2007

Business Imperatives And Fiduciary Duty

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A. The Conflict: Trustee As Beneficiaries' Advocate Versus The "Business Imperative"

1. The slow erosion and eventual repeal of the Glass Steagall Act, which separated commercial and investment banking institutions, induced increasing numbers of institutional trust companies to merge, affiliate with, or purchase financial institutions offering investment banking services. 12 U.S.C. §377 (1935), repealed by Pub. L. 106-102, 113 Stat. 1341 (1999). See Joan M. LeGraw & Stacey L. Davidson, Glass-Steagall and the "Subtle Hazards" of Judicial Activism, 24 New Eng. L. Rev. 225, 226-28 (1989). As a result, banks now offer both trustee and investment services, and increasing numbers of financial institutions are entering the trust market. Institutional trustees can maximize profits by investing trust assets in related companies, earning both trustee commissions and other fees, such as those related to the management and sale of the investment. Trust departments now routinely earn additional commissions and fees for banks by investing trust assets in proprietary mutual funds and other investment vehicles managed or sold by trustee banks.

2. This development directly conflicts with the trustee’s duty of loyalty, which requires the trustee...
to subordinate its interests to the trust’s. Until recently, the duty flatly prohibited a trustee from earning any fees in addition to trustee commission, or in any way profiting from its position as trustee, without advance authorization from the settlor, trust beneficiaries, or a court. In recent years, banks have strenuously advocated for relaxation of the duty of loyalty, arguing that change is needed to enable banks to remain competitive, and more importantly, that trust customers want trustee banks to engage in self-dealing. That is, trust customers choose particular banks to act as trustees because they offer not only investment expertise but a variety of sound financial products in which to invest trust assets. In short, the “business imperative,” to use Professor Robert Whitman’s term, requires relaxation of stringent duty of loyalty standards.

3. Banks’ aggressive lobbying efforts recently have resulted in state and uniform statutes that weaken, and in some instances eviscerate, the protections afforded by centuries-old duty of loyalty rules. These changes have occurred without sufficient consideration or understanding of trust law’s underlying objectives. If the term “trustee” is to have any distinct meaning, fiduciary standards should ensure that trustees do not advance their interests at the trust’s expense. This article argues that the duty of loyalty rules should seek to require trustees to make full disclosure in advance of taking action that might be detrimental to the trusts interests. The traditional duty of loyalty standard accomplishes that objective. Some newer statutes, however, fully undermine it.

B. Rules Should Be Designed To Force Full Disclosure In Advance Of Self-Dealing

1. The Playing Field Is Not Level At The Time Of Trust Creation

a. When the trust creator (“settlor”) negotiates with the institutional trustee, the trustee is in the superior bargaining position. See Melanie B. Leslie, Trusting Trustees: Fiduciary Duties and the Limits of Default Rules, 94 Georgetown L. J. 67 (2005) (exploring how information asymmetries between trustees, settlors, and beneficiaries justify making some fiduciary duties mandatory). Trustees generate business by holding themselves out as uniquely qualified both to manage trust assets and zealously protect and advance beneficiaries’ interests. Relying on those implicit or explicit representations, the settlor brings to the table a set of assumptions about the services she is purchasing. Although the settlor may not be familiar of the details of the loyalty standard, it is a safe bet that the settlor assumes that the trustee will subordinate its interests to those of the trusts. On the other hand, the institutional trustee is a repeat player that understands background law and how to tailor trust terms to its own advantage. Cf. Jeffrey N. Gordon, The Mandatory Structure of Corporate Law, 89 Colum. L. Rev. 1549, 1566 (1989) (arguing that “uncertainty about operation of the customized term is likely to run against the prospective shareholder and in favor of the firm” since the firm has greater incentive than the shareholder to understand how a particular customized charter term will operate).

b. With troubling frequency, trust settlors of modest wealth are entering into trust arrangements without the advice of independent counsel. This exacerbates the bargaining imbalance between settlor and trustee. Unfortunately, settlor representation does not always cure the problem. Of course, the vast majority of attorneys will aggressively represent their clients. Moreover, professional trustees often obtain business from trust attorneys who recommend trustees to their clients, which may create an incentive for trustees to behave in accordance with fiduciary standards. John Langbein, Questioning
the Trust Law Duty of Loyalty: Sole Interest or Best Interest?, 114 Yale L.J. 929 (2005). But the traditional model in which a wealthy client selects a family lawyer whose primary motive is to protect the settlor by choosing a reputable trustee and drafting a trust instrument thoroughly protective of the beneficiaries’ interests has become less prevalent in recent years, as commercial banks and traditional trust companies lose market share to brokerage firms and other non-traditional trust providers. See V. Gerard Comizio and Jeffrey L. Hare, Regulatory Developments for Banks and Thrifts Conducting Trust and Fiduciary Activities, 59 Bus. Law. 1299 (May 2004).

c. With increasing frequency, it is the trustee who works with, and has authority over, settlor’s attorney. The client may consult an investment adviser, who recommends a revocable living trust and an attorney to look over the documents. As Professor Gerald Johnston explains:

It is a widespread practice among corporate fiduciaries to retain the services of the lawyer who drafted a will or trust in which a bank is named as executor or trustee to perform any legal work that may be necessary in estate or trust administration. In probating a testator’s estate, legal services are virtually always needed because of the strict application of laws relating to unauthorized practice of law, which preclude corporate fiduciaries from handling matters processed through the probate court system. The policy of retaining the draftsman to provide legal services has been described as a “gentlemen’s agreement” between financial institutions and the bar, as “reciprocal back scratching,” as a “symbiotic relationship,” and, less generously, as a “conspiracy” between corporate executors and lawyers to exploit the client by recommending that the testator name a bank as executor in exchange for assurance that the executor, once appointed, will retain the attorney to assist in the probate of the testator’s estate.


d. Although this arrangement appears to give the attorney power over the trustee (because the trustee wants to induce the attorney to bring it business), it does not seem beyond the pale to suppose that some attorneys engaged in this type of symbiotic relationship might agree to trust terms simply to keep the relationship on an even keel. See Robert H. Sitkoff, An Agency Costs Theory of Trust Law, 89 Cornell L. Rev. 621, 644-45 (2004) (arguing that “information-forcing default rule[s]” are justified to remedy informational asymmetries between inexperienced settlors and repeat player trust attorneys); see, e.g., Committee on Professional Ethics & Conduct v. Baker, 492 N.W.2d 695 (Iowa 1992) (reprimanding attorney for accepting over 100 referrals from financial services company establishing living trusts and failing to advise clients in a disinterested fashion).

e. When attorneys are the ones seeking the recommendations, trustees face little pressure to impress them. See, e.g., Committee on Professional Ethics & Conduct v. Baker, supra. And, as a spate of recent disciplinary cases demonstrates, some attorneys might be tempted to protect their referral source. See, e.g., State v. Laden, 893 P.2d 771 (Colo. 1995) (publicly censuring attorney for aiding trust marketer in the unauthorized practice of law by issuing standard form advice letters in response to trust marketer’s clients’ requests for legal advice); Committee on Prof. Ethics v. Mattias, 521 N.W.2d 704 (Iowa 1994) (lawyer’s license suspended for accepting referrals from company that marketed living trusts); In re Mid-America Living Trust Associates, Inc., 927 S.W.2d 855 (Mo. 1996) (enjoining living trust company, which sold living trust kits to clients and recommending attorneys to those clients, from doing business in Missouri); Cincinnati Bar Assoc. v. Kathman, 748 N.E.2d 1091 (Ohio 2001)
(suspending attorney from practicing law for aiding trust marketer in the unauthorized practice of law and failing to render meaningful legal advice to trust marketer's customers).

f. The asymmetrical information problem is exacerbated by a lack of market mechanisms. Leslie, *Trusting Trustees, supra*. Compare the trust settlor to the corporate shareholder. Unlike shareholders, settlors cannot look to share price or information markets to help evaluate the performance of the fiduciary. Although even uninformed shareholders can free-ride on the efforts of institutional investors, the settlor with inadequate information is on her own.

2. **Trust Beneficiaries Are Poor Monitors Of Trustee Behavior**
   a. Because the trust relationship extends well beyond the death of the settlor, the responsibility for monitoring trustees' behavior falls to the beneficiaries. Trust beneficiaries tend to be uniquely poor monitors. See generally, Leslie, *Trusting Trustees, supra* (exploring how information asymmetries between trustees, settlers, and beneficiaries justify making some fiduciary duties mandatory). Often, the very reason that beneficiaries received an inheritance in trust is because the settlor did not believe they were capable of managing large sums of money on their own, either because they are minors or because they lack financial sophistication. Most beneficiaries, therefore, are ill equipped to understand whether a trustee's actions are in the trust's best interests. Moreover, because institutional trustees hold themselves out as being trustworthy, beneficiaries are likely to trust the trustee instead of closely monitoring his or her behavior.

   b. Moreover, the market forces that pressure other types of fiduciaries (such as corporate fiduciaries) to avoid opportunistic behavior are largely absent in the trust context. See Leslie, *Trusting Trustees, supra*. There is no public information market that informs beneficiaries that trustees' acts might be harming the trust. Because most trust management is secret, disclosed only to beneficiaries, trustees who have failed to internalize the loyalty norm may not worry that self-dealing acts will be communicated to their customers as a whole. Even if a particular beneficiary discovers that her trustee is performing poorly, she will be unlikely to communicate this to the trustee's other clients, of whom she is unaware.

   c. Finally, the beneficiary's ability to exit the relationship is severely constrained. Leslie, *Trusting Trustees, supra*. Beneficiaries often depend, at least to some degree, on the trust assets. Moreover, there is no market for beneficiaries' interests, especially if the trust is a spendthrift trust. Replacing a trustee is difficult and expensive. Beneficiaries' relative inability to exit is relevant for two reasons; first, trustees who have not internalized the loyalty norm can cause greater damage to beneficiaries. Unlike other relationships, where participants can end the relationship by breaking it off or selling their shares, beneficiaries may be stuck with a self-dealing trustee for years. Even if beneficiary discovers that the trustee is performing poorly, she will be unlikely to communicate this to the trustee's other clients, of whom she is unaware.

3. **Default Rules Should Seek To Force Disclosure**
   a. In sum, in crafting a set of rules to protect settlors and beneficiaries, it makes sense to place the burden to disclose opportunistic behavior squarely on the trustee. The trustee knows the details about the self-dealing investments in which it wishes to engage. If, at the time of contracting, the
trustee contemplates investing in proprietary mutual funds, the burden should be on the trustee to disclose that fact, and to receive the settlor's express permission to do so, subject to qualifications on which the now-informed settlor demands. If, during the life of the trust, the trustee wishes to benefit from its position in ways not contemplated in the trust document, the trustee should have the burden of fully disclosing the details of the proposed transaction to the beneficiaries before engaging in the behavior.

b. As it turns out, duty of loyalty principles designed to force prior disclosure have been in place for well over 100 years. Trust law’s “no further inquiry” and “advance approval” doctrines compensate for imbalances in bargaining position and the absence of monitoring capability. See generally, Leslie, In Defense, supra. Recent statutory enactments, most notably the Uniform Trust Code, gut those long-standing rules in favor of a more lenient approach. In doing so, they place trust settlors and beneficiaries at a serious disadvantage.

C. Established Duty Of Loyalty Principles Best Force Disclosure

1. The No Further Inquiry Rule

a. For centuries, trust law has stubbornly insisted that when the trustee profits from engaging in a conflicted transaction with the trust, the beneficiary may void the transaction unless the trustee obtained prior approval. See Restatement (Third) of Trusts §78 cmt. a (Preliminary Draft No. 6, May 23, 2003) (stating that the “duty of loyalty is, for trustees, particularly strict even by comparison to the standards of other fiduciary relationships”). The trustee is held per se liable simply upon the beneficiary’s showing that the trustee had a personal interest in the transaction (the “no further inquiry” rule), even if the self-interested transaction caused the trust no damage. See Restatement (Third) of Trusts §78 cmt. b (Preliminary Draft No. 6, May 23, 2003) (stating that under the no further inquiry rule “it is immaterial that the trustee may be able to show that the action in question was taken in good faith, that the terms of the transaction were fair, and that no profit resulted to the trustee”). The trustee must disgorge all profits realized as a result of the transaction and return them to the trust.

b. Consider an example: X is trustee of a testamentary trust that holds as an asset a 20-acre plot of land. X determines that the time is right to sell the land for development. In addition to being trustee, X also happens to be a developer, and she would like to purchase the land from the trust herself. After obtaining several appraisals, X purchases the land from the trust for a sum that she reasonably believes represents the land’s fair market value. If the trust’s beneficiaries sue the trustee for breach of the duty of loyalty, should they prevail even though the trustee seemed to have paid a fair price? The law answers “yes.” See, e.g., Staats v. Bergen, 17 N.J. Eq. 554, 559 (Err. & App. 1867) (finding trustee liable for breach of the duty of loyalty for purchasing trust property at a foreclosure sale because “the interest of the [trustee] was directly antagonistic to the that of the complainant. A low price was the gain of the defendant, but it was, in the same ratio, a loss to the complainant”); Marshall v. Carson, 38 N.J. Eq. 250 (Err. & App. 1884) (finding that trustee who purchased land from the trust breached duty of loyalty because “there is an inherent conflict of interest in the idea that a purchaser wants to pay the lowest possible price for land, while a trustee wants to sell the land for the best possible price.”)
i. If X had sold the land on the open market, she would have used her best efforts to obtain the highest possible price for the land, which might have resulted in a higher sale price. If so, the beneficiaries were harmed by the trustee's purchase of the trust assets, even if the trustee paid a price within the range of the property's fair market value, because the trustee did not, and could not expect to, advocate for the trust beneficiaries seeking to obtain the highest price. See Restatement (Third) of Trusts §78 cmt. b (Preliminary Draft No. 6, May 23, 2003) (stating that “[a] trustee commits a breach of trust by purchasing trust property, even as the highest bidder at a public auction”; the Restatement (Second) of Trusts §170 suggests that a trustee should obtain court approval for the purchase of trust property; and that a court should grant that approval only when the purchase is in the beneficiary's best interests.) Instead, the trustee, not the trust, captured some of the value generated by the deal. Moreover, beneficiaries and a court would have difficulty determining after the fact whether X in fact paid top dollar for the property; the market is a better indicator of fair market value than is an *ex post* judgment by the court. As Robert Cooter and Bradley Friedman have put it, “To overcome difficulties in proof, the law infers disloyalty from its appearance, presuming that a fiduciary will appropriate the principal's asset when it is in her self-interest to do so.” See Robert Cooter and Bradley J. Friedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. Law Rev. 1045, 1055 (1991).

c. The no further inquiry rule supports trust settlors' objectives. The trustee earns compensation for acting as the beneficiaries' advocate. The trustee's duty is to subordinate its own interest to the beneficiaries' interests. The trustee's role is to advocate zealously for trust beneficiaries at all times, without regard for the trustee's personal interests. The trustee's promise to subordinate its interests to those of the beneficiaries reassures the settlor that her loved ones will be well cared for after her death.

d. The no further inquiry rule also corrects for the lack of external pressures on the trustee. See Leslie, *In Defense*, supra. The rule's bright-line prohibition on self-dealing without advance approval, and the unusually harsh remedy it provides (disgorgement of all profits, even if the trust was not harmed) create appropriate disincentives to self-dealing. See Robert H. Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency*, 28 J. Corp. L. 565, 573 (2003); Restatement (Third) of Trusts §78 cmt. b (Preliminary Draft No. 6, May 23, 2003) (recognizing that beneficiaries' attempts to monitor trustee performance are likely to be "inefficient if not ineffective" because monitoring efforts will be "wastefully expensive," and suffer from a lack of information, resources, and necessary knowledge and experience). Were there a thick, functioning market for beneficial interests in trusts, the rule would not be necessary. Because there is no such market, the rule operates as a substitute.

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

2. The Advance Approval Requirement

a. There is one important exception to the complete prohibition on self-dealing: the advance approval doctrine. If a trustee genuinely believes that an opportunistic transaction is also the best option for the trust, the trustee may obtain authorization from the settlor (in the trust document), the beneficiaries (after the trust is up and running), or a court. See Leslie, *In Defense*, supra.
b. Settlor-authorized conflicts are allowed because they reflect settlor’s determination that allowing the conflicted transaction will maximize the trust’s value and effectuate settlor’s intent. In authorizing the transaction, the settlor relieves the beneficiary from the need to monitor the trustee’s behavior with respect to that transaction. Thus, the no further inquiry rule’s effect to compensate for lack of monitoring is not implicated when settlors authorize specific conflicted transactions. By dictating that trustees must obtain advance approval for any transaction from which the trustee stands to profit personally, the rule corrects for beneficiaries’ inability to assess whether the trustee is conflicted with respect to any particular transaction. By requiring the trustee to explain to a court or to the beneficiary why the transaction is in the trust’s best interests, it relieves the beneficiary of the need to have the same knowledge and expertise as the trustee. By allowing the beneficiary to state a claim upon a simple showing that trustee sat on both sides of a transaction, it places the burden of production on the trustee. And because disclosure does generate some cost, the rule ensures that the trustee will not habitually or regularly self-deal, but will do so only when a conflicted transaction really is in the trust’s best interests. See Leslie, In Defense, supra.

c. Trustees may also obtain authorization for self-dealing acts from the beneficiary. Historically, courts have scrutinized trustee claims of beneficiary authorization quite closely, rejecting such authorization as a defense to trustee self-dealing if trustee cannot prove that the consenting beneficiaries were fully informed of the details of the problematic transactions.

d. Finally, trustees may appeal to a court for advance approval. In some number of cases, the judicial process is unlikely to amount to a full-blown trial and appeal, and is not likely to be expensive. Of course, when judicial proceedings do take on the characteristics of a full-blown trial, the costs of approval may outweigh the benefits of the transaction to the trust. In those cases, it is hard to believe that the cost of a missed opportunity constitutes serious harm to the trust. The more opposition the proposal raises, the less likely the beneficiaries will be harmed if the opportunity is missed. See Leslie, In Defense, supra.


a. The no further inquiry rule best ensures that settlors and beneficiaries understand what the trustee is doing, alerts them to the need to monitor behavior, and, by putting burden on the trustee to make the case for the conflicted transaction, best facilitates monitoring.

b. The common law duty of loyalty both protected settlors and beneficiaries, and allowed them to authorize conflicted transactions when it was in the trust’s best interest to do so. It is hard to believe, therefore, that the change in loyalty rules is a response to client demand. The only explanation for new statutes gutting the no further inquiry rule is that institutional trustees demanded the changes to make life easier and more profitable. See Leslie, In Defense, supra.

D. The Uniform Trust Code And The New Loyalty Rules: Bad For Trust Settlors And Beneficiaries

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

I. Sale to trust by corporate trustee. A corporate trustee violates its duty to the beneficiary if it purchases property for the trust from one of its departments, as where it purchases for the trust securities owned by it in its securities or banking department. A corporate trustee cannot properly purchase for the trust property owned by an affiliated or subsidiary corporation in which it has the entire interest or a controlling interest or an interest of such a substantial nature that there would be a temptation to consider its own advantage in making the sale and not to consider solely the advantage to the beneficiaries of the trust. The rule is the same where the shares of the selling corporation are owned by the shareholders of the corporate trustee.

See Restatement (Second) of Trusts, §170, cmt. I (emphasis added). The Restatement (Second) offers the following examples of prohibited transactions:

Illustrations:

1. A is trustee for B. A is also a bond dealer. A purchases certain bonds and sells them to himself as trustee. A commits a breach of trust in so doing.

2. A is trustee for B. A is a member of a firm of bond dealers. A purchases for the trust certain bonds owned by the firm. He commits a breach of trust in so doing.

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

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


b. State Statutes

1. In the last 20 years, state legislatures have enacted statutes that authorize institutional trustees to invest trust assets in mutual fund accounts that they manage. These statutes enable institutional trustees to earn additional fees, and create an incentive for trustees to invest in assets that earn them an additional commission.
The following statutes authorize trustees to invest in mutual funds or other investments from which they will earn additional commissions or fees:

- Ind. Code §28-1-12-3 (2004)
- Utah Code Ann. §75-7-802 (Supp. 2004)

Many of these statutes exacerbate asymmetrical information problems. By failing to contract around the statute, most settlors would be agreeing to an exception to the long-established prohibition on self-dealing without even knowing it. Moreover, because beneficiaries will be poor judges of whether the investment chosen by the trustee is an inferior option, trustees would have little incentive to invest in any products other than those in which the institution has an additional interest. Finally, these statutes erode the normative proscription against self-dealing that is the basis of trust law.

With a nod to the information and monitoring problems that authorization of proprietary mutual funds creates, some state statutes require a trustee who earns such commissions and fees to expressly disclose that fact to the trust beneficiaries.

The Nebraska statute goes farther, requiring trustees to obtain beneficiaries’ consent to double-dipping in writing. Neb. Rev. Stat. §30-3205 (1995). And a smaller number of states go farther to protect beneficiaries: these state statutes authorize trustees to invest in their own funds but force trustees to choose between earning trustee commissions or mutual fund administrator fees.

The Uniform Trust Code validates the trend with no critical analysis, and takes an extreme approach in failing to adopt the protections for beneficiaries that some states have. Section 802(f)
simply states that trustees who purchase investments from related companies are not presumed to have violated the duty of loyalty, and that the trustee may earn additional fees or commissions, payable by the trust, in so doing. The comments suggest that this self-interested investing is no longer subject to the no further inquire rule. Although the comments warn that “the trustee, in deciding whether to invest in a mutual fund, must not place its own interests ahead of those of the beneficiaries” it is difficult to know what this means. If the trustee chooses a mutual fund in part to gain a financial advantage, who will be the wiser? If the very point of the no further inquiry rule is to provide a substitute for inadequate monitoring, then it makes no sense to say that the duty of loyalty still applies to this type of investing. Although the statute requires the trustee to issue annually a report that includes “the rate and method by which compensation was determined” (UTC §802(f)), many beneficiaries will be unable to understand whether trustee’s proprietary funds are the best choice. Institutional trustees will have free reign to engage in self-interested investing.

Leslie, In Defense, supra.

(1) In a recent draft of the Restatement (Third), the drafters take note of this state statutory development, and characterize it as an “exception” to the duty of loyalty. They do not appear to endorse these statutes however. See Restatement (Third) of Trusts §78 cmt. c(8) (Preliminary Draft No. 6, May 23, 2003) (noting that the UTC comments purporting to justify the exception merely describe the advantages of mutual funds, but do not explain why investments in proprietary mutual funds are necessary) and comment c (describing the proprietary mutual fund exception as “an exception that has been adopted by (and is dependent upon) legislation enacted in most American jurisdictions”) (emphasis supplied).

2. Elimination Of The No further Inquiry Rule With Respect To Other Types Of Proprietary Investing By Institutional Trustees: Section 802(c)(4)

a. The UTC does an about-face with respect to traditional loyalty doctrine in its treatment of trustees who transact trust business with related individuals. Transactions between the trustee and the trustee’s spouse, close relatives, agents, attorneys or entities in which the trustee (or a person that owns a significant interest in the trustee) has an interest are no longer subject to the no further inquiry rule. See UTC §802(c)(4). As the comments make clear, such transactions give rise only to a presumption of breach, which the trustee can rebut by establishing that the transaction was not affected by the conflict of interest. The comments suggest that trustee can meet its burden by establishing that the consideration was fair or close to market value, which replaces the no further inquiry rule with the corporate fairness standard. Oddly, the comments to section 802(c)(4) suggest that the section as a whole is comparable to the federal regulation governing federally chartered banks. (The last sentence of the comment reads “For a comparable provision regulating fiduciary investments by national banks, see 12 C.F.R. §9.12(a).”) Yet the regulation to which the comment refers in fact flatly prohibits (unless otherwise authorized by state law) most types of conflicted transactions between fiduciaries and companies related to them. The regulation to which the Comments refer, 12 C.F.R. §9.12(a), reads as follows:

§9.12 Self-dealing and conflicts of interest.
(a) Investments for fiduciary accounts — (1) In general. Unless authorized by applicable law, a national bank may not invest funds of a fiduciary account for which a national bank has investment discretion in the stock or obligations of, or in assets acquired from: the bank or any of its directors, officers, or employees; affiliates of the bank or any of their directors, officers, or employees; or individuals or organizations with whom there exists an interest that might affect the exercise of the best judgment of the bank.

(2) Additional securities investments. If retention of stock or obligations of the bank or its affiliates in a fiduciary account is consistent with applicable law, the bank may:

(i) Exercise rights to purchase additional stock (or securities convertible into additional stock) when offered pro rata to stockholders; and

(ii) Purchase fractional shares to complement fractional shares acquired through the exercise of rights or the receipt of a stock dividend resulting in fractional share holdings.

b. UTC §802(c)(4) is another significant departure from well-established doctrine. As Bogert notes, historically the law has not distinguished between when the trustee acts to benefit itself, and when the trustee acts to benefit some third party. (“Indirect disloyalty is just as objectionable as direct.” George T. Bogert, Trusts §95, at 344 (West, 6th ed. 1987).) Both are violations of the duty of loyalty and subject to the no further inquiry rule.

i. Bogert’s treatise gives as a specific example of indirect self-dealing a case where a trustee sells trust property to X, to enable X to resell the property for a profit; here, even if the sale is “otherwise unexceptional” and trustee derives no direct profit, the beneficiary can void the transaction. Bogert, supra note , at 342-343. Further, Bogert emphasizes, “whether the trustee acted in good faith and with honest intentions is not relevant, nor is it important that the transaction attacked was fair and for adequate consideration so that the beneficiary has suffered no loss as a result of the disloyal act.” Bogert, supra note , at 343. Bogert further explains that the harshness of the rule is necessary to send a clear message to trustees to avoid temptation. Bogert, supra note , at 343.

ii. A recent draft of the Restatement (Third) continues the prohibition on indirect self-dealing, and reaffirms that the no further inquiry rule applies to such transactions. See Restatement (Third) of Trusts §78 cmt. e (Preliminary Draft No. 6, May 23, 2003), which provides that:

[T]he duty of loyalty prohibits the trustee from engaging in transactions, as trustee, with persons with whom the trustee is closely related or associated. The prohibition also applies to transactions by a trustee, acting in either a fiduciary or personal capacity, with third persons if the transaction would create a reasonably foreseeable risk of future conflict between the trustee’s fiduciary and personal interests. Although not involving self-dealing in the literal or narrowly financial sense,... these are transactions that could, if allowed, expose trustees to the temptation of considering interests other than those of the trust beneficiaries.

Loyalty-based prohibitions therefore apply to transactions...between the trustee, as trustee, and family members for whom the trustee could be expected to have a natural, personal concern. For this purpose, the reference to “family members” includes the trustee’s spouse and parents, the trustee’s descendants and their spouses, and other individuals who are the natural objects of the trustee’s bounty.

iii. Even though courts are sometimes more lenient when a non-professional trustee transacts with family members, no court has suggested that this leniency should apply when an institutional

c. Section 802(c)(4) increases monitoring costs for beneficiaries. Leslie, *In Defense*, supra. Even the beneficiary who attempts to monitor the trustee’s performance to detect self-interested transacting will face significant obstacles. To detect self-dealing, a beneficiary must know the extent of the institutional trustee’s other corporate holdings. What is the name of trustee’s parent company and that parent company’s subsidiaries? In what companies might the trustee be personally invested? To determine whether the self-dealing transaction is really in the trust’s best interests, the beneficiary must engage in a comparative analysis of other investment options—has the investment trustee chosen a superior alternative to all of the other market options? If the trustee transacts business with the trust, the beneficiary must determine whether the price the trustee received represents fair market value, or the profit the trustee made was no more than beneficiary would have had to pay a disinterested third party. In short, to monitor trustee behavior adequately, the beneficiary would have to have the same knowledge of the market, financial sophistication, and information that the trustee has. This would defeat the very purpose of a trust that outlives the settlor, which is to relieve the beneficiary of the responsibility for asset management. A regime that expects the beneficiary to monitor the trustee is a regime in which the beneficiary is performing the trustee’s job.

3. *Implications For Attorneys Who Represent Settlor And Beneficiaries*

   a. The Uniform Trust Code’s erosion of the no further inquiry rule and the advance approval doctrine has serious implications for those attorneys who represent settlors and trust beneficiaries. Those who negotiate trust documents can no longer rely on default rules that protect the trust’s interests. Because the UTC’s default rules benefit institutional trustees, lawyers must raise the issue of trustee self-dealing and take proactive steps to protect trust settlors against its negative effects. The trust document should stipulate whether and to what extent the trustee will be permitted to earn profits in addition to trustee commissions, and should require the trustee to make full disclosure of investment activities to beneficiaries.

   b. The UTC also creates difficulties for attorneys who represent beneficiaries’ interests. Because the UTC removes the strict liability rule and allows the trustee a “best interest” defense, breach of duty will be more difficult to prove and litigation will become more expensive. When trustees invest in proprietary mutual funds, proving breach will be extraordinarily difficult: the UTC shields the trustee from liability if the mutual fund is a prudent investment, even if it is not the superior investment.