizing use of protectors. The Cook Islands International Trust Amendment Act of 1989 began the move toward statutory recognition, and other offshore jurisdictions followed suit. Although all of the statutes recognize that the protector is the holder of a power,[19] the statutes otherwise embrace significantly different conceptions of the protector. Thus, the statute enacted in the British Virgin Islands provides expressly that a protector "is not liable to the beneficiaries for the bona fide exercise of the power."[20] By contrast, the Belize statute provides that "[i]n the exercise of his office a protector shall owe a fiduciary duty to the beneficiaries of the trust or to the purpose for which the trust is created."[21]

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16 *See* Gideon Rothschild, *Establishing and Drafting Offshore Asset Protection Trusts*, 23 EST. PLAN. 65, 70 (1996) ("The protector's powers should generally be drafted as negative powers and subject to the anti-duress provisions to protect against an order compelling the protector to exercise control over the trust.").

17 *See* Robert T. Danforth, *Rethinking the Law of Creditors' Rights in Trusts*, 53 HASTINGS L.J. 287, 309 (2002).

18 *Cf. Affordable Media*, 179 F.3d at 1242 (trust settlors name themselves as protectors; court relies on their occupancy of office of protector to conclude that settlors retained power to force repatriation of trust assets).

19 *See, e.g.*, International Trusts Act of 1984 § 7 (as amended 1989) (Cook Islands) ("'Protector' in relation to an international trust means a person who is the holder of a power which when invoked is capable of directing a trustee in matters relating to the trust . . . .").

20 Trustee Ordinance § 86(3) (1961) (as amended by the Trustee (Amendment) Act (1993)) (British Virgin Islands).

21 Belize Trusts Act 1992 § 16(5), *available at* http://www.ifsc.gov.bz/acts/trustsact.pdf. *See generally* MAURIZIO LUPOI, TRUSTS: A COMPARATIVE STUDY 257-62 (Simon Dix trans., 2000).

Despite the statutory differences, appointment of a trust protector has become standard in offshore asset protection trusts.[22] And, in more recent years, the use of protectors has spread to domestic trusts as well.

B. *Domestic Trusts*

1. Limited Foresight and Changed Circumstances

Widespread use of protectors in offshore trusts led American lawyers to recognize the protectors' potential to solve problems facing settlors of domestic trusts. One such problem involves how to adapt the trust's provisions to account for circumstances not foreseen by the settlor at the time of the trust's creation.[23] As trusts become longer in duration, the problems of change and inadequacy of foresight increase in importance.[24] Changes in law, for instance, might result in frustration of the settlor's purposes. Similarly, unforeseen changes in family situation could make modification of the trust terms desirable. Judicial modification or termination of the trust is always a possibility, but existing doctrine places a number of obstacles in front of parties who seek judicial modification.[25] Moreover, a judicial proceeding costs money, which will typically operate to deplete trust resources.

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[22] Donovan W. M. Waters, *The Protector: New Wine in Old Bottles?*, *in* TRENDS IN CONTEMPORARY TRUST LAW 64 (A.J. Oakeley ed., Oxford Univ. Press 1996).

[23] *See* Edward Rock & Michael Wachter, *Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 NW. U. L. REV. 651, 664 (2002) (noting the need for flexibility because the settlor will have passed from the scene when many unanticipated events unfold).

[24] *See generally* Stewart E. Sterk, *Jurisdictional Competition to Abolish The Rule Against Perpetuities: R.I.P. for the R.A.P.*, 24 CARDOZO L. REV. 2097 (2003) (cataloging reasons for a move in many states to authorize perpetual trusts).

[25] Black letter law has long been that beneficiaries can compel termination or modification of a trust if all of them consent, so long as there is no material purpose in continuing the trust. *See* RESTATEMENT (SECOND) OF TRUSTS § 337 (1959). For an application of the black letter law, see, e.g., Am. Nat'l Bank of Cheyenne v. Miller, 899 P.2d 1337 (Wyo. 1995) (authorizing termination). If, however, the trust is spendthrift, legislatures and courts have often concluded that termination would frustrate a material purpose, thus precluding termination. *See, e.g.*, CAL. PROB. CODE § 15404(b) (West 2005); Culver v. Title Guarantee & Trust Co., 70 N.E.2d 163 (N.Y. 1946). Other courts have been even more restrictive, finding material purposes inconsistent with termination simply because the trust instrument provides a life interest to an income beneficiary. *See* Adams v. Link, 145 A.2d 753 (Conn. 1958).

The drafters of the Restatement (Third) of Trusts have attempted to liberalize traditional termination rules in two ways. First, the black letter of section 65 permits termination even if a material purpose would be frustrated, so long as a court concludes that "the reason for termination . . . outweighs the material purpose." RESTATEMENT (THIRD) OF TRUSTS § 65(2) (2003). Second, a comment to section 65 provides that a spendthrift provision does not by itself establish that termination would frustrate a material purpose of the trust. Instead, a spendthrift clause furnishes only "some indication" of a material purpose inconsistent with termination. *Id.* § 65 cmt. e.

The settlor could, of course, account for these problems by making the trust revocable, but settlors have a variety of reasons for parting more completely with any interest in the trust property.[26] Moreover, if the trust is designed to be perpetual, revocability is not an option, because the settlor is in no position to revoke after her death.

Alternatively, the settlor could confer on one or more beneficiaries a right to modify the trust's terms. This alternative, however, creates two potential problems, at least if the instrument authorizes the beneficiary to modify in favor of herself. First, a beneficiary with power to modify might act in self-interest, frustrating the settlor's wishes. Second, the power to modify might be construed as creating in the beneficiary a general power of appointment, generating unfortunate tax consequences.[27]

To avoid these problems, the settlor could give modification powers to the trustee, but trustees are often reluctant to modify or terminate trusts, even when termination would serve the settlor's interests.[28] Moreover, the settlor may choose the trustee for reasons unrelated to the trustee's ability to account for the settlor's imperfect foresight.

Against this background, the trust protector offers what may be an attractive alternative—a person whose primary function is to exercise judgment on behalf of the trust settlor. The model may be most attractive when the protector is a trusted confidante of the settlor, but that model can only work for the lifetime of the confidante. Even a professional protector, or a successor chosen by the settlor's original protector, may be superior to the other available alternatives for dealing with deficiencies in the settlor's foresight.

2. Policing the Trustee

[26] For instance, if the trust were revocable, the settlor would be treated as the owner of the trust property for federal income tax purposes. 26 U.S.C. § 676 (2000).

[27] *See* 26 U.S.C. § 2041 (property over which decedent enjoyed general power of appointment included in decedent's estate); 26 C.F.R. § 20.2041-1(b) (2006) ("[A] power given to a decedent to affect the beneficial enjoyment of trust property or its income by altering, amending, or revoking the trust instrument or terminating the trust is a power of appointment."); *see also* Alexander A. Bove, Jr., *The Trust Protector: Trust(y) Watchdog or Expensive Exotic Pet?*, 30 EST. PLAN. 390, 395 (2003).

[28] Thus, trustees sometimes challenge the termination of trusts—generally unsuccessfully—in order to preserve their right to commissions. *See, e.g.*, Moore v. First Nat'l Bank & Trust Co. of Macon, 130 S.E.2d 718, 721 (Ga. 1963) (finding that the incidental benefit which the trustee may derive from future commissions is not of such a character as gives it a vested right to the continuance of the trust); *see generally* 4 SCOTT ON TRUSTS § 337 (4th ed. 2001).

Although trust protectors became popular in a context where the settlor's main objective was to protect trust assets against settlor's creditors, the protector device also has potential to protect trust assets against the actions of the settlor's chosen trustee. When the settlor creates a trust, she conveys to the trustee legal title to the trust property. Inherent in the trust, however, is the settlor's intention that the trustee not treat the property as his own. Instead, trust law presumes that the settlor wants the trustee to manage the trust assets prudently and in the interest of the trust beneficiaries.[29] Fiduciary duty law gives content to that presumption, which the settlor can modify with appropriate language in the trust instrument.[30]

A critical issue remains, however: how does the settlor ensure that the trustee acts in accordance with the settlor's expectations? Trust law's traditional response is to enlist the trust beneficiaries as monitors, through the mechanism of an action for breach of fiduciary duty.[31] By subjecting the trustee to potential liability, trust law encourages the trustee to comply with settlor's instructions. But monitoring by the beneficiaries is both imperfect and costly. First, the beneficiaries themselves often lack the expertise to detect breach.[32] Second, the beneficiaries may be dependent on the trustee, and hence they may be reluctant to take action to discipline the trustee.[33] In combination, these factors suggest potential underdeterrence of trustee misbehavior.[34] In addition, of course, the trust beneficiaries will bear much of the litigation cost. And, as Professor Leslie has demonstrated, market monitoring—which has some potential for disciplining fiduciaries in the corporate context—is wholly inadequate in the trust context.[35]

By contrast, if the settlor appoints a trust protector, the protector might be in a position to relieve the trust beneficiaries of the primary

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29 *See generally* RESTATEMENT (THIRD) OF TRUSTS §§ 76-78 (Tentative Draft No. 4, 2005) (providing that the trustee has a duty to administer the trust "in accordance with the terms of the trust and applicable law," and then describing the duty of prudence and duty of loyalty).

30 *See* RESTATEMENT (THIRD) OF TRUSTS § 76, cmt. on Subsection (1); b(1) (Tentative Draft No. 4, 2005) ("[T]he normal standards of trustee conduct prescribed by trust fiduciary law may, at least to some extent, be modified by the terms of the trust. Briefly stated, much of trust law, especially trust fiduciary law, is default law—but some is not."); *see also* John H. Langbein, *Mandatory Rules in the Law of Trusts*, 98 NW. U. L. REV. 1105 (2004); Langbein, *supra* note 9, at 660.

31 *See generally* RESTATEMENT (SECOND) OF TRUSTS § 205 (1959) (discussing liability in the case of a breach of trust); *see also* Rock & Wachter, *supra* note 23, at 653-55.

32 *See* Leslie, *supra* note 3, at 84.

33 *See* Benjamin G. Carter, *Relief for Beneficiaries Suing for Breach of Fiduciary Duty: Payment of Accounting Costs Before Trial*, 76 WASH. U. L.Q. 1411, 1421-26 (1998).

34 *See* Melanie B. Leslie, *In Defense of the No Further Inquiry Rule: A Response to Professor John Langbein*, 47 WM. & MARY L. REV. 541, 558-62 (2005).

35 *See* Leslie, *supra* note 3, at 79-84. *But see* Jonathan R. Macey, *Private Trusts for the Provision of Public Goods*, 37 EMORY L.J. 295, 317 (1988) (arguing that simplicity of trust decisions reduces the need for market monitoring of trustees).

responsibility for monitoring the trustee. Moreover, with appropriate language in the trust instrument, the protector might be able to avoid the cost of litigation. The settlor, for instance, could require the trustee to obtain the protector's consent before taking particular actions and could even give the protector power to remove the trustee without judicial approval.[36] In this way, the trust protector can serve, at least in theory, as an efficient check on the agency costs associated with private express trusts. It is this insight, and its doctrinal implications, that serves as the focus for Part III.

C. *Statutory Recognition*

Until recently, no American statute made any mention of trust protectors. Over the last eight years, however, five states have enacted statutes explicitly authorizing or defining trust protectors. South Dakota enacted the first such statute in 1997,[37] followed by Idaho in 1999,[38] Alaska[39] and Wyoming[40] in 2003, and Tennessee in 2004.[41] The Alaska statute differs significantly from the statutes enacted in the other four states. In the other states, the statutes insulate trustees—generally denominated "excluded fiduciaries"—from liability for following directions given to them by trust protectors.[42] The Alaska statute includes no comparable provision. The statutes also differ significantly on the protectors' own liabilities. The Alaska statute provides explicitly that, subject to contrary provisions in the trust instrument, "a trust protector is not liable or accountable as a trustee or fiduciary . . . ."[43] By

36 Indeed, this might be the most common power conferred on the trust protector. *See* Waters, *supra* note 22, at 105.

37 1997 S.D. Sess. Laws 280, § 1 (codified as amended at S.D. CODIFIED LAWS §§ 55-1B-1 to 55-1B-5 (2005)).

38 1999 Idaho Sess. Laws 331, § 1 (codified at IDAHO CODE ANN. § 15-7-501 (2005)).

39 2003 Alaska Sess. Laws 130, § 1 (codified at ALASKA STAT. § 13.36.370 (2005)).

40 2003 Wyo. Sess. Laws 124, § 1 (codified as amended at WYO. STAT. ANN. § 4-10-710 – 4-10-718 (2005)).

41 The Tennessee statute, 2004 Tenn. Pub. Acts 537, § 66, as well as its Section Comment, can be found at TENN. CODE ANN. § 35-15-808 (2005).

42 The Tennessee statute, based on the Uniform Trust Code, is somewhat equivocal. The comment to the section tracks the comment to the UTC, which suggests that the trustee bears minimal oversight responsibility. *See* text accompanying note 49, *infra*. But the text of the statute includes a provision absent from the UTC. That provision insulates the trustee from liability when following the directions of the protector. TENN. CODE ANN. § 35-15-808(e).

The other statutes unequivocally insulate the trustee from liability for following the protector's directions. *See* IDAHO CODE ANN. § 15-7-501(2); S.D. CODIFIED LAWS § 55-1B-5; WYO. STAT ANN. §§ 4-10-715, 4-10-717. These states typically denominate trustees who have received directions from a trust protector as "excluded fiduciaries." *See, e.g.*, S.D. CODIFIED LAWS § 55-1B-1.

43 ALASKA STAT. § 13.36.370(d).

contrast, statutes in the other four states direct that a protector should be treated as a fiduciary unless the trust instrument provides to the contrary.[44]

The Uniform Trust Code (UTC) also makes provision for trust protectors. Although the trust protector label appears only in a Comment,[45] the statute itself speaks in terms of a trust that confers "upon a person . . . power to direct certain actions of the trustee."[46] The UTC does not provide trustees with absolute immunity from liability for following the directions of a trust protector. Section 808 provides that the trustee shall act in accordance with the exercise of a power held by a protector "unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty that the person holding the power owes to the beneficiaries of the trust."[47] Thus, the UTC standard requires that the trustee exercise "minimal oversight responsibility" before following the protector's directions.[48] Moreover, the UTC creates a presumption that the holder of a "power to direct" is a fiduciary.[49]

Most states, however, have made no statutory provision for protectors and have not yet developed case law defining the relationships among protectors, trustees, settlors, and beneficiaries.[50] Moreover, even in states that have labeled protectors as fiduciaries, the scope of the fiduciary duties owed by the protector remain substantially uncertain. It is against that uncertainty that we turn to the role protectors might play in controlling agency costs.

44 IDAHO CODE § 15-7-501(4); S.D. CODIFIED LAWS, § 55-1B-4; TENN. CODE ANN. § 35-15-808(d); WYO. STAT. ANN. § 4-10-711.

45 UNIF. TRUST CODE § 808 cmt. (2005).

46 *Id.* at § 808(b).

47 *Id.*

48 *Id.* at § 808 cmt.

49 *Id.* at § 808(d).

50 A Washington statute, however, provides, without mentioning trust protectors by that name, that a person with a power to direct or control the acts of a fiduciary shall be deemed to be a fiduciary. WASH. REV. CODE § 11.100.130 (West 2005).

Moreover, several states have expressly provided that when the trust instrument vests in someone other than the trustee power to make investment decisions, the trustee should be treated as an "excluded fiduciary" and should bear no liability for losses resulting from an investment made by the direction of someone else with investment powers. Excluded fiduciary terminology predates the advent of trust protectors, and appears in statutes in a number of states to insulate trustees from liability when acting pursuant to a direction authorized by the trust instrument. *See* COLO. REV. STAT. § 15-1-307 (2005); GA. CODE ANN. § 53-12-194 (2005); OHIO REV. CODE ANN. § 1339.43 (LexisNexis 2005); TEX. PROB. CODE ANN. § 114.003 (Vernon 2005); VA. CODE ANN. § 26-5.2 (2006); *see also* IND. CODE ANN. § 30-4-3-9 (2005) (relieving trustee of liability without using excluded fiduciary language).

II. THE PROTECTOR AND AGENCY COSTS

A. *Monitoring the Trustee*

1. The Optimistic Model

Agency costs arise because it is often difficult for a principal to observe whether the agent is acting on the principal's behalf.[51] The principal could eliminate agency costs altogether by aligning the agent's compensation perfectly with the agent's efforts, but that would transform the agent into the principal; the original principal would no longer have any interest in the agent's actions. That, in turn, would defeat the principal's purpose in creating an agency relationship.

The best the principal can do is to assure that some system is in place to monitor the agent's performance and to accept some losses resulting from the divergence between the interests of the principal and the agent. If the cost of monitoring and the losses resulting from divergence prove too great, the principal will not create the agency relationship.

Private express trusts generate agency costs. The settlor cannot observe the trustee's behavior and does not want the trustee to reap the benefits of the trustee's decisions. Moreover, unlike corporate fiduciaries, whose behavior as agents is often subject to market discipline,[52] the typical trustee faces little market pressure in the performance of its duties.[53] As a result, the success of the trust depends on the strength of the mechanisms available for monitoring trustee behavior. In the prevailing model, fiduciary duties enforceable by trust beneficiaries provide that mechanism.[54] The trustee's duties of care, loyalty, impartiality, and the duty to provide information to the beneficiaries all operate to constrain a trustee who would otherwise shirk or ignore the interests of the trustee's principals.[55]

[51] *See* Sitkoff, *supra* note 2, at 643-46.

[52] *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 856-57 (1992).

[53] *See* Sitkoff, *supra* note 2, at 643-46; Leslie, *supra* note 3, at 99.

[54] *See generally* Davis v. United States, 495 U.S. 472, 483 (1990) ("A defining characteristic of a trust arrangement is that the beneficiary has the legal power to enforce the trustee's duty to comply with the terms of the trust.").

[55] *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS § 77 (Tentative Draft No. 4, 2005) (duty of prudence); RESTATEMENT (THIRD) OF TRUSTS § 78 (Tentative Draft No. 4, 2005) (duty of loyalty); RESTATEMENT (THIRD) OF TRUSTS § 79 (Tentative Draft No. 4, 2005) (duty of impartiality); RESTATEMENT (THIRD) OF TRUSTS § 82 (Tentative Draft No. 4, 2005) (duty to furnish information to beneficiaries).

The prospect of fiduciary duty litigation, however, has several deficiencies as a mechanism for assuring that the trustee acts in the interest of the trust settlor. First, trustees understand that actions for breach of fiduciary duty are costly to the beneficiaries, in more than one way. Most obviously, the beneficiaries face litigation costs. If the beneficiaries are ultimately successful in their effort to establish the trustee's breach, they may be able to recover those costs from the trust or the trust estate.[56] Recovery from the trust estate, however, would be a hollow victory, because in most cases, the beneficiaries are the equitable owners of the trust estate. Moreover, when the beneficiaries' action proves unsuccessful, even the trustee's defense costs will ultimately be borne by the trust.[57] Of perhaps equal importance, many trust beneficiaries are dependent on the trustee, particularly if the trustee enjoys discretion about distributions among beneficiaries.[58] These factors will lead rational, educated beneficiaries to refrain from bringing breach of trust actions even when those actions have a reasonable prospect of success, thereby resulting in under-deterrence of breach by trustees.

Second, the assumption of rational, educated beneficiaries is a heroic one. Many trust beneficiaries are the recipients of interests in a trust for a reason (other than the potential tax advantages emerging from

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[56] *Compare* Shriner v. Dyer, 462 So. 2d 1122 (Fla. Dist. Ct. App. 1984) (beneficiaries recover litigation fees from trust, even after failing to recover them from trustees individually after establishing trust mismanagement), *and* Palmer v. Hartford Nat'l Bank & Trust Co., 279 A.2d 726 (Conn. 1971) (beneficiaries recover from the trust itself the litigation costs they incurred in opposing proposed sale of trust property at a price far lower than price purchaser ultimately paid), *with* Feinberg v. Adolph K. Feinberg Hotel Trust, 922 S.W.2d 21 (Mo. Ct. App. 1996) (trustee's misappropriation of assets so reprehensible that it warranted ordering trustee to pay beneficiary's costs), *and* Reynolds v. First Ala. Bank, 471 So. 2d 1238 (Ala. 1985) (trustee bears beneficiaries' attorneys fees in successful action for breach of fiduciary duty). *See generally* 3 SCOTT ON TRUSTS, *supra* note 28, § 188.4 ("[W]here it is held that the trustee is subject to a surcharge, the expense is payable by the trustee personally.").

Some state statutes appear to mandate that the trustee bear the beneficiaries' litigation costs, including attorneys fees, in cases where the beneficiary has successfully maintained an action for breach of trust. *See, e.g.*, IND. CODE ANN. § 30-4-3-11(a)(4) (2005); CAL. PROB. CODE § 17211(b) (West 2006). Other statutes appear to give reviewing courts discretion to assess the successful beneficiaries' litigation costs against the trustee. *See, e.g.*, GA. CODE ANN. § 53-12-193(a)(4) (2005).

[57] *See, e.g.*, Jessup v. Smith, 119 N.E. 403, 404 (N.Y. 1918) (Cardozo, J.) (holding that trustee was entitled to reimbursement for attorneys fees because the trustee "owed a duty to the estate to stand his ground against unjust attack. He resisted an attempt to wrest the administration of the trust from one selected by the testator and to place it in strange hands."); Saulsbury v. Denton Nat'l Bank, 335 A.2d 199 (Md. Ct. Spec. App. 1975); Weidlich v. Comley, 267 F.2d 133 (2d Cir. 1959); *see also* Carter, *supra* note 33, at 1421-26 (1998); 3 SCOTT ON TRUSTS, *supra* note 28 § 188.4 (4th ed. 2001) ("The trustee can properly pay out of the trust estate expenses of litigation incurred in a successful attempt to prevent the beneficiaries from subjecting the trustee to a surcharge.").

[58] *See generally* Leslie, *supra* note 3, at 87.

the marital deduction[59] and the generation-skipping transfer tax exemption[60]). If the trust settlor had confidence in the financial acumen of the beneficiaries, the settlor might well have passed his assets to the beneficiaries free of trust, eliminating the agency cost problem altogether. Trustees as a group should understand the limited capacity of trust beneficiaries, creating another potential for under-deterrence.

Third, the preferences of the trust beneficiaries may not perfectly reflect the settlor's preferences. If the trustee takes an action with the approval of the trust beneficiaries, the trustee is unlikely to face an action for breach of fiduciary duty; the settlor is dead, and may in any event lack standing to bring action for breach.[61] This fact, too, reduces the value of fiduciary duty litigation, or its prospect, as a mechanism for monitoring agency costs.

Appointment of a trust protector addresses and mitigates each of these concerns. First, if the protector has power to direct the trustee to take particular actions, or even power to veto particular actions, the protector can avoid the litigation costs associated with actions for breach of fiduciary duty. Second, the settlor can choose a protector with the business acumen necessary to evaluate the actions taken by the trustee. And third, the protector acts as the settlor's surrogate; the settlor can choose a protector whose focus is on achieving the settlor's objectives, even when those objectives conflict with the preferences of the beneficiaries.

None of this is to suggest that appointment of a trust protector eliminates agency costs from the settlor/trustee relationship. But on this optimistic account, the protector operates to ameliorate significantly the agency cost issues that confront the traditional trust. The protector gives the settlor an additional tool in policing the trustee; if the tool proves unhelpful, the settlor is no worse than she was before—she is still left with the traditional mechanisms available for disciplining trustees.

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59 26 U.S.C. § 2056(a) (2000).

60 26 U.S.C. § 2631.

61 Established doctrine holds that a settlor who retains no beneficial interest in a trust cannot bring an action against a trustee for breach of fiduciary duty unless the settlor has entered into a separate contract with the trustee to ensure the trustee's performance. RESTATEMENT (SECOND) OF TRUSTS § 200 cmt. b. For applicaton of the rule, see, e.g., Sanders v. Citizens Nat'l Bank of Leesburg, 585 So. 2d 1064 (Fla. Dist. Ct. 1991) (settlor of life insurance trust has no standing to sue trustee for negligence and breach of trust); Edmondson v. Edmondson, 226 N.W.2d 615 (Minn. 1975) (settlor cannot maintain action for accounting when settlor lacked beneficial interest in the trust). Professor Gaubatz has discussed a number of exceptions to the general rule against settlor standing, and Professor Langbein has advocated that the traditional rule should be reversed to authorize settlor standing in the absence of a contrary instruction in the trust instrument. *See* John T. Gaubatz, *Grantor Enforcement of Trusts: Standing in One Private Law Setting*, 62 N.C. L. REV. 905 (1984); Langbein, *supra* note 9, at 664.

2. Wrinkles in the Account

The optimistic account of the trust protector as a tool in the effort to reduce agency costs ignores one important fact: the protector himself is an agent. When a trust settlor names a trust protector, the settlor creates new sets of relationships—settlor/protector, beneficiary/protector, and trustee/protector—that complicate analysis of agency costs. This section examines several of the complications.

a. Disciplining the Protector

On the vast majority of trust issues, the settlor's interests and those of the beneficiary are closely aligned. In those cases, agency costs are minimized when the protector acts as the settlor would want it to. But what guarantee is there that the protector will do so? Personal loyalty to the settlor acts to discipline the protector in some set of cases, particularly when the protector is a close friend, confidant, or relative of the settlor. But what of professional protectors, or successor protectors who enjoy no strong personal bond to the settlor?

Even if the settlor were to provide detailed instructions to the protector (which would defeat much of the purpose of appointing a protector), there is no obvious market mechanism for assuring that the protector follows the settlor's instructions.[62] The protector is not likely to have a financial interest in complying with those instructions; protector compensation cannot easily be tied to the degree of fealty the protector displays towards the settlor's wishes.[63] Moreover, the protector's performance will often be impossible to measure.

In the absence of personal loyalty and market forces as mechanisms to discipline protectors, legal liability rules provide an alternative enforcement mechanism. Because the trust settlor will generally be dead when significant decisions face the protector, enforcement of duties will necessarily fall to the trust beneficiaries. Beneficiary enforcement generates two familiar difficulties. First, even

[62] Professors Gilson and Kraakman have made similar observations with respect to outside corporate directors. Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 875-76 (1991) (noting absence of evidence that market for outside directors exists at all); *see generally* Black, *supra* note 52, at 850-51 (noting that the effectiveness of agents watching agents depends in considerable measure on institutional detail).

[63] *Cf.* Gilson & Kraakman, *supra* note 62, at 875 (noting that corporations cannot pay outside directors enough to create appropriate incentives to monitor management).

when the interests of the trust beneficiaries are perfectly aligned with those of the settlor, beneficiary enforcement replicates the costs associated with fiduciary duty litigation against trustees. Second, when the settlor's apparent preferences diverge from the interests of the beneficiaries, the more enforceable rights the legal regime confers on the beneficiaries, the greater the incentives for the protector to act as the agent of the beneficiaries rather than the agent of the settlor.

b. Why Not Co-Trustees?

For the settlor who seeks to monitor trustee behavior, there is an obvious alternative to appointment of a trust protector: appoint co-trustees, each of whom can monitor the other's actions. Appointment of co-trustees generates a number of advantages for the settlor. Unlike the uncharted law surrounding trust protectors, there is a well-established body of law governing the responsibilities of co-trustees. Because co-trustees are generally entitled to exercise trust powers only by consent of a majority,[64] no trustee can act without persuading co-trustees of the merits of the action—assuring that no individual trustee will act arbitrarily. Reinforcing that protection against arbitrary action is the rule that makes one co-trustee liable for another co-trustee's breach of fiduciary duty if reasonable care would have prevented the breach.[65] Moreover, one co-trustee is liable for another's self-dealing, on the theory that the disinterested trustee's duty of care extends to assuring that the co-trustee does not breach his duty of loyalty.[66] In light of the monitoring possibilities that accompany appointment of co-trustees, why would a trust settlor find it attractive to appoint a protector instead?

64 At common law, trustees of private trusts could act only by unanimous consent. That rule, however, has generally been abandoned by statute. *See, e.g.*, N.Y. EST. POWERS & TRUSTS LAW § 10-10.7 (McKinney 2005) (providing that fiduciary powers may be exercised by majority of fiduciaries); *see also* RESTATEMENT (THIRD) OF TRUSTS § 39 (2003) (concurrence of both trustees necessary when trust names two trustees; concurrence of majority necessary when there are three or more trustees).

65 *See* RESTATEMENT (THIRD) OF TRUSTS § 81(2) (Tentative Draft No. 4, 2005) ("Each trustee also has a duty to use reasonable care to prevent a co-trustee from committing a breach of trust and, if a breach of trust occurs, to obtain redress."); *see also id*. at cmt. e (establishing that co-trustee is liable for trustee's breaches if co-trustee participated or acquiesced in the breach, improperly delegated administration to the breaching trustee, or enabled the trustee to commit the breach by failing to exercise reasonable care); CAL. PROB. CODE § 16402 (Deering 2006). For cases applying the general rules to hold co-trustees liable, see, e.g. Rutanen v. Ballard, 678 N.E.2d 133 (Mass. 1997) (co-trustee who abandoned administration duties to trustee and failed to inform trustee of breach held liable for breach); Estate of Chrisman, 746 S.W.2d 285 (Mo. Ct. App. 1988) (rejecting co-trustee's argument that she should not be liable because she deferred to decisions of co-trustee).

66 *See, e.g.*, *In re* Rothko, 372 N.E.2d 291 (N.Y. 1977); *In re* Durston's Will, 74 N.E.2d 310 (N.Y. 1947).

With respect to offshore trusts, especially those designed for asset protection purposes, there is an obvious answer: appointing a domestic co-trustee would increase the likelihood that a domestic court could exert jurisdiction over the trust assets.[67] Once removed from the asset protection context, the reasons for appointing a protector instead of a co-trustee become less apparent. In some commonwealth countries, but not the United States, the conception of the trustee as a representative of the interests of the beneficiaries, rather than the trust settlor, might lead settlors to prefer protectors to co-trustees.[68] Even in the United States, cost might be a factor if one assumes that trustees are entitled to commissions and protectors are not, but cost differences become less significant when one recognizes that the settlor can generally set the compensation of both protectors and trustees by private agreement.

From an agency cost perspective, the principal reason for choosing to appoint a protector rather than a co-trustee is the difference in decisionmaking structure that results from the protector/trustee relationship. Co-trustees typically make decisions by consensus; each has equal input into trust decisions; each is equally accountable for the consequences of those decisions.[69] The settlor, by contrast, may prefer to repose primary decisionmaking responsibility in a single authority—the trustee—subject only to intermittent review by the protector.[70] The authority model of decisionmaking reduces the need for the protector to acquire and process information about every aspect of the trust, effectively reducing monitoring costs.[71] The settlor can use a protector

[67] *See generally* Stewart E. Sterk, *Asset Protection Trusts: Trust Law's Race to the Bottom*, 85 CORNELL L. REV. 1035, 1089-1100 (2000) (noting the difficulty in obtaining personal jurisdiction over an offshore trustee, and exploring the possibility of obtaining in rem jurisdiction over trust property).

[68] *See* Sitkoff, *supra* note 2, at 662-63 (noting more significant deference given to beneficiary wishes in English trusts). *See generally* 4 SCOTT ON TRUSTS, *supra* note 28, § 337:

> The American courts have laid emphasis on the idea that the wishes of the settlor should be controlling except where it would be opposed to some definite policy to give effect to his desires. In England, on the other hand, the courts have felt that although the extent of the interests of the beneficiaries depends on the intention of the settlor, the control of their interests should be in their own hands, except where the interests of others limit such control. In the United States the courts take the view that the settlor can dispose of his property as he likes. In England the beneficiary of a trust can dispose of his interest as he likes.

Id.

[69] *See* RESTATEMENT (THIRD) OF TRUSTS § 81 (Tentative Draft No. 4, 2005) (each trustee has a right to participate in trust administration; each has a duty to prevent co-trustees from committing breach, and also a duty to seek redress if breach occurs).

[70] Geoffrey Manne has suggested a similar model for governance of charitable entities—a contract relationship with a firm whose principal role is to monitor the behavior of charitable boards. Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227, 262-64 (1999).

[71] *Cf.* KENNETH J. ARROW, THE LIMITS OF ORGANIZATION (1974) (discussing the advantages of the authority model of decisionmaking).

as a check on trustee behavior without making the protector a full partner in trust decisionmaking. Moreover, the authority model—trustee as decisionmaker with protector as a check—also limits (but does not eliminate) the potential for quid-pro-quo decisionmaking by co-trustees who have to interact on a regular basis with respect to trust administration.[72]

Of course, the settlor could accomplish the same objectives by naming co-trustees and carefully outlining, in the trust instrument, their respective responsibilities. But that approach has its own drawbacks. In particular, the settlor is unlikely to anticipate in advance all of the ways in which the settlor seeks to alter the background law surrounding co-trustees. As a result, the existence of an established body of co-trustee law becomes a negative, not an advantage. If the settlor wants to depart significantly from the allocation of duties customarily borne by co-trustees, the settlor may be better off avoiding the co-trustee label.[73]

c. The Effect of the Protector on the Trustee's Performance

In an ideal world, appointment of a protector would reduce agency costs by providing additional incentives to the trustee to safeguard the interests of the trust beneficiaries (thereby advancing the wishes of the trust settlor). In practice, however, there is danger that appointment of the protector could have the opposite effect—it could reduce the incentives for the trustee to exercise prudence in managing the trust assets.

The danger is three-fold. First, once a protector is appointed, the trustee becomes, to varying degrees, accountable to the protector.[74]

[72] Some trust protectors might ultimately find it in their financial interests to align themselves with trustees rather than trust settlors. Neither the settlor nor the trust beneficiaries are likely to be repeat players in their interactions with the professional trust protector. By contrast, as protectors become more common, protectors and trustees will have ongoing relationships. Especially if protectors are in a position to replace trustees, or to name successor trustees, there will be significant reasons for trustees to ingratiate themselves with protectors, creating symbiotic relationships. These relationships, however, are unlikely to inure to the benefit of the settlor and trust beneficiaries.

[73] Of course, even if the trust instrument eschews the co-trustee label, courts are likely to draw analogies to co-trustees. *See, e.g.*, Gathright's Trustee v. Gaut, 124 S.W.2d 782, 783 (Ky. Ct. App. 1939) (trust advisors considered as co-trustees with limited authority); Lewis v. Hanson, 128 A.2d 819, 828 (Del. 1957), *aff'd sub nom.* Hanson v. Denckla, 357 U.S. 235 (1958) (trust advisor a fiduciary "in the nature of a co-trustee . . . .").

[74] Kenneth Arrow has described the problem associated with a regime in which a supposed decisionmaker is held accountable for every action he takes: "If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem." ARROW, *supra* note 71, at 78.

If the initial assumption is that the trustee was selected as the person or institution best suited to making a class of decisions, holding the trustee accountable to a person less suited to

That accountability may lead the trustee to be responsive to the protector's wishes even when the trustee believes that the protector's preferences diverge from the interests of the beneficiaries (and the settlor). Especially if the settlor has chosen the trustee because of the trustee's expertise in making the decisions delegated to him, making the trustee accountable to the protector threatens to reduce the quality of the trustee's decisions.

Second, even a trustee who is resolute about maintaining independence from the protector will be inclined to expend energy persuading the protector of the merits of the trustee's decision. That is, if the trustee concludes that its ultimate obligation is to the beneficiaries (or the settlor), the trustee will best promote the interests of the beneficiaries and settlor if it assures that the protector does not interfere with the trustee's decisions. That, in turn, diverts the trustee's energies from its primary function: making appropriate investment and distribution decisions.[75]

Third, appointment of a protector can lead to inefficient diffusion of responsibility, with the trustee expending less care in making investment and distribution decisions, expecting that the protector will review those decisions in any event. (Conversely, the protector may rely on the trustee's care and prudence in making the initial determination.)

The extent to which the appointment of a protector threatens to reduce the quality of the trustee's decisions varies with the powers accorded the protector. The most obvious threat arises when the trust instrument gives the protector power to direct the trustee's investment and/or distribution decisions. Once the protector exercises that power, the trustee could reasonably conclude that the trustee's duty is to follow the protector's directions, not to exercise independent judgment about the wisdom of the protector's decisions.[76] The trustee might be especially inclined to follow the protector's directions in cases where the protector has power to replace the trustee. In effect, the trustee could behave as the protector's agent, not as a watchdog for the interests of the beneficiaries.

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make the decision can generate perverse results. *See generally* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 107-09 (2004) (identifying the difficult tradeoffs between authority and accountability in the corporate setting).

[75] For a similar point with regard to corporate decisionmakers, see Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 813 (2001) (observing that when more monitors of corporate CEOs are in place, CEOs spend more time influencing monitors and less time engaging in more productive tasks).

[76] Indeed, if the settlor gives the protector power to direct investment decisions, the trustee will generally be obligated to follow those directions. *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS § 75 (Tentative Draft No. 4, 2005).

Even when the trust instrument limits the protector to veto power, the trustee might exercise less care than the trustee would otherwise exercise, expecting that a particularly imprudent decision would be vetoed by the protector, and that, in any event, the trustee could use the protector's failure to veto as evidence of the prudence of the trustee's initial decision.

The danger that appointment of a protector will diminish the quality of the trustee's decisions does not establish that protectors inevitably increase agency costs. But the danger does have two significant implications. First, settlors and their lawyers should take care, both in the selection of trustees and protectors, and in the allocation of power between trustees and protectors, to minimize the danger. In many circumstances, appointment of a protector may prove unnecessary or counterproductive.[77] Second, courts (and, perhaps, legislatures) should structure the legal incidents of the relationship between trustees and protectors with these agency costs in mind. Section IV focuses on that issue of doctrine.

B. *The Trust Protector and the Settlor's Foresight*

A trust settlor might appoint a trust protector to perform functions entirely unrelated to monitoring the trustee's performance. For instance, the settlor might confer on a protector the power to modify or terminate the trust, to change the trust's situs, or to make discretionary distributions to particular beneficiaries. The settlor might name a protector with these powers for the same reason a settlor might create a power of appointment: to assure that the trust is responsive to information not available to the settlor at the time the settlor creates the trust.

The settlor, for instance, will not be in a position to foresee the details of tax law changes that might make continuation of the trust on its current terms superfluous or even counterproductive. Nor can the settlor anticipate changes in state law—perhaps with respect to creditor claims or trust duration—that might make it desirable to change the trust's location.

A settlor's imperfect foresight extends beyond changes in law. Trust assets could change significantly in value after creation of the trust, in ways that would alter the settlor's distributional preferences, or even, in some circumstances, lead to termination of the trust. The circumstances of the trust beneficiaries might also change in ways that

[77] *Cf.* Waters, *supra* note 22, at 105 (noting that settlors might reasonably fear that appointment of a protector would "add one more layer of costs and bureaucracy").

would alter the settlor's preferred distribution. If, for instance, the settlor created a generation-skipping trust on the assumption that settlor's children would be sufficiently wealthy to benefit from the trust, the settlor's preferences might change markedly if one or more of settlor's children were to encounter financial setbacks. The tax advantages associated with the generation-skipping transfer tax exemption would then fade in importance.

To account for changes like these, the settlor could include in the trust instrument first, a statement of the trust's purposes, and second, an authorization for one or more trust beneficiaries to petition for judicial modification or termination of the trust if the terms of the trust no longer serve those purposes.[78] But that approach entails significant legal costs, and also reposes in courts judgment calls that the settlor might rather repose in a trust protector—someone who might be closer to the family, or someone with more tax or financial expertise.

When a settlor appoints a protector to compensate for his lack of foresight, the issue is not whether the protector will effectively monitor the trustee's performance; the protector's responsibilities are independent of the trustee's actions. Instead, from an agency cost perspective, the issue is how best to assure that the protector will act as a faithful agent. In the first instance, that is an issue for the settlor and the settlor's lawyers in drafting the trust instrument. But legal doctrine also has a role to play in minimizing agency costs.

III. Shaping Doctrine

A. *Introduction*

The trust instrument itself provides a starting point for determining the legal liabilities of the trust protector. Indeed, it would be reasonable to start with the assumption that the judicial role in regulating trust protectors should be the role specified by the settlor in the trust instrument. That is, the protector's liabilities are largely a matter of contract, capable of careful articulation in the trust instrument. But many trust instruments are silent, or incomplete, about the liabilities of the protector.[79] Moreover, even if a trust instrument were to include language purporting to determine the protector's liabilities, there is

[78] *Cf. id.* at 666 (noting that in the trust context, "using courts to provide flexibility is marginal"); Rock & Wachter, *supra* note 23, at 664 (discussing possibility of judicial reformation).

[79] *See* Duckworth, *supra* note 12, at 174 (noting that it is "not the usual practice for the trust instrument to lay down comprehensive rules").

good reason to believe, in light of the limited experience with trust protectors, that neither the settlor nor the settlor's lawyer will have fully anticipated the range of issues that might arise in conjunction with the protector's action and inaction. As a result, courts will inevitably develop a set of default rules to deal with trust protectors, and those rules may sometimes take on a "mandatory" character, displacing explicit instructions in the trust instrument. My objective in this section is to offer a tentative sketch of the legal regime that should surround trust protectors, drawing both on agency cost concepts, and on existing fiduciary duty law.

As we have seen, the protector's role with respect to management issues differs significantly from its role with respect to distribution issues. The trustee is the primary manager of the trust assets, and the protector's role is primarily that of a monitor. By contrast, when the trust instrument confers on the protector the power to alter the trust's distribution scheme, the protector becomes the primary decisionmaker, not a monitor of trustee behavior. This difference has implications for the legal framework surrounding the two issues, and suggests that the two sets of issues should be discussed separately.

B. *The Protector's Power with Respect to Management Issues*

1. The Analytical Framework

Trust instruments frequently give trust protectors the power to direct or veto portfolio management decisions made by the trustee. Any evaluation of the protector's legal responsibilities with respect to these powers requires attention to two separate but related questions: first, how should an appropriately responsive protector behave with respect to the power conferred on him by the trust instrument; and second, what legal liabilities will induce the appropriate behavior? In familiar terms, these questions reduce to what standard of behavior the protector should employ, and what standard of review of the protector's actions will induce that standard of behavior.[80]

Consider first the standard of behavior. With respect to management issues, the settlor's primary concern will generally be to provide maximum return to the trust beneficiaries. Thus, on management issues, where the settlor's interests and those of the beneficiaries are closely aligned, the legal framework should generally

[80] *Cf.* Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437 (1993) (examining policies behind divergent standards of conduct and review in corporate cases).

aim to have the protector behave as the settlor would want the protector to behave.[81]

How would the typical settlor want the protector to behave with respect to the powers the settlor has conferred upon the protector? A first possibility is that the settlor wants the protector to act as a trustee would act, scrutinizing each investment decision as if the protector were the primary decisionmaker, doing the research necessary to identify the most prudent decision and then exercising the protector's powers to assure that the trustee or trustees make that decision. A second, polar opposite, possibility is that the settlor had no expectations of the protector; that the settlor wanted the protector to have complete freedom to act, or not to act, to suit the protector's pleasure. A third alternative is that the settlor wanted the protector to defer to the trustee's decisions, even when the protector disagreed with those decisions, acting only when the trustee's decision amounted to an abuse of discretion, or exceeded the bound of reasonableness, or some comparable standard. That is, the settlor might have wanted the protector to act only in those situations in which, absent a protector, a court would intervene to protect trust beneficiaries.

If the typical settlor would opt for the first standard of behavior—the protector acts as a trustee would act—determining the standard of review would be easy: use the same standard applied to review trustee decisions. When the issue relates to the trustee's duty to invest prudently, courts typically intervene only when the trustee has abused its discretion.[82] That abuse of discretion standard is designed to preserve primary decisionmaking responsibility in the trustee, not the

[81] There may, of course, be cases in which the trust settlor has a strong, but idiosyncratic, belief that a particular investment strategy is in the interest of the trust beneficiaries, or that the trustee should pursue a particular strategy even if it is not in the interest of the beneficiaries. The classic case is In re *Pulitzer's Estate*, 249 N.Y.S. 87 (Sur. Ct. 1931), in which Joseph Pulitzer directed that the trustee not have the power to sell shares in his newspaper corporation. These are cases, however, in which the settlor is likely to provide express and clear instructions in the trust instrument rather than entrusting enforcement of his wishes to a trust protector.

Suppose, however, the settlor were to include such directions and empower the protector to enforce them. Doctrinal limitations on dead-hand control prevent the settlor, as principal, from imposing particular restrictions on one form of agent (the trustee). *See generally* John H. Langbein, *Mandatory Rules in the Law of Trusts*, 98 NW. U. L. REV. 1105, 1118-19 (2004). There would seem to be little reason, then, to suggest that the protector—another form of agent—should have more power than the principal to evade these limits on dead-hand control.

Moreover, any attempt by the protector to enforce the settlor's directions would be met with litigation by the trustee, concerned about the trustee's own liability for causing depletion of trust assets. If the result of such litigation would be to require that the trustee ignore the settlor's instructions (and those of the protector), then the protector would have served no purpose by seeking to enforce the restrictions. In that circumstance, it would appear peculiar to assume that the settlor would have wanted the protector to take futile actions.

[82] *See* RESTATEMENT (THIRD) OF TRUSTS § 87 (Tentative Draft No. 4, 2005).

reviewing court, while nevertheless holding the trustee accountable for its decisions.[83]

If the typical settlor would opt for the second standard of behavior—the protector acts at the protector's pleasure—determining the standard of review would also be easy: relieve the protector from all fiduciary duty, and insulate the protector from suit altogether.

Assuming that the settlor would opt for the first standard of behavior, however, is inconsistent with the settlor's decision to appoint a protector rather than a co-trustee. If the settlor had wanted the protector to duplicate the behavior of a trustee, the settlor would have named the protector a trustee.

More plausible, in at least some circumstances, is the assumption that the settlor would opt for the second standard of behavior—the protector acts at his pleasure. Settlor might so indicate in the trust instrument.[84] Or, even without an express indication in the trust instrument, the relationship of the settlor and the beneficiary may make it clear that settlor was prepared to repose complete confidence in the protector.[85] Alternatively, the rights conferred on the protector may make it clear that settlor intended to enable the protector to act purely out of self-interest—as where the protector is the trust's principal beneficiary.[86]

In these circumstances, determining the appropriate standard of review is also easy: courts should not intervene to reverse any action or inaction by the protector, and should not impose liability on the protector for action or inaction. Put in other terms, the court should conclude that the protector is not accountable to the trust beneficiaries for his actions; the protector is not bound by fiduciary duties.[87]

In most circumstances, however, this second assumption—that the settlor intended for the protector to act, or not act, without regard to the settlor's purposes—is as implausible as the assumption that the

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[83] *See id.* at cmt. b ("[J]udicial intervention is not warranted merely because the court would have differently exercised the discretion."); *cf.* Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821, 834 (2004) (noting comparable reasons for the business judgment rule in the corporate context: "litigation on substantive decisions, and even on duty of care issues, would be about matters on which reasonable people would disagree. . . . [N]either judges nor shareholders are likely to be capable of making better decisions than the professionals charged with running the business.").

[84] *Cf.* Bove, *supra* note 27, at 392-93.

[85] *Cf.* RESTATEMENT (THIRD) OF TRUSTS § 75 cmt. c(1) (Tentative Draft No. 4, 2005) (power given to settlor's widow or widower to prevent sale of residential property held in the trust by refusing to consent to its sale would presumptively be a power for the benefit of the occupant-power holder, and thus not a power held in a fiduciary capacity).

[86] *See* Bove, *supra* note 27, at 392-93.

[87] The settlor will often want to avoid this conclusion in order to assure that the protector does not hold a general power of appointment, which could generate adverse tax consequences. *See id.* at 395.

settlor intended the protector to be an additional trustee. Taken to its extreme, such an assumption could leave the protector as a principal beneficiary of the trust: the protector could agree to exercise his powers in accordance with the preferences of the highest bidder. Even if a settlor were prepared to endorse such behavior with the initial hand-picked protector, it is difficult to attribute to the settlor assumption of such a risk with any successor protector.

In most circumstances, therefore, the most likely alternative is that the settlor intends for the protector to defer to the trustee's judgment most of the time. The settlor reposes in the protector powers that constrain the trustee's management decisions not because the settlor expects the protector to exercise those powers, but because the existence of those powers will increase the trustee's responsiveness to the interests of the trust beneficiaries (and ultimately to the settlor's wishes). Typically, the settlor is not attempting to shift all decisionmaking responsibility from the trustee to the protector; such a shift would simply replicate the agency costs in a traditional trust that has no protector. Instead, the settlor presumably expects the protector to monitor trustee behavior without displacing the discretion ordinarily reposed in the trustee—the person or institution selected by the settlor to manage the trust assets. That is, the settlor expects the protector to assume a monitoring role comparable to the role a court might play, absent the attendant litigation costs. Accordingly, the settlor expects the protector to intervene only when the trustee has abused its discretion. The question, then, is how to structure the legal liabilities of trustee and protector to minimize the sum of agency and monitoring costs.

Unfortunately, the standards for judicial review of the protector's actions that flow from this assumption about the preferred standard of protector behavior are not self-evident. Absolving the protector of legal accountability for his actions—based on the assumption that settlors typically appoint protectors to avoid the costs associated with judicial enforcement of a trustee's fiduciary duties—provides the protector with license to act in ways that are contrary to the settlor's wishes and the beneficiaries' interests.[88] As we have seen, the no accountability

[88] Moreover, it is not clear that such a regime would ultimately avoid litigation costs. Whenever the protector's instruction appears sufficiently inimical to the interests of the trust beneficiaries, the trustee would have an incentive to seek judicial instructions in order to avoid the trustee's own liability for following the protector's instructions.

A trustee is entitled to seek instructions whenever he has reasonable doubt regarding any matter relating to administration of the trust. *See* Adler v. Adler, 713 N.E.2d 348 (Ind. Ct. App. 1999). These matters can include the construction of the trust instrument, the extent of the trustee's duties or powers, the identity and interests of the beneficiaries, or the resolution of a dispute among beneficiaries. *See* RESTATEMENT (THIRD) OF TRUSTS § 71 (Tentative Draft No. 4, 2005); Patterson v. Polk, 317 S.W.2d 286 (Ark. 1958); Lowe v. Johnson, 469 N.E.2d 768 (Ind. Ct. App. 1984); *In re* Merlin A. Abadie Inter Vivos Trust, 791 So. 2d 181 (La. Ct. App. 2001). A standard is the appropriate standard of review when the settlor expects the protector to act in the protector's own self-interest. But a standard of review that holds the protector liable when he has not acted with the care, skill, and caution the law normally demands of trustees effectively induces the protector to intervene in every trust decision, not to act as a monitor of trustee behavior.[89]

To induce protectors to function as settlors intend them to function—as monitors of trustee behavior—trust law must devise and apply a more deferential standard of review than that applied to trustees. The precise standard will differ depending on the powers the settlor has conferred on the protector. What is critical to recognize, however, is that routine transplantation to protectors of the fiduciary standards applied to trustees would represent an analytical error.[90] To the extent settlors expect protectors to play a role distinct from trustees, the standard of review applied to the protector's actions must reflect that distinction.

2. Requirements that the Trustee Secure Protector's Consent

Consider first the trust settlor who seeks to constrain the trustee's power by requiring the trustee to obtain the protector's consent before taking specified actions. For instance, the trust instrument might require the trustee to obtain the protector's consent before changing the trust's investment portfolio. Or, the trust instrument might require the protector's consent before the trustee engages in a more limited set of transactions, such as the sale of shares of a closely-held corporation in

trustee's ignorance of the terms of the trust will not shield him from liability for breach of duty when he fails to seek instructions. *See In re* Marriage of Petrie, 19 P.3d 443 (Wash. Ct. App. 2001). However, in the absence of fraud or concealment, seeking instructions demonstrates good faith on the part of the trustee and shields him from liability. *See In re* Riordan's Trusteeship, 248 N.W. 21 (Iowa 1933); Willis v. Braucher, 87 N.E. 185 (Ohio 1909).

89 Professors Johnson and Millon have recently argued that, in the corporate context, fiduciary duty standards for corporate officers should be more stringent than those applied to corporate directors. Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers are Fiduciaries*, 46 WM. & MARY L. REV. 1597 (2005). They argue, in particular, that corporate officers—the corporation's primary decisionmakers—should be liable for ordinary negligence, while corporate directors should face a looser "gross negligence" standard. *Id.* at 1630-31. They justify this distinction by noting that "officers bear primary responsibility for stewardship of the corporation's business activities," while the board or directors, "meeting only occasionally and lacking intimate knowledge of the corporation's activities, is incapable of managing the publicly held corporation in a direct manner." *Id.* at 1637-38. That is, they see the standard of review designed for optimal monitoring as different from the standard appropriate for primary management activity.

90 *Cf. id.* at 1600-01 (decrying the failure of courts and commentators to distinguish between duties of officers and those of directors, despite significant differences in institutional function).

which the settlor was a principal. In these cases, the settlor might be relying on the protector's investment expertise.

In other cases, the settlor might authorize the trustee to engage in self-dealing transactions, but only with the protector's consent. Or the settlor might require the protector's consent before the trustee could make particular distributions of income or principal. In each of these situations, the settlor's appointment of the protector avoids the need for judicial monitoring of the trustee's actions, and hence has the potential to reduce agency costs.

When the settlor conditions the trustee's power to act on obtaining the protector's consent, the protector's position most closely resembles that of a co-trustee.[91] In both situations, the settlor is unwilling to repose all responsibility for management of trust assets in a single person or entity, and requires a single trustee to persuade another party—either a co-trustee or a protector—before taking a significant action with respect to trust assets. From a standard of behavior perspective, the settlor expects the protector to evaluate the trustee's proposed action with the care ordinarily expected of a trustee; the settlor does not contemplate inaction or deference by the protector. The protector's inaction would paralyze the trust. To take an extreme case, suppose the protector simply refused to respond to all requests by the trustee.[92] It appears inconceivable that the settlor intended to relegate the trustee to seeking judicial approval of its actions—especially when the principal reason for appointing the protector is to avoid the monitoring costs associated with judicial review.[93]

Conversely, the settlor does not expect the protector to act as a rubber stamp on decisions made by the trustee. When the settlor requires the trustee to seek explicit approval from the protector, the settlor typically expects the protector to exercise his best judgment in evaluating the trustee's recommendation.[94] That is, the settlor expects the protector to act with the prudence required of a co-trustee. And when the settlor appoints co-trustees, both the standard of behavior and the standard of review are well-established, subject to express provisions in the trust instrument relieving one or more of the trustees from responsibility for particular actions.[95] A comparable legal regime

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91 *See* RESTATEMENT (THIRD) OF TRUSTS § 75 cmt. f (Tentative Draft No. 4, 2005) (If the terms of the trust do not permit the trustee to act without the direction or consent of the fiduciary power holder, the "designated person's fiduciary duties and liabilities with respect to the power are generally comparable to those of a trustee.").

92 Duckworth, *supra* note 12, at 249.

93 *Id.* at 178.

94 *Cf.* 2A SCOTT ON TRUSTS, *supra* note 28, § 185 (The power holder abuses discretion if, "in exercising or failing to exercise the power he acts dishonestly or from an improper motive or fails to use his judgment or acts beyond the bounds of reasonable judgment.").

95 *See* RESTATEMENT (THIRD) OF TRUSTS § 81 cmt. a (Tentative Draft No. 4, 2005) ("When a

appears appropriate for trust protectors: when the instrument conditions the trustee's power to act on the consent of the protector, the protector must act with prudence in giving or withholding consent, and must act not out of self-interest, but instead in the interest of the trust beneficiaries. Moreover, the protector's duties should expose the protector to parallel liabilities for consenting and for failing to consent.[96] The settlor who requires the protector's consent expects an exercise of judgment; a failure to exercise that judgment with prudence and loyalty exposes the protector to liability whether the protector has followed a course of action or a course of inaction.[97]

3. The Protector's Power to Initiate Action

Rather than requiring the protector to approve or disapprove actions taken by the trustee, the trust instrument might confer on the protector power to initiate action with respect to trust management. In this situation, unlike the situation in which the settlor has required the trustee to obtain the protector's consent before acting, the settlor has conferred on the protector discretion to act, or not to act.[98] Although the protector has fiduciary duties in either instance, the standard of review applied to the protector's failure to act should differ significantly from the standard applied when the protector initiates a self-interested or imprudent action.[99]

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trust has multiple trustees, the fiduciary duties of trustees stated in this Chapter, except as modified by the terms of the trust, apply to each of the trustees."); Waters, *supra* note 22, at 72, 84; 2A SCOTT ON TRUSTS, *supra* note 12, § 185.

96 *See* RESTATEMENT (THIRD) OF TRUSTS § 75 cmt. f (Tentative Draft No. 4, 2005) (Power holder whose consent is a predicate for trustee action is liable for losses to the trust as a result of the power holder's breach of fiduciary duty "whether as a result of improper exercise of the power or improper failure to exercise it.").

97 *Cf.* Sherry v. Little, 167 N.E.2d 872 (Mass. 1960).

98 Sometimes, the protector's position may be a hybrid, imposing on the protector no explicit obligation to approve or direct investments, but providing that the trustee cannot take action without the protector's approval. *See* Duckworth, *supra* note 12, at 253 (Example 2).

99 The Restatement endorses a differential standard for the protector's actions and failures to act, but offers a somewhat different formulation:

> If the terms of the power merely authorize the designated person to direct a trustee who is otherwise under a duty to proceed with the administration of the trust so long as the power is not exercised, ordinarily the only duty of the power holder is not to exercise the power in a manner inconsistent with the fiduciary duties owed to one or more of the beneficiaries.

RESTATEMENT (THIRD) OF TRUSTS § 75 cmt. f (Tentative Draft No. 4, 2005). The Comment goes on to suggest, however, that the power holder may have an affirmative duty to act "when the power holder knows or should know that the purposes of the power call for some action to be taken." *Id.*

a. The Protector's Failure to Act

When the trustee may not act without the protector's approval, the protector's inaction has the potential to paralyze trust administration. By contrast, when the trust instrument confers on the protector the power to initiate actions, the protector's failure to exercise that power will not prevent the trustee from administering the trust.[100] The trustee can continue to make decisions about investments and distributions without securing approval from the protector.

Suppose, for instance, the trust instrument gives the protector power to require the trustee to make particular investments, or power to remove the trustee. The settlor does not expect the protector to exercise these powers, unless unanticipated circumstances arise. If the trustee acts prudently and loyally, the protector will never have occasion to exercise these powers. Suppose, however, the trustee acts disloyally or imprudently. What are the trust protector's responsibilities?

First, how much investigation into the trustee's actions is the protector obligated to conduct? The settlor might reasonably expect the protector to know the content of the trust portfolio, but it is unlikely that the settlor expects the protector to make efforts to determine the marketability of assets held by the trust in order to assure adequate diversification. Nor is it likely that the settlor expects the protector to familiarize himself with the trustee's personal portfolio to determine whether the trustee has engaged in self-dealing.[101]

Second, even if the protector believes that the trustee has made an unreasonable investment decision, it is not clear that the settlor would want the protector to direct the trustee to reverse that decision. Imagine a trustee who has sold trust property to himself as an individual, or to an entity in which the trustee holds a financial interest. Assume further

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100 The Restatement distinguishes between these two situations in Comment f, where one paragraph deals with cases in which "the terms of the trust do not permit the trustee to act without the direction or consent of" the power holder, and the following paragraph deals with a trust in which "the terms of the power merely authorize the designated person to direct a trustee who is otherwise under a duty to proceed with the administration of the trust so long as the power is not exercised. . . ." *Id.*

101 Nor is the trustee likely to inform the protector of such self-dealing unless the trustee believes that the protector will approve the self-dealing and insulate the protector from liability. Consider also, in the corporate context, Professor Eisenberg's observation that

> in those cases in which the board is called upon to approve a self-interested transaction involving principal senior executives, the board's sole source of advice may be the proponent of the transaction. In short, unlike the typical business decision, in determining whether to approve a self-interested transaction involving principal senior executives, disinterested directors may receive only self-interested advice.

Eisenberg, *supra* note 80, at 453.

that the protector knows of the trustee's self-dealing, but believes that the trustee has paid the trust an adequate price for the property.[102] Or, imagine a trustee who has retained in the trust portfolio a heavy concentration of real estate previously owned by the settlor, or of stock in a few closely-held corporations.[103] The protector believes that the trustee has retained these assets for longer than reasonably necessary, and that as a result, the trust portfolio is not adequately diversified. In these hypothetical situations, the protector knows of the trustee's breach, or has reason to suspect breach, and has power to act, either by removing the trustee or by directing the trustee to make other investment decisions. In each case, however, the settlor might prefer that the protector refrain from acting.

The protector may have reasons—rooted in the beneficiaries' best interests—for deferring to the trustee's decision even if the protector believes that those decisions reflect a breach of fiduciary duty. Especially if the trustee is solvent, the protector may conclude that the beneficiaries will be better off as a result of the trustee's decision. The protector (like the settlor) may have confidence in the trustee's investment instincts, however inconsistent with modern portfolio theory, and may conclude that allowing the trustee's decision to stand will leave the beneficiaries better off: if the trustee's instincts pay off, the beneficiaries profit, while if they do not, the trustee is liable for breach. The trustee's liability itself is a mechanism for diversifying the beneficiaries' risks.

In some ways, the protector's position is akin to that of a reviewing court facing a challenge to the action of a corporate officer or director. The officers and directors have primary responsibility for running the corporation, and courts are loathe to interfere with their business judgments even if those judgments appear—from the court's perspective—to be unreasonable.[104] As a result, courts apply the

[102] *See* RESTATEMENT (THIRD) OF TRUSTS § 78 cmt b. (Tentative Draft No. 4, 2005) ("[U]nder the so-called 'no-further inquiry' principle it is immaterial that the trustee may be able to show that the action in question was taken in good faith, that the terms of the transaction were fair, and that no profit resulted to the trustee.").

[103] *See* RESTATEMENT (THIRD) OF TRUSTS § 227(b) (1992) (embracing duty to diversify); *id.* § 229 (setting forth duty, within reasonable time, to make and implement decisions concerning retention and disposition of original assets to comply with duties in sections 227 and 228).

[104] There are a number of reasons for this reluctance—first, "it may be hard for judges to differentiate bad business decisions from good business decisions that turn out badly." William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of* Van Gorkom *and its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV 449, 454 (2002). Second, judges and other decisionmakers may have a "hindsight bias" that might lead to imposition of liability even when none is warranted. *Id.* at 455. Third, interference with business judgments on an ordinary negligence standard would lead to excessive risk aversion by corporate officials. *Id.* Ultimately, the result might be reluctance to serve as a director. *Id.*; *see also* Velasco, *supra* note 83, at 833-34; Rock

business judgment rule and defer to those decisions without an inquiry into their reasonableness.[105] In effect, courts abstain from deciding whether the decisions are reasonable in order to preserve the decision-making authority of the corporation's primary decision makers.[106]

The analogy, of course, is less than perfect; significant differences exist between trustees and corporate officers.[107] In particular, while decisions made by corporate officers are often *sui generis*,[108] protocols exist—no self-dealing, diversification of portfolio—by which protectors can measure trustee behavior. In addition, corporate officers and directors are subject to market monitoring not typically available with respect to trustees.[109]

Nevertheless, it remains true that if the protector has a responsibility to act whenever the protector concludes that an actual or prospective decision of the trustee would be inconsistent with the interests of the beneficiaries, the protector is in effect assuming the primary decisionmaking responsibility for the trust. The trustee knows that the protector will exercise its powers whenever the trustee does not anticipate the protector's preferences. As a result, the trustee has every incentive to seek the protector's blessing before making any decision, effectively ceding any discretion the trust instrument conferred upon the trustee, and ignoring the interests of the trust beneficiaries. The protector effectively becomes a replacement for the trustee rather than a monitor of trustee behavior. The result is to make the protector an additional intermediary who adds little value; on the contrary, if the settlor chose the trustee because the settlor valued the trustee's investment and administrative skills, substituting the protector for the trustee might reduce the trust's value to the settlor and the beneficiaries.

& Wachter, *supra* note 23, at 667-68. For the suggestion that these reasons apply with lesser force to officers than to directors, see Johnson & Millon, *supra* note 89, at 1642.

105 *See generally* Eisenberg, *supra* note 80, at 443 (Under a business judgment standard, "a director or officer will not be liable for a decision that resulted in a loss to the corporation, even if the decision is unreasonable."); Bainbridge, *supra* note 74, at 108 (The business judgment rule "protect[s] those who make errors of judgment, even when those errors rise to the level of negligence").

106 *See* Bainbridge, *supra* note 74, at 108 (stating that the business judgment rule is justified because judicial review threatens free exercise of managerial power).

107 *See generally* Robert H. Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency*, 28 J. CORP. L. 565, 577 (2003); Leslie, *supra* note 3, at 77-88; Rock & Wachter, *supra* note 23, at 664-68.

108 *See* Eisenberg, *supra* note 80, at 444 (noting that because business decisions are unique, corporate decisionmakers can rarely shield themselves by showing that they followed accepted protocols or practices).

109 *Compare* Bainbridge, *supra* note 74, at 122 (noting that "[m]arket forces work an imperfect Darwinian selection on corporate decision makers"), *and* Macey, *supra* note 35, at 317-20, *with* Leslie, *supra* note 3, at 77-88, *and* Sitkoff, *supra* note 107, at 677-78.

From an agency cost perspective, it is difficult to imagine that a typical settlor would want such an activist protector. If the settlor did want such an activist protector, the settlor would be more likely to prohibit the trustee from acting without the protector's consent, or to make the protector a co-trustee. A better assumption is that the typical settlor wants the protector to intervene only in cases where the protector can discern no rational basis for the trustee's action.[110]

This assumption about appropriate protector behavior leads to a deferential standard of review of the protector's decision not to act: the protector should be liable for breach by failing to act only if the protector has made no reasonable inquiry into the trustee's behavior[111] or if no reasonable person would fail to act on the facts available to the protector.[112] So long as protector can establish a reasonable basis for failing to act—and deference to the judgment of the trustee will qualify as such a reasonable basis, unless that judgment is plainly inconsistent with the interests of the trust beneficiaries—the protector's failure to act should not subject the protector to liability.[113]

b. The Protector's Actions

Unlike the protector who fails to act, a protector who exercises a power conferred on him by the trust instrument takes affirmative responsibility for managing some aspect of the trust. It would be peculiar to assume that a settlor would expect that a protector who takes on that responsibility would exercise less prudence than other fiduciaries in discharging management functions. That is, if a protector directs a trustee to make particular investments, the typical settlor would expect that the protector's behavior would be governed by the duties of

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[110] *Cf.* Eisenberg, *supra* note 80, at 442 (noting that even the business judgment rule requires that the decision be rational, even if unreasonable).

[111] To assert the protection of rules designed to protect the exercise of judgment, decisionmakers generally have to show that they have exercised that judgment by making a conscious decision based on a reasonable inquiry. *See* Eisenberg, *supra* note 80, at 441 ("[A] director's failure to make due inquiry, or any other simple failure to take action—as opposed to a decision not to act—does not qualify for the protection of the [business judgment] rule."); Bainbridge, *supra* note 74, at 99 ("[Directors] may only invoke the business judgment rule when they have made a conscious decision.").

[112] Some commentators have described the business judgment review standard as one that examines decisionmaker actions for "rationality" rather than "reasonableness"; for them, an irrational decision is "one that is so blatantly imprudent that it is inexplicable, in the sense that no well-motivated and minimally informed person could have made it." Allen, Jacobs & Strine, *supra* note 104, at 452.

[113] *Cf.* RESTATEMENT (THIRD) OF TRUSTS § 75 cmt. f (Tentative Draft No. 4, 2005) ("[T]here may be an affirmative duty to act when the power holder knows or should know that the purposes of the power call for some action to be taken.").

care, loyalty, and impartiality that would constrain a trustee.[114] And if the standard of behavior expected of protectors who exercise management responsibility is the same as the standard expected of trustees, courts have strong reasons to apply the same standard of review: that is, the protector should be liable for the same behavior that would generate liability in trustees.[115]

Sometimes, the management responsibilities assumed by the protector will have direct analogues to responsibilities typically borne by trustees—as when the protector directs the trustee to make particular investments, or when the protector exercises discretion in directing the distribution of trust assets. With respect to these decisions, the protector's behavior should be governed by the duties of care, loyalty, and impartiality that would constrain a trustee.[116]

At other times, the protector will act in a way that is not directly analogous to any action a trustee might take. In these instances, too, the protector bears fiduciary responsibilities, but precedent from existing trust law is less likely to be helpful in defining those responsibilities. Consider, for instance, the protector who removes an existing trustee.[117] That removal necessarily imposes costs on the trust—as for the accounting necessary to resolve the respective liabilities of the old and new trustees. The protector should be obligated to explain why incurring these costs was in the interest of the trust beneficiaries; if the protector cannot offer a plausible explanation, the protector has breached its duty to those beneficiaries.[118]

One might object that this regime—limited accountability for the protector's failure to act; fiduciary liability for actions taken by the protector—will skew the protector's incentives towards inaction. From an agency cost perspective, however, this system of skewed incentives is a plus, not a minus. The tension between authority and accountability is central to every agency relationship. A settlor's objective in using a trust protector is to make the trustee more accountable without removing from the trustee the authority to act in areas where the trustee has presumed expertise. A regime in which the protector generally defers to the trustee's decisions, intervening only in extraordinary circumstances, has the potential to advance the settlor's objectives better than a regime in which the protector has incentives to intervene in day-to-day management. Imposing fiduciary duties on the protector

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114 *See* 2A SCOTT ON TRUSTS, *supra* note 28, § 185.

115 *Cf.* Warner v. First Nat'l Bank, 236 F.2d 853, 858 (8th Cir. 1956) (holding that managing advisor to executors was not himself a trustee, but might be liable for giving fraudulent or careless advice).

116 *See* 2A SCOTT ON TRUSTS, *supra* note 28, § 185 (4th ed. 2001).

117 *See, e.g.*, Von Knierem v. Bermuda Trust Co., Ltd., [1995] S.C.B. 154.

118 *See id.*; *see also* Duckworth, *supra* note 12, at 251 (Example 1).

when the protector exercises its power reduces threats to the trustee's authority. By contrast, imposing fiduciary duties on the trustee when the protector fails to act would introduce increased protector intervention, and a corresponding reduction of the trustee's authority. At the same time, the knowledge that the protector has power to intervene, even if the protector has limited financial incentive to do so, supplements the prospect of fiduciary duty liability as a mechanism for holding the trustee accountable.

4. Protector Self-Dealing

So far, the discussion has focused on providing incentives to induce the protector to engage in appropriate monitoring of trustee behavior. But what of the protector who uses his power to engage in self-dealing. That is, suppose the protector "consents" to a trustee decision to invest trust assets in an enterprise in which the protector has an interest, or suppose the protector directs the trustee to make such an investment. The approach to these issues should generally be obvious: absent language or circumstances suggesting the contrary, there is little reason to believe that the settlor was more willing to permit self-dealing by the protector than by the trustee. Hence, the protector's liability for losses due to affirmative actions taken by the protector in which the protector stands to benefit personally should be comparable to trustee liability.

A somewhat more difficult question arises when the trustee proposes a trust investment that stands to benefit the protector, and the protector has power to veto that decision, but does not do so. One might conclude that the trustee's judgment about the propriety of the investment should insulate the protector from liability. That is, if the trustee, who has no personal interest, decides that the investment is a prudent one, the primary risk of self-dealing—the inability of the self-dealer to separate his own interest from the trust's interest—has been eliminated. But that conclusion ignores an important fact: the trustee will often have an incentive to curry favor with the protector, who may have the power to veto the trustee's decisions, or even to replace the trustee.[119] Hence, a trustee may not exercise dispassionate review of investments that generate benefit for the trust protector. As a result, the protector, like a trustee, should be required to veto such transactions, or to obtain court approval. Of course, if the trust settlor reaches a

[119] *Cf.* Johnson & Millon, *supra* note 89, at 1613-14 (discussing "cozy" relationship between boards of directors and senior officers that may impede monitoring of behavior by officers).

different conclusion, the settlor can draft the trust instrument accordingly.

C. *Protector Powers Related to Trust Distribution Rather than Trust Management*

Consider now the protector whose powers do not extend to review of the trustee's administration of the trust. That is, suppose the protector's powers relate largely to adjustments in the time and method of trust distribution. Thus, to deal with the settlor's inability to foresee future events, the settlor empowers the protector to modify the trust's terms, or to terminate the trust, or to change the trust situs to better insulate trust assets from creditor claims. Alternatively, the settlor empowers the protector to authorize distributions to particular trust beneficiaries if, in the protector's judgment, circumstances warrant.

Disputes are most likely to arise when action by the protector would have differential effects on the various trust beneficiaries, aiding some while harming others. Thus, a protector's decision to modify a generation-skipping trust to permit settlor's impoverished child to reach trust principal would be of clear benefit to the child, but not to the settlor's grandchildren.[120] Similarly, a protector's decision to move the trust's situs to a jurisdiction that has abolished the Rule Against Perpetuities, and to modify the instrument to eliminate trust termination provisions might assist settlor's remote descendants at the expense of living descendants who would prefer rapid distribution of trust principal.

In situations like these, there is no readily available metric for evaluating the protector's action or inaction.[121] The warring beneficiaries may have disparate interests that are not amenable to easy aggregation. Moreover, neither the protector nor a reviewing court will possess strong evidence of the settlor's wishes; the settlor will typically

120 Typically, a generation-skipping trust would be drafted to preclude the settlor's child from reaching the trust corpus. If the child had an unlimited power to invade principal, the child would hold a general power of appointment over the trust property, and the property would be included within the child's taxable estate under 26 U.S.C. § 2041 (2000), thus defeating the settlor's original purpose.

121 A similar problem arises with respect to a trustee's duty of impartiality, which is easy to state but difficult to define. As the drafters of the Restatement have put it, "[i]t would be overly simplistic, and therefore misleading, to equate impartiality with some concept of 'equality' of treatment or concern—that is, to assume that the interests of all beneficiaries have the same priority and are entitled to the same weight in the trustee's balancing of those interests." RESTATEMENT (THIRD) OF TRUSTS § 79 cmt. b (Tentative Draft No. 4, 2005).

have appointed the protector precisely because the settlor could not anticipate the circumstances that have, in fact, unfolded.[122]

Under these circumstances, close judicial scrutiny of the protector's actions is likely to involve increased monitoring cost without a commensurate reduction in agency cost. If courts deem the protector to have breached a duty of care or duty of impartiality whenever the court concludes that a different decision would have better served the aggregate interests of the trust beneficiaries, courts will encourage disappointed beneficiaries to litigate every adverse protector determination.[123] Moreover, it is far from clear that the results reached by courts in those litigations would, on average, be superior to those reached by the protectors who made the initial decisions.[124] After all, the settlor reposed his confidence in the protector, not in the reviewing court.

At the same time, abandoning all judicial scrutiny over the protector's decisions would leave protectors unduly free of ties to their principals. Markets are unlikely to be effective in disciplining trust protectors; even if a class of professional protectors were to emerge, it would be difficult for settlors to identify which protectors had been most effective in making distribution decisions.[125] Moral obligation would serve as the most significant constraint on protector behavior. In general, law's experience with other fiduciaries has been that moral obligation, often an essential component in guiding fiduciary behavior,[126] is not by itself sufficient to generate optimal levels of care and loyalty.[127]

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[122] *Cf. id.* ("[I]t is often the case that the implications of the duty of impartiality are complicated by the difficulties of determining, and the vagueness of, some relevant aspects of the settlor's intentions and objectives . . . .").

[123] *Cf.* Rock & Wachter, *supra* note 23, at 667 (noting, in the corporate context, that imposing close judicial scrutiny when judges cannot reliably distinguish between negligent and non-negligent behavior "causes a host of problems").

[124] *See id.* at (noting as a justification of the business judgment rule that "courts with inferior information will do systematically worse than the internal governance mechanism in adjudicating the merits of a dispute"); *cf.* RESTATEMENT (THIRD) OF TRUSTS § 87 (Tentative Draft No. 4, 2005) ("When a trustee has discretion with respect to the exercise of a power, its exercise is subject to supervision by a court only to prevent abuse of discretion.").

[125] *Cf.* Leslie, *supra* note 3, at 82-84 (detailing absence of market monitoring of trustee performance).

[126] *See generally* Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1256-66 (1999) (exploring obligational norms, and conceptualizing fiduciary duties as a form of obligational norms).

[127] Indeed, the law of trusts developed in the fourteenth and fifteenth centuries when the chancellor began to require the trustee—previously bound only by moral obligations—to act upon the dictates of his conscience. *See* Richard H. Helmholz, *The Early Enforcement of Uses*, 79 COLUM. L. REV. 1503, 1503 (1979).

The natural compromise is to subject protectors to judicial review, but to apply a deferential standard to the protector's actions.[128] Courts already apply such a standard to trustees of discretionary trusts.[129] A protector with power to decide whether to make distributions of trust income or principal occupies essentially the same position, and should generally be subject to the same standard of review.

Sometimes, however, the protector's powers have no ready analogues in the realm of discretionary trusts. The trustee of a discretionary trust, for instance, rarely has power to terminate or modify the trust, or to change its situs. Nevertheless, the basic principle that remains is a similar one: a protector fulfills his legal duty to the beneficiaries when the protector identifies at least one trust purpose that would be advanced by the protector's decision to exercise, or not to exercise, a non-management power conferred on him by the trust instrument, and when the protector's decision was reasonably calculated to advance that purpose.[130] Whether the protector should have advanced some other trust purpose, or chosen another course of action

[128] *Cf.* RESTATEMENT (THIRD) OF TRUSTS § 87 (Tentative Draft No. 4, 2005) (abuse of discretion standard applied to discretionary powers held by trustees).

[129] When the trust instrument confers on the trustee broad discretion and does not constrain that discretion by reference to an external standard—such as support or maintenance of a particular beneficiary—courts typically sustain the trustee's exercise of discretion so long as the trustee has a legitimate motive and no personal stake in the decision. *See, e.g.*, *In re* Trusts A & B, 672 N.W.2d 912, 919 (Minn. Ct. App. 2004); Bushong v. Castle, No. 98AP-29, 1998 WL 767453 (Ohio Ct. App. Oct. 27, 1998) (sustaining trustee's payment to life beneficiary with prepaid checks, even when trustee made no investigation of need, because there was no evidence of bad faith by the trustee); Strong v. Dann, 108 A. 86, 87 (N.J. Ch. 1919) ("[T]he court has no power to command or prohibit the exercise of the discretion confided to the trustee if his conduct be *bona fide*, and there is neither proof nor suggestion of *mala fides* in this case.").

If the trustee of a discretionary trust refuses to consider a distribution decision suggested by a beneficiary, the trustee's failure to exercise judgment may be an abuse, but even in that case, the court will not compel the trustee to make any payment; instead, the court may simply direct the trustee to exercise the judgment conferred on the trustee by the trust instrument. *See, e.g.*, Finch v. Wachovia Bank & Trust Co., 577 S.E.2d 306 (N.C. Ct. App. 2003) (refusing to compel payment when trustee abused discretion by refusing to consider making payments to charity favored by trust beneficiary, and concluding that decision whether or not to make payment was within trustee's discretion).

When the trust instrument constrains the trustee's discretion by referring to an external standard, such as "reasonable maintenance, comfort and support" or procurement of "necessary and reasonable medical care," courts are more likely to find an abuse of discretion when the trustee does not appear guided by that standard, even if the trust instrument purports to confer on the trustee "sole and uncontrolled discretion." *See* Marsman v. Nasca, 573 N.E.2d 1025 (Mass. App. Ct. 1991); First Nat'l Bank v. Howard, 229 S.W.2d 781 (Tex. 1950); *see also* Schofield v. Commerce Trust Co., 319 S.W.2d 275 (Mo. Ct. App. 1958) (finding it was an abuse of discretion not to make payments for son's medical care when instrument authorized trustee to make payments "if necessary for upkeep of my son").

[130] A similar standard applies to a trustee's exercise of broad discretionary powers in a discretionary trust. So long as the trustee's action is founded on a legitimate motive, and the trustee's action is not tainted by self-interest, courts will not upset the trustee's exercise of discretion. *See, e.g.*, *In re* Trusts A & B, 672 N.W.2d at 919.

that would have better advanced the protector's chosen purpose, should be beyond the scope of judicial review. What the settlor expects from the protector is a reasonable exercise of judgment;[131] if doctrine expects much more, protectors may become difficult to find.[132]

D. *Remedies for Breach by the Protector*

Suppose imposing fiduciary duties on trust protectors is necessary to minimize agency costs. What recourse do the trustee or the beneficiaries have for breach of those duties? First, and most obviously, the beneficiaries have a claim against the protector for losses suffered as a result of the protector's breach.[133] Without a personal claim against the protector, the protector has little financial incentive to avoid self-dealing or other misconduct, and litigation would serve as an ineffective tool for monitoring the protector's behavior. But damage actions against the protector do not exhaust the potential remedies available to the trustee and the beneficiaries.

Consider the case in which the trustee and the protector are at odds. Either the trustee needs the protector's consent to take action and the protector will not give consent, or the protector has given the trustee directions that the trustee does not want to follow. In those situations, the trustee should be free to seek judicial direction, much as a trustee could seek judicial construction of the trust instrument or judicial approval of a transaction in which the trustee has a personal interest.[134] The trustees are not directly seeking to compel action by the protector, but rather to obtain judicial approval for their own actions, which would

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[131] *Cf.* RESTATEMENT (THIRD) OF TRUSTS § 87 cmt. c (Tentative Draft No. 4, 2005) ("When the exercise of a discretionary power is left to the judgment of a trustee, an abuse of discretion may result from the trustee's improper failure to exercise that judgment.").

[132] *Cf.* Allen, Jacobs & Strine, *supra* note 104, at 455 (noting, in the corporate context, that liability for negligence could be highly disproportionate to the incentives for serving as a director, making it difficult to attract qualified candidates as outside directors).

[133] Antony Duckworth has raised a doctrinal question about judicial enforcement of protector obligations. He suggests that enforcement requires a recognized basis, such as contract or trust, and he finds difficulty with each in the context of protectors. The protector may not have formally entered into a contract accepting the position, and the protector, unlike a trustee, does not hold any legal interest in the trust property. Duckworth concedes, however, that one way or another, courts will find a basis for liability against protectors who breach fiduciary duties. Duckworth, *supra* note 12, at 254-55.

[134] In a case arising in the Isle of Man, a court held that a trust should not fail for want of a protector, and when no successor protector could be appointed, a court could exercise the powers conferred on the trust protector. Steele v. Paz Ltd., discussed in Waters, *supra* note 22, at 114-15. Presumably, the same principle would apply when the protector refuses to take action required by the trust instrument as when the office of the protector becomes vacant.

not otherwise be authorized under the terms of the trust instrument.[135] The situation is not materially different from one in which co-trustees disagree, and either has standing to seek judicial directions to avoid liability for breach resulting from the other's preferred course of action.[136]

When the protector's behavior displeases the beneficiaries, but not the trustee, the beneficiaries have three alternatives: they can seek to compel the protector to take particular action, they can seek removal of the protector, or they can seek damages for the protector's breach of fiduciary duty. A beneficiary who seeks to compel the protector to act faces an uphill battle. If the beneficiary wants the protector to intervene in a matter of trust administration, the problem is that the trust instrument typically—and sensibly—contemplates that the protector will defer to the trustee's judgment on such matters, except in unusual circumstances. If the protector chooses to defer to the trustee on an administrative matter, the beneficiaries should not be entitled to compel the protector to oppose the trustee unless the trustee's action would itself be a clear breach of the trustee's fiduciary duty. If the instrument gives the protector power to direct distributions from the trust, a beneficiary is on firmer ground in seeking to compel the protector to act, but a court would nevertheless apply an "abuse of discretion" standard comparable to that applicable to the trustee of a discretionary trust. The same standard ought to apply if a beneficiary were seeking to prevent the protector from authorizing distributions.

Consider next the trust protector who has already engaged in misconduct. The protector should be as subject to removal as other fiduciaries who have misconducted themselves, on a similar rationale: past is prologue.[137] With trustees or executors, however, judicial removal is typically accompanied by appointment of a substitute fiduciary.[138] From an agency cost perspective, however, it is less clear

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[135] *Cf.* Duckworth, *supra* note 12, at 255 (discussing Canadian and English cases in which the court itself gave directions to the trustee when the person with power to give the trustee investment directions became disabled, because of a conflict of interest, from giving those directions).

[136] *See* RESTATEMENT (THIRD) OF TRUSTS § 81 cmt. c. (Tentative Draft No. 4, 2005) ("If a situation arises in which prudence requires that the trustees reach a decision and they are unwilling or unable to do so, the trustees have a duty to apply to an appropriate court for instructions.").

[137] *See, e.g.*, Mahoney v. Mahoney, 370 N.E.2d 1011 (Mass. App. Ct. 1977) (refusing appointment of trustee because her use of trust assets for herself under a previous will undermined confidence in her ability to fairly administer the trust); Brault v. Bigham, 493 S.W.2d 576 (Tex. Civ. App. 1973) (holding that an attempted appropriation of trust funds was an indication of future danger to the trust).

[138] *See, e.g.*, CONN. GEN. STAT. § 16-223 (2004); N.Y. EST. POWERS & TRUSTS LAW § 7-2.6 (McKinney 2005) (authorizing appointment of successor trustee upon removal of trustee). *See generally* 2 SCOTT ON TRUSTS, *supra* note 28, § 108.2.

that removal of one protector should be followed by appointment of another. The protector, unlike a trustee, is not essential for administration of the trust. Moreover, as we have seen, appointment of the protector introduces agency costs that may or may not outweigh the benefits the protector generates in better monitoring of trustee behavior. Hence, appointment of a substitute protector should not be automatic. Instead, much should depend on the terms of the trust instrument. Suppose, for instance, that the settlor of the trust appointed a protector with whom the settlor had a close personal relationship, and included no provision for a substitute protector. There is little reason to think such a settlor would want a court to appoint a substitute upon forfeiture of the office by the settlor's chosen protector. Conversely, if the trust instrument makes provision for successors, or makes it impossible for the trustee to perform its function without a protector (for instance, if the trust instrument provides that the trustee may not make new investments without the protector's consent), then a court should appoint a substitute protector in deference to the settlor's expressed intentions.

E. *Effect of the Protector's Action and Inaction on Trustee Liability*

In a world without trust protectors, potential liability for breach of fiduciary duty has served as a principal mechanism for deterring misbehavior by trustees. Once a settlor introduces a trust protector into the picture, should the protector's presence affect the potential liability of the trustee? That is, to what extent should protector monitoring serve as a substitute for, rather than merely a supplement to, trustee liability for breach of fiduciary duty?

The trustee's argument in these cases would be that the protector, by action or inaction, implicitly authorized the trustee's behavior, and that the protector's authorization immunized the trustee from liability for breach of fiduciary duty.

1. Powers Not Held by the Protector in a Fiduciary Capacity

As we have seen, the trust instrument might explicitly provide that a trust protector owes no fiduciary duties to trust beneficiaries, or context might make it clear that the protector can act out of personal self-interest. In those circumstances, if the protector acts within the power granted by the trust instrument, and directs the trustee to make particular investments, or withholds consent from decisions the trustee believes prudent, the trustee who follows the protector's directions, or who abstains from taking actions to which the protector refuses to consent, should not be liable to the beneficiaries for breach of fiduciary duty. In these limited circumstances, the clear intent of the settlor to insulate the trustee from liability should prevail; when the trust instrument implicitly or explicitly authorizes the protector to act in self-interest, the trustee has no power to veto decisions made by the protector even if those decisions are not in the interest of the other trust beneficiaries.[139]

We now turn to the more common situation in which the protector does owe duties to the trust beneficiaries.

2. Inaction by the Protector

In a regime where protector deference to the trustee's decisions should be the norm, the trustee should not be in a position to seek shelter from the protector's inaction. The protector's failure to intervene in administration of the trust need not signal approval of the trustee's action, but might instead represent a reluctance to interfere with the trustee's exercise of discretion conferred by the settlor.

Moreover, in those cases where the trust instrument prevents the trustee from acting without the consent or direction of the protector, and the protector withholds that consent or direction, the trustee may not use the protector's inaction as a shield for the trustee's own inaction when the trustee knew or should have known that the protector's inaction could harm the trust or breach a duty owed by the protector.[140] In that situation, the trustee's obligation is to seek judicial directions.[141]

3. Protector Ratification of the Trustee's Action

Similarly, when the trust instrument requires that the protector consent to particular actions proposed by the trustee, the protector's

[139] A number of cases involving a beneficiary or settlor with power to direct or consent to trust investments have reached the same conclusion. *See*, *e.g.*, Ditmars v. Camden Trust Co., 76 A.2d 280 (N.J. Super. Ct. Ch. Div. 1950) (holding that the trustee was insulated from liability by life tenant's refusal to consent when the instrument gave the life tenant power of approval for sale of securities); Reeve v. Chase Nat'l Bank, 287 N.Y.S. 937 (N.Y. App. Div. 1936) (holding that the settlor's direction to purchase bonds insulated the trustee from liability when settlor reserved complete control over trust investments); *In re* Jacobs' Trust Estate, 183 A. 49 (Pa. 1936) (same).

[140] *See* RESTATEMENT (THIRD) OF TRUSTS § 75 cmt. g (Tentative Draft No. 4, 2005) ("Where the terms of the trust do not allow the trustee to act without the consent of another, the trustee is not necessarily justified in doing nothing merely because the consent has not been received.").

[141] *Id.*

ratification should not generally insulate the trustee from liability for breach of fiduciary duty. Insulating the trustee from liability permits the trustee to shift responsibility for decisions to the protector, and reduces the incentive for the trustee to exercise care: if the protector ratifies the trustee's action, the trustee would escape liability; if the protector does not ratify, the trustee cannot take the action, and therefore cannot incur liability. Moreover, even if the protector has the power to remove the trustee, that removal power would provide an incentive for the trustee to do the protector's bidding, not to act as an independent safeguard of the interests of the trust beneficiaries.

The position of the trustee whose action receives approval from the trust protector resembles the position of a trustee whose action is endorsed by a co-trustee. Endorsement or approval by the co-trustee does not relieve the trustee who proposes an action from liability for breach of fiduciary duty.[142] The rationale for that rule applies with equal force to the trustee who needs and obtains consent from a protector: when the settlor reposed power in multiple fiduciaries, the settlor expected each independently to act with prudence and loyalty toward the trust beneficiaries.[143]

The situation is different when the settlor has named a trust protector with the express purpose of insulating the trustee from liability from particular claims of breach of fiduciary duty—particularly claims of self-dealing by the trustee. The no-further-inquiry rule typically requires a trustee to seek court approval for any transaction between the trustee and the trust, however advantageous that transaction might be for the trust.[144] A settlor might name a trust protector, with power to

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[142] *See* RESTATEMENT (THIRD) OF TRUSTS § 81(2) (Tentative Draft No. 4, 2005) (providing that each trustee "has a duty to use reasonable care to prevent a co-trustee from committing a breach of trust . . . ."); *see also* UNIF. TRUST CODE § 703(e) (2005) ("A trustee may not delegate to a cotrustee the performance of a function the settlor reasonably expected the trustees to perform jointly."); 2A SCOTT ON TRUSTS, *supra* note 28, § 184 (4th ed. 2001).

[143] *See generally* UNIF. TRUST CODE § 703 cmt. ("Cotrustees are appointed for a variety of reasons."). Having multiple decision-makers serves as a safeguard against eccentricity or misconduct. By contrast, when a trustee receives approval for a proposed action from all of the trust's beneficiaries, as opposed to a co-trustee or trust protector, that approval does generally insulate the trustee from liability for the action, so long as the trustee has provided the beneficiaries with complete information. *See, e.g.*, Meier v. Union Trust Co. of Indianapolis, 176 N.E. 42 (Ind. Ct. App. 1931); Mann v. Day, 165 N.W. 643 (Mich. 1917); Turner v. Fryberger, 109 N.W. 229 (Minn. 1906). In that situation, however, there is no potential for explicit or implicit collusion between the parties to limit the rights of trust beneficiaries; the beneficiaries themselves have consented to the arrangement. Moreover, estoppel principles would generally preclude beneficiaries from challenging actions they themselves have approved.

[144] *See* RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. b (Tentative Draft No. 4, 2005) ("[U]nder the so-called 'no further inquiry' principle it is immaterial that the trustee may be able to show that the action in question was taken in good faith, that the terms of the transaction were fair, and that no profit resulted to the trustee."). For discussion of the continued vitality of the no further inquiry rule, compare Langbein, *supra* note 5, with Melanie B. Leslie, *In Defense of the*

approve self-dealing by the trustee, precisely to avoid the costs associated with judicial approval. In that situation, protector's approval should insulate the trustee from liability.

4. Protector Directs Action by the Trustee

The most difficult problems arise when the trustee follows directions given by the trust protector. Ordinarily, when the trust instrument confers on the protector authority to direct the trustee to make particular investments or distributions, the trustee is obligated to follow directions issued by the protector in the exercise of that authority.[145] Sometimes, however, the protector's directions may breach the protector's fiduciary duty, even if the directions are not inconsistent with the express language of the trust instrument.[146]

As a practical matter, the trustee faced with directions of questionable validity has several choices. The trustee can follow the protector's directions.[147] The trustee can seek judicial approval of a decision to follow the protector's directions.[148] The trustee can seek approval from the trust beneficiaries. If the trustee obtains judicial approval or approval from the trust beneficiaries, the trustee has effectively insulated itself from liability for breach of fiduciary duty. But what if, instead, the trustee follows the protector's directions?

If the trust beneficiaries were optimal monitors of the actions of trust protectors, there would be little reason to hold the trustee liable for following the protector's directions, even when those directions breached the protector's fiduciary duty. Because the beneficiaries can hold the protector accountable through an action for breach of fiduciary duty, the protector would have ex ante incentives to act appropriately,

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No Further Inquiry Rule: A Response to Professor John Langbein, 47 WM. & MARY L. REV. 541 (2005).

145 As the Restatement points out:

> Where the terms of the trust provide that, in administering the trust, the trustee shall take certain actions if so directed by another person, it is ordinarily the trustee's duty to comply with that person's direction; the trustee would ordinarily be liable for a loss resulting from failure to do so.

RESTATEMENT (THIRD) OF TRUSTS § 75 cmt. b (Tentative Draft No. 4, 2005).

146 *See generally* Bove, *supra* note 27, at 390, 392.

147 The trustee can first question the protector, which might, in some circumstances, cause the protector to reconsider. If, however, the protector does not reconsider, the trustee is left with the same alternatives.

148 RESTATEMENT (THIRD) OF TRUSTS § 75 cmt. e (Tentative Draft No. 4, 2005) (stating that if the power holder insists upon compliance with the power holder's directions despite the trustee's objection, the trustee may apply to the court for instructions); *cf. In re* Rogers, 63 O.L.R. 180 (1929) (discussed in Waters, *supra* note 22, at 75).

while the beneficiaries would receive compensation ex post when the protector does not act appropriately.

But a primary reason for introducing protectors into the world of domestic trusts is that beneficiaries are often inadequate monitors of their own interests. The trustee, on the other hand, has typically been appointed to protect the interests of the trust beneficiaries. Holding the trustee liable for failing to seek judicial or beneficiary consent before acceding to the protector's questionable directions provides the trustee with an incentive to monitor the protector's actions.[149] In most cases, this incentive will result in discussions between the protector and the trustee, resulting in a resolution that incorporates the judgments of both protector and trustee.[150]

The difficult problem is determining when the cost to the trustee of monitoring the protector's behavior exceeds the value of that monitoring.[151] In general, the cost to the trustee of monitoring the prudence of the protector's investment directions is likely to be low. As a result, if a protector directs the trustee to follow investment practices not explicitly authorized by settlor and seriously at odds with modern portfolio theory, the trustee should not be entitled to follow the protector's directions without risk of liability.[152] By contrast, the cost to the trustee of determining whether protector has engaged in self-dealing is likely to be higher.[153] The trustee has little reason to know enough about the protector's personal financial affairs to determine whether the protector's decisions generate personal benefit for the protector.[154]

149 For authorities suggesting that the trustee should be liable in this instance, see *In re* Cross, 175 A. 212, 214 (N.J. Eq. 1934), *rev'd on other grounds*, 176 A. 101 (N.J. 1935); Note, *Trust Advisors*, 78 HARV. L. REV. 1230, 1233 (1965); SCOTT ON TRUSTS, *supra* note 28, at 574-75; Waters, *supra* note 22, at 85-86.

150 Alternatively, if the protector persists in directing an action that the trustee believes constitutes a breach of fiduciary duty, the trustee would be forced to seek judicial instructions. *See generally Trust Advisors*, *supra* note 149, at 1233.

151 The Restatement of Trusts attempts to capture this problem by providing that if the holder of a power to direct the trustee violates a fiduciary duty in exercising the power, "the trustee is not liable for acting in accordance with the exercise of the power unless the trustee knows or should have known that the power holder acted in violation of the fiduciary duty." RESTATEMENT (THIRD) OF TRUSTS § 75 cmt. e (Tentative Draft, No. 4, 2005).

152 For a case holding a professional co-executor subject to liability for losses that resulted when co-executor, testator's brother, refused to consent to a sale of stock, and the will required brother's consent to any sale, see In re *Cross*, 172 A. 212 (N.J. Prerog. Ct. 1934), *rev'd on other grounds*, 176 A. 101 (N.J. 1935). The court wrote that the testator's direction that stock not be sold without the brother's consent "ceased to be a shield when the estate became endangered by his conduct." *Id.* at 215. The decision was reversed on the ground that the brother's actions were not negligent.

153 In many instances, the protector may be the only source of information about his own self-dealing, he may be unlikely to disclose that self-dealing. *Cf.* Eisenberg, *supra* note 80, at 453.

154 *Cf.* RESTATEMENT (THIRD) OF TRUSTS § 75 cmt. e (Tentative Draft No. 4, 2005):

> [W]here the terms of the trust provide that the trustee shall make such investments as a designated person may direct, and the person directs a trustee to purchase certain

Moreover, generating that information about a transaction that, on its face, appears to be in the interests of the trust beneficiaries would typically cost more than the information is worth to those beneficiaries. Hence, the trustee should not typically bear liability for failing to detect self-dealing by a protector in a transaction that appeared to be fair and prudent for the beneficiaries.[155]

F. *The Effect of the Trust Instrument: Default or Mandatory Rules?*

The preceding sections have demonstrated that the typical settlor concerned about agency costs should want to impose fiduciary duties on trust protectors, and should not want to exculpate them from liability. The remaining question is whether the liability regime sketched out in previous sections should be treated as a default regime or as one with mandatory elements.

For a variety of reasons, the case for mandatory rules is a weak one.[156] First, the variation in reasons for appointing protectors, and hence, the capacities and weaknesses of protectors appointed, vary too significantly to impose on trust settlors a one-size-fits-all regime for governance of trust protectors. Second, the newness of the protector concept suggests that experimentation rather than fiat is more likely to lead to efficient regulatory structures. Third, at this juncture, protectors as a class have little market power and no stranglehold on information, making it unlikely that they could dupe settlors or their lawyers into including protector provisions unfavorable to the trust beneficiaries. Hence, one would expect courts to demonstrate considerable respect for alternative governance schemes developed by settlors and their lawyers—especially when those schemes are narrowly tailored to address identified potential conflicts.

Nevertheless, some cautions are in order. First, it will be difficult for settlors and their lawyers to determine in advance the sorts of imprudent or self-interested behavior in which protectors might engage. Broad exculpatory clauses might reflect imperfections of foresight

> securities, the trustee is not liable for doing so merely because it is later shown that the designated person had a personal interest in having the trust purchase the securities, provided the trustee neither knew nor had reason to believe that (and thus a duty to investigate whether) this conflict of interests existed.

Id.

155 *Cf.* Duckworth, *supra* note 12, at 254 (trustee should be excused if trustee acted "honestly and reasonably and ought fairly to be excused").

156 *But see* Duckworth, *supra* note 12, at 176 (discussing limits on powers the protector might have).

rather than clarity of purpose.[157] Trust settlors will rarely intend to give protectors the equivalent of fee ownership of the trust assets (at least when the protector is not a very close relative).[158] But the combination of broad powers together with a broad exculpatory clause can give the protector very close to absolute rights in the trust property. Hence, for the same reasons courts have been unwilling to construe trust instruments to exculpate trustees from all breaches of fiduciary duty, courts should properly be skeptical of overbroad provisions purporting to exculpate trust protectors—particularly when the protector's conduct has been egregious.[159]

CONCLUSION

The relationship between the trust's settlor and a trust protector is founded primarily on trust; the settlor trusts the protector to act as a faithful agent. In this respect, the relationship resembles that between fourteenth century landowners and their feoffees—precursors to the modern trustee who agreed to do the bidding of their principals by holding, and transferring, legal title in accordance with instructions given to them by those principals.[160] Initially, the feoffee's obligations were entirely moral; his duties were not enforceable at all.[161] But the history of the early trust suggests that the relationship between the protector and the settlor, like the relationship between landowner and feoffee, will not long escape the scrutiny of the legal system; trust alone has proven inadequate to ensure that trustees act as faithful agents.[162] Fiduciary duties have emerged to play a significant, albeit supplementary, role.

Fiduciary duties are likely to play a similar role in disciplining trust protectors. But protectors are not simply trustees by another name. The settlor who names a protector chooses to forego more traditional arrangements for shared responsibility for trust decisions, presumably out of a belief that the protector model adds value that traditional arrangements cannot capture. That added value is most likely to come in two forms: reduced agency costs in monitoring trustee behavior, and increased ability to adapt the trust to changed circumstances. But the agency costs associated with policing the protector threaten to dissipate

157 *See* Leslie, *supr*a note 3, at 103.
158 *See* Duckworth, *supra* note 12, at 178.
159 *Cf.* Waters, *supra* note 22, at 85, 98-100.
160 *See generally* 1 SCOTT ON TRUSTS, *supra* note 28, § 1.3.
161 *Id.*
162 *Id.* § 1.4.

this added value. If the protector is to survive as a trust institution, it will do so because the fiduciary duty regime that surrounds protectors minimizes those agency costs while maintaining the advantages associated with protectors.

At this point in the development of the trust protector, any attempt to describe a fiduciary duty regime that minimizes agency costs is necessarily tentative and incomplete. My objective here has been to provide a framework for developing that regime.