

The Evolution of the Law of Trustee's Powers and Third Party Liability for Participating in a Breach of Trust: An Economic Analysis

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Maybe Professor Fratcher was not so wrong after all.

I. INTRODUCTION

Law and economics scholars assert that there is a natural tendency for legal systems to favor efficient rules over inefficient rules.¹ Moreover, for the law to remain efficient, as conditions change, so too must the law.² The evolution of the law concerning a trustee's powers and a third party's liability for participating in a breach of trust generally supports these propositions. The standard of liability for third parties participating in a breach of trust, as set forth in the recently adopted Uniform Trust Code, however, does not.

From an economic perspective, the standard of liability for participating in a breach of trust allocates the risk of harm associated with a breach of trust between the trust beneficiaries and the third party who participated in the breach. Allocating all or part of the harm to a party creates incentives for that party to take precautions to minimize the risk of a breach, thereby reducing the expected costs of

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¹ See KENNETH G. DAU-SCHMIDT & THOMAS S. ULEN, LAW AND ECONOMICS ANTHOLOGY 501 (1998); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 27 (5th ed. 1998); E. Donald Elliott, *The Evolutionary Tradition in Jurisprudence*, 85 COLUM. L. REV. 38, 62–63 (1985); Marc J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641, 641 (1996); see also *infra* Part III.A.3 for a discussion of what constitutes efficiency.

² Roe, *supra* note 1, at 663–64; Paul H. Rubin, *Why Is the Common Law Efficient?*, 6 J. LEGAL STUD. 51, 51 (1977).

harm allocated to it.³ Efficiency is promoted when the total expected costs associated with a breach of trust (the costs of the precautions plus the costs of a breach plus the administrative costs) are minimized.⁴

At common law, a third party who participated in a breach of trust was basically strictly liable.⁵ By allocating virtually all the harm associated with a breach to the third party, the law created an incentive for third parties who dealt with a trustee to take precautions—to engage in a broad inquiry—to reduce the risk of harm by ensuring that the transaction was authorized.⁶ Although the broad duty of inquiry was costly, it minimized the expected costs of a breach by minimizing the probability of a breach.⁷ In light of the nature and purpose of the common law trust, to *preserve* the trust property, this approach was efficient.⁸

Over time, however, the purpose of the trust changed from *preserving* the trust property to *managing* it.⁹ As applied to the modern trust, the common law standard of liability became cumbersome and inefficient.¹⁰ Imposing the common law broad duty of inquiry to the modern trust each and every time a trustee proposed to transact would result in substantial costs with little offsetting benefit.¹¹ Eliminating the common law broad duty of inquiry would substantially reduce the transaction costs for third parties interested in dealing with a trustee, thereby improving efficiency.

The Uniform Trustees' Powers Act ("UTPA")¹² adopts this economic approach and *completely* abolishes the common law broad

³ See ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 300–11 (3d ed. 2000); Robert Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution*, 73 CAL. L. REV. 1, 3 (1985).

⁴ DANIEL H. COLE & PETER Z. GROSSMAN, PRINCIPLES OF LAW AND ECONOMICS 214 (2005); COOTER & ULEN, *supra* note 3, at 300–01.

⁵ See *infra* notes 41–44 and accompanying text.

⁶ See *infra* Part V.B.

⁷ See *infra* notes 149–52 and accompanying text.

⁸ See *infra* notes 152–53 and accompanying text.

⁹ See *infra* notes 98–101 and accompanying text.

¹⁰ See *infra* notes 102–06 and accompanying text.

¹¹ See *infra* Part V.C for a discussion of the costs and benefits.

¹² The National Conference of Commissioners on Uniform State Laws approved the Uniform Trustees' Powers Act in 1964. UNIF. TRS. POWERS ACT, 7C U.L.A. 388 (2000) [hereinafter UTPA]. The UTPA had been adopted in sixteen states, though several of them have adopted the Uniform Trust Code ("UTC") and repealed the UTPA. See *id.*; UNIF. TRUST CODE (amended 2003), 7C U.L.A. 143 (Supp. 2004) [hereinafter UTC]. Kansas, New Mexico, and Wyoming have already adopted the UTC and repealed the UTPA. See UTC, 7C U.L.A. 143. In addition, the adoption of the UTC and the repeal of the UTPA was effective in Nebraska as of January 1, 2005,

duty of inquiry.¹³ The UTPA automatically grants each trustee broad powers over the trust property¹⁴ and provides that a third party who deals with a trustee is not liable unless he or she had actual knowledge that the transaction constituted a breach of trust.¹⁵ The actual knowledge standard of liability allocates virtually all of the risk of harm associated with a breach of trust to the settlor and trust beneficiaries, thereby creating an incentive for them to take precautions to minimize the risk of a breach.¹⁶

Like the UTPA, the recently adopted Uniform Trust Code ("UTC")¹⁷ also grants each trustee broad powers over the trust property and abolishes the common law broad duty of inquiry, but the UTC protects a third party who deals with a trustee only if the third party acted in good faith.¹⁸ The good faith standard of liability implicitly imposes a limited duty to inquire when the third party suspects or has reason to suspect that the proposed transaction constitutes a breach of trust.¹⁹ By imposing a limited duty of inquiry, the good faith standard bifurcates the allocation of harm between the third party and the trust beneficiaries depending on the situation. This bifurcation creates incentives for both parties to take precautions to minimize the risk of a breach of trust.²⁰

All things being equal, prevailing law and economics theory and the success of the good faith standard in other areas of law support the position that the UTC's good faith approach is more efficient than the UTPA's actual knowledge approach.²¹ The problem, however, is that all things are not equal. Courts and juries have a natural "hindsight bias" in favor of trust beneficiaries and against the

and will be effective in Arizona on January 1, 2006. *Id.* The National Conference of Commissioners on Uniform State Laws no longer lists the UTPA as a uniform law. *Id.* at 144.

¹³ UTPA § 7, 7C U.L.A. 431.

¹⁴ *Id.* § 2(a), 7C U.L.A. 398.

¹⁵ *Id.* § 7, 7C U.L.A. 431.

¹⁶ See *infra* note 67 and discussion accompanying notes 187–88; see also notes 200–14 and accompanying text.

¹⁷ The National Conference of Commissioners on Uniform State Laws adopted the UTC on August 3, 2000. David M. English, *The Uniform Trust Code (2000) and Its Application to Ohio*, 30 CAP. U. L. REV. 1, 1 (2000). "[M]inor cleanup amendments were approved in August 2001." David M. English, *The Uniform Trust Code (2000): Significant Provisions and Policy Issues*, 67 MO. L. REV. 143, 144 (2000). The UTC has been adopted in five states (Arizona, Kansas, Nebraska, New Mexico, and Wyoming) as of the writing of this Article. See UTC, 7C U.L.A. 143 (Supp. 2004).

¹⁸ See *infra* notes 112–16 and accompanying text.

¹⁹ See *infra* notes 173–77, 260–63 and accompanying text.

²⁰ COOTER & ULEN, *supra* note 3, at 304–11; Cooter, *supra* note 3, at 7–8.

²¹ See *infra* notes 186–89 and accompanying text.

trustee and any third party who dealt with the trustee.²² Hindsight bias increases the risk that a third party erroneously will be held liable for participating in the breach. In addition, there are higher administrative costs associated with the good faith standard.²³ When the increased litigation costs and risk of an erroneous judgment are factored into the analysis, the actual knowledge standard arguably is more efficient than the good faith standard.²⁴

Although the actual knowledge standard of liability arguably is the more efficient approach, imposing a limited duty of inquiry is the more equitable approach.²⁵ To the extent one believes that the added equitable consideration makes the limited duty of inquiry the “better” approach, the bad faith standard of liability should be favored over the good faith standard. The bad faith standard of liability helps to counter the natural judicial bias in favor of trust beneficiaries and reduces the litigation costs and risk of an erroneous judgment against a third party due to hindsight bias.²⁶

II. DOCTRINAL BACKGROUND

The issue of a third party’s liability for participating in a breach of trust presupposes (1) a trust, and (2) a breach of trust.²⁷ A trust arises when one party, the settlor, transfers property to a second party, the trustee, for the benefit of a third party, the beneficiary.²⁸ The trustee typically holds legal title,²⁹ while the beneficiaries hold

²² See *infra* notes 191–227 and accompanying text.

²³ See *infra* notes 228–53 and accompanying text.

²⁴ See *infra* note 254 and accompanying text.

²⁵ See *infra* notes 183, 255–58 and accompanying text.

²⁶ See *infra* Part VII for an analysis of the differences between the good faith and bad faith standards.

²⁷ For a general discussion of a third party’s liability for participating in a breach of trust, see RESTATEMENT (SECOND) OF TRUSTS ch. 9, §§ 283–326 (1959); GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES §§ 881–912 (rev. 2d ed. 1995 & Supp. 2002); 4 AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS §§ 283–326 (4th ed. 1989). Although the *Restatement (Third) of Trusts* has been adopted, it does not yet contain any corresponding provisions that would alter the positions set forth in the *Restatement (Second) of Trusts* concerning a third party’s liability for participating in a breach of trust.

²⁸ RESTATEMENT (THIRD) OF TRUSTS §§ 3, 10 (2003); BOGERT, *supra* note 27, § 1; 1 SCOTT & FRATCHER, *supra* note 27, §§ 3 to 3.2 (4th ed. 1987); John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625, 632 (1995).

²⁹ The trustee typically holds legal title to the trust property. This is not required, however. The trust property may be an equitable interest. RESTATEMENT (THIRD) OF TRUSTS § 2 cmt. d, § 42 cmt. a; BOGERT *supra* note 27, §§ 1, 146; 1 SCOTT & FRATCHER, *supra* note 27, § 2.6 (4th ed. 1987).

equitable title.³⁰ A breach of trust occurs when the trustee exceeds the scope of his or her authority over the trust property,³¹ or when the trustee violates one or more of the fiduciary duties the trustee owes the beneficiaries.³² Where the breach involves a third party, the issue that arises is *when* should the third party be liable for participating in the breach of trust.³³

Although there are a variety of ways in which a third party may be involved in a breach of trust,³⁴ the most common scenario arises when a trustee conveys trust property to the third party in exchange for other property or services, and the transaction constitutes a breach of trust.³⁵ While the beneficiaries can sue the trustee for breach of trust,³⁶ they might also be able to sue the third party.³⁷ If the third party is liable, the beneficiaries can recover the trust property from the third party;³⁸ and if that is not an adequate remedy, the beneficiaries may also recover damages from the third party.³⁹

In many respects, the issue of a third party's liability for participating in a breach of trust is simply a variation of the age old question: When can a party who lacks good title nevertheless transfer

³⁰ RESTATEMENT (THIRD) OF TRUSTS § 2 cmt. d, § 42 cmt. a; BOGERT, *supra* note 27, §§ 146, 181; 1 SCOTT & FRATCHER, *supra* note 27, § 2.7 (4th ed. 1987); *see also* Langbein, *supra* note 28, at 632, 636.

³¹ RESTATEMENT (SECOND) OF TRUSTS § 201 cmt. b; 2A SCOTT & FRATCHER, *supra* note 27, §§ 163A to 164 (4th ed. 1987).

³² RESTATEMENT (SECOND) OF TRUSTS § 201 cmt. c, ch. 7, topic 2, introductory note; BOGERT, *supra* note 27, § 861; 2A SCOTT & FRATCHER, *supra* note 27, §§ 170–85 (4th ed. 1987); 3 SCOTT & FRATCHER, *supra* note 27, § 201 (4th ed. 1988).

³³ RESTATEMENT (SECOND) OF TRUSTS §§ 283–326; BOGERT, *supra* note 27, § 901; 4 SCOTT & FRATCHER, *supra* note 27, §§ 293–326 (4th ed. 1989).

³⁴ BOGERT, *supra* note 27, § 901.

³⁵ “Typical examples of this situation are where the trustee in breach of trust transfers trust property to a third person, who may or may not be a bona fide purchaser, or where a personal creditor of the trustee attaches or levies on trust property.” 4 SCOTT & FRATCHER, *supra* note 27, § 279A (4th ed. 1989); *see also* RESTATEMENT (SECOND) OF TRUSTS §§ 283–93; BOGERT, *supra* note 27, §§ 881–905.

³⁶ RESTATEMENT (SECOND) OF TRUSTS § 205; BOGERT, *supra* note 27, § 861; 3 SCOTT & FRATCHER, *supra* note 27, § 205 (4th ed. 1988).

³⁷ RESTATEMENT (SECOND) OF TRUSTS § 295; BOGERT, *supra* note 27, § 871; 4 SCOTT & FRATCHER, *supra* note 27, § 295 (4th ed. 1989).

³⁸ RESTATEMENT (SECOND) OF TRUSTS §§ 291(1)(a), 292(1); BOGERT, *supra* note 27, §§ 868, 901; 4 SCOTT & FRATCHER, *supra* note 27, §§ 291, 291.1, 292 (4th ed. 1989). The third party can then sue the trustee to recover the consideration it gave to the trustee. From an economic perspective, the third party bears the risk that the trustee is judgment proof. Another way to think about the issue is to ask: Who should bear the risk that the trustee is judgment proof—the trust beneficiaries or the third party who participated in the breach of trust?

³⁹ RESTATEMENT (SECOND) OF TRUSTS §§ 291(1)(b)–(c), 292(2)–(3); BOGERT, *supra* note 27, §§ 868, 901; 4 SCOTT & FRATCHER, *supra* note 27, §§ 291, 291.2, 291.3, 292 (4th ed. 1989).

good title to a third party?⁴⁰ The answer depends on the interplay of property law, commercial law, equity, settlor's intent, and the nature of a trust—and it is best to analyze this interplay from a historical perspective.

III. HISTORICAL BACKGROUND AND ECONOMIC ANALYSIS

A. *Early Common Law Approach*

1. The Law of Property

At early common law, *any* third party who dealt with someone acting on behalf of another was strictly liable if the transaction turned out to be unauthorized. This approach was based upon the classic property rule of *nemo dat quod non habet*⁴¹—"no one can give what he has not."⁴² If a party did not hold good title, that party could not transfer good title unless the owner *expressly* consented to *that* transfer.⁴³ This rule was absolute at early common law. Even where an owner transferred property to an agent, the agent could not transfer title to a third party unless the owner consented to the particular transaction in question.⁴⁴

⁴⁰ The starting point for this issue is a classic property rule. See RESTATEMENT (SECOND) OF TRUSTS § 206 cmt. b. The issue can arise in a plethora of different situations where a third party deals with one who is acting on behalf of another party (e.g., principal and agent, bailor and bailee, employer and employee, estate and personal representative). 1 SCOTT & FRATCHER, *supra* note 27, § 12 (4th ed. 1987). The question then becomes whether a third party's liability for participating in a breach of trust is simply a subset of this larger issue, such that the same standard of liability should apply, or whether there is something unique about the trust situation that warrants treating a third party who deals with a trustee differently.

⁴¹ "No one can give that which he has not." THE SELF-PRONOUNCING LAW DICTIONARY 559 (2d students ed. 1948).

⁴² 2 WILLISTON ON SALES § 311 (rev. ed. 1948); see also William D. Warren, *Cutting Off Claims of Ownership Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 469, 470 (1963) ("No one can transfer to another a better title to goods than he himself has.").

⁴³ "The initial common law position was that equities of ownership are to be protected at all costs: an owner may never be deprived of his property rights without his consent." Grant Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1057 (1954); see also 1A SCOTT & FRATCHER, *supra* note 27, § 75 (4th ed. 1987).

⁴⁴ Warren, *supra* note 42, at 470 (stating that "the courts . . . went to extremes to protect the principal from the consequences of even slight deviations by the agent from the authority granted him" (citing 2 WILLISTON ON SALES § 317 (rev. ed. 1948))). Also, "[i]n § 317 Professor Williston collects the cases where the agent though he may be authorized to sell the goods to some person or upon some terms, is not authorized to sell them to the person or upon the terms on which the sale was

The rule favoring absolute protection of ownership worked well at early common law. Most transactions were personal transactions, conducted face-to-face between a buyer and seller who usually lived near each other.⁴⁵ The buyer was expected either to know the seller, or to inquire as to the seller's rights to transfer the property in question.⁴⁶ The buyer bore all of the risk that the seller might not have good title to transfer.⁴⁷ Placing this risk on the buyer protected owners by imposing a broad duty on the buyer to inquire diligently into the seller's title and/or authority to sell before purchasing.⁴⁸

2. The Law of Trusts

As applied to trusts, the interests of trust beneficiaries were well protected under the common law rule favoring absolute protection of ownership. A third party wishing to deal with a trustee did so at its own risk. If the transaction turned out to constitute a breach of trust, the third party was liable for participating in the breach.⁴⁹ Placing the risk of loss on the third party protected trust beneficiaries by imposing a broad duty on a third party to inquire diligently into the trustee's title and/or authority to sell before dealing with the trustee.⁵⁰ Despite the costs inherent in the broad duty of inquiry, imposing the duty on third parties who were interested in dealing with a trustee promoted efficiency.

in fact made." Warren, *supra* note 42, at 470 n.10 (internal quotation marks omitted).

⁴⁵ Gilmore, *supra* note 43, at 1057 ("The initial common law position was that equities of ownership are to be protected at all costs: an owner may never be deprived of his property rights without his consent. That worked well enough against a background of local distribution where seller and buyer met face to face and exchanged goods for cash.").

⁴⁶ Warren, *supra* note 42, at 470.

⁴⁷ Gilmore, *supra* note 43, at 1057 ("Classical theory required that the principal be protected and that the risks of agency distribution be cast on the purchaser."). The early common law approach could be summed up in the well-known phrase "buyer beware."

⁴⁸ See generally Warren, *supra* note 42.

⁴⁹ A third party who knew or should have known that he or she was dealing with a trustee had a duty to inquire into whether the trustee had the power to engage in the transaction in question. In addition, the third party was charged with proper construction of the trust terms. The combined effect was that if a third party dealt with a trustee and the transaction constituted a breach of trust, the third party was strictly liable. RESTATEMENT (SECOND) OF TRUSTS § 297 cmts. f to i (1959); BOGERT, *supra* note 27, §§ 565, 894; 4 SCOTT & FRATCHER, *supra* note 27, §§ 297.3–297.4 (4th ed. 1989).

⁵⁰ 4 SCOTT & FRATCHER, *supra* note 27, §§ 297.3–297.4 (4th ed. 1989).

3. Economic Primer on Efficiency

From an economic perspective, laws create incentives that affect people's behavior.⁵¹ In deciding which types of incentives should be created, law and economics assumes that all things being equal, efficiency should be favored.⁵² Efficiency maximizes utility and wealth⁵³ and is generally promoted by the free and voluntary exchange of resources.⁵⁴

There are two widely accepted definitions of efficiency. The first is the Pareto approach. A Pareto superior transaction is one where after the transaction at least one party is better off, and no one is worse off.⁵⁵ The second definition of efficiency is the Kaldor-Hicks approach. Under the Kaldor-Hicks approach, after the transaction one or more parties may be worse off, but the benefits to those who are better off exceed the harm to those who are worse off.⁵⁶ Under the Paretian approach, any party harmed *must* be compensated to ensure that no party is worse off as a result of the transaction. In contrast, under the Kaldor-Hicks approach, a harmed party does *not* have to be compensated for the transaction to be efficient. The transaction need only generate sufficient benefits for the parties who gained that they *could* compensate the harmed parties and still be better off.⁵⁷

The Pareto approach also maximizes individual autonomy.⁵⁸ Under this approach, a transaction is wealth maximizing only if each party *actually consents* to that particular transaction. In contrast, the

⁵¹ Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1053–54 (2000).

⁵² POSNER, *supra* note 1, at 13, 27.

⁵³ *Id.* at 12–15. Wealth and utility are not the same; but a discussion of the differences and why most economists use wealth as a substitute for utility is beyond the scope of this Article.

⁵⁴ *Id.*

⁵⁵ *Id.* at 13–15. The typical example of a Pareto superior transaction is one that involves two parties. *Id.* at 13. Economists assume that the parties agree to an exchange of resources only if both parties to the transaction think that they will be better off. *See id.* at 14. If the transaction involves an agent (i.e., a party acting on behalf of one of the principals), the risk that the transaction will not be a Pareto superior transaction increases. The agent may mistakenly enter a transaction thinking it is one that will benefit the owner, when in reality the owner will be harmed by the transaction. The transaction would not be Pareto superior because someone, here one of the principals to the transaction, would be worse off after the transaction.

⁵⁶ *Id.* at 13–15.

⁵⁷ *Id.*

⁵⁸ JEFFREY L. HARRISON, *LAW AND ECONOMICS: CASES, MATERIALS AND BEHAVIORAL PERSPECTIVES* 51 (2002).

Kaldor-Hicks approach is more utilitarian.⁵⁹ It focuses on the *net* benefit. Individual autonomy is sacrificed in the interest of overall societal gain.

4. Economic Analysis of the Early Common Law Approach

By adopting the rule of *nemo dat quod non habet*,⁶⁰ the common law courts were implicitly adopting a Pareto approach to efficiency.⁶¹ The courts focused on the individual parties to the transaction and the requirement that each party had to consent.⁶² By requiring the actual owner of the property to consent, as opposed to allowing his or her agent's consent to be binding, the law ensured that the transaction would occur only if both parties agreed that the transaction would make them better off.⁶³ Any other rule ran the risk of an agent entering into a transaction on the belief that it would make an owner better off when in fact it did not. Under the rule of *nemo dat*, if an agent entered into a transaction without the owner's consent, and if it harmed the owner, the owner could rescind the transaction and recover the property.⁶⁴

Because the owner had the right to rescind the transaction and recover the property if he or she did not consent to the transaction, the risk of an agent entering into an unauthorized transaction was placed completely on the buyer.⁶⁵ The only way for a buyer to avoid this risk was to conduct a thorough inquiry into the agent's authority to ensure that the owner had consented to the proposed transaction.

⁵⁹ See *id.* at 59.

⁶⁰ See *supra* note 41 and accompanying text for a discussion of the rule of *nemo dat*.

⁶¹ The common law rule may not constitute perfect Pareto superiority, but it generally reflects a Paretian approach. (As John Maynard Keynes opined, "Practical men, who believe themselves to be quite exempt from any intellectual forces, are usually the slaves of some defunct economist." JOHN MAYNARD KEYNES, *THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY* 383 (1936)). The common law courts' focus on the individual parties to the transaction and the insistence that the owner had to consent—regardless of the benefits to the purchaser and possibly others—is more consistent with the Pareto superior requirement that no one can be worse off after the transaction than it is with the Kaldor-Hicks approach. See POSNER, *supra* note 1, at 13–14. The common law courts did not consider the effect of this approach on third parties; rather, they focused only on the effect of the proposed transaction on the individual parties to the transaction. See also *supra* notes 55–59.

⁶² See POSNER, *supra* note 1, at 13–14.

⁶³ See *supra* note 55 and accompanying text for a discussion of Pareto superior transactions.

⁶⁴ See *supra* notes 41–44 and accompanying text.

⁶⁵ See *supra* notes 46–48 and accompanying text.

The common law broad duty of inquiry followed logically from the rule of *nemo dat*.⁶⁶ Any other rule would have undermined the principle of *nemo dat* and could have resulted in transactions that were not Pareto superior. As applied to the common law trust, the broad duty of inquiry promoted Paretian efficiency.⁶⁷

B. The Rise of Commercialism and the Good Faith Purchaser Doctrine

1. The Rise of Commercialism

With the development of the marketplace, where commercial goods from outside the immediate area were offered for sale, typically by agents, tension arose between the needs of the marketplace and the common law rule of *nemo dat*.⁶⁸ Third parties wishing to purchase goods at market needed assurances that they were receiving good title. Where an agent represented the owner, the risk that the

⁶⁶ See *supra* note 41 and accompanying text for a discussion of the rule of *nemo dat*.

⁶⁷ An alternative way of assessing the efficiency of the common law approach is to ask whether it is more efficient to put the risk of loss from a breach of trust on the third party who deals with the trustee or on the trust beneficiaries—i.e., which party is the least cost avoider? It is assumed that whichever party bears the risk of loss will take steps to minimize the risk as long as such steps are efficient. See COLE & GROSSMAN, *supra* note 4, at 213. If the risk of loss is placed on the third party, the third party can take steps to reduce the risk of a breach by inquiring into the trustee's power to engage in the proposed transaction. If the risk of loss is placed on the trust beneficiaries, it may be cost prohibitive for them to take steps to reduce the risk of a breach. Putting the risk of loss on the trust beneficiaries would impose a duty on them to monitor and supervise the trustee. See *supra* note 4 and *infra* notes 191–94. Imposing such a duty on trust beneficiaries is inconsistent with one of the principal purposes of a common law trust; namely, trusts are used for people who need protecting (i.e., the elderly, widows, minors, and orphans). See *infra* note 194 and accompanying text. Such individuals are incapable of monitoring or supervising their own trustee. Moreover, the *ex ante* logistical difficulties of attempting to monitor or supervise an agent are substantial. See Eric A. Posner, *Agency Models in Law and Economics*, in CHICAGO LECTURES IN LAW AND ECONOMICS 225–26 (Eric A. Posner ed., 2000). Finally, supervising an agent assumes that the supervising party has control over the agent. At common law, and even today, trust beneficiaries have no control over a trustee. They have no right to remove a trustee; even a breach of trust, in and of itself, may not be sufficient grounds. BOGERT, *supra* note 27, §§ 519–20, 524, 527; 2 SCOTT & FRATCHER, *supra* note 27, § 107 (4th ed. 1987); RESTATEMENT (THIRD) OF TRUSTS § 37 cmts. d & e (2003). Trust beneficiaries have no effective means of supervising or controlling their trustee. See *infra* notes 205–19 and accompanying text.

⁶⁸ Gilmore, *supra* note 43, at 1057 (“But as the marketplace became first regional and then national, a recurrent situation came to be the misappropriation of goods by a faithless agent in fraud of his principal. Classic theory required that the principal be protected and that the risks of agency distribution be cast on the purchaser. The market demanded otherwise.”).

transaction might be unauthorized was on the buyer.⁶⁹ For commercial markets to thrive and grow, third parties who purchased goods at market needed greater protection.⁷⁰

With time, the economic benefits of the marketplace and the development of commercial goods led to several exceptions to the traditional common law rule favoring absolute protection of ownership. Statutorily, legislatures enacted Factor's Acts, which provided that where an owner entrusted commercial goods to a commercial agent, buyers who purchased the goods at market were protected and received good title even if the agent did not have authority to sell the goods.⁷¹ Judicially, courts broadened their construction of what constituted an owner's consent, thereby permitting one without good title to transfer good title to a buyer.⁷² The effect of these developments was to permit a good faith purchaser to obtain good title, even if the owner had not expressly authorized the sale in question.⁷³

⁶⁹ *Id.*; see also Warren, *supra* note 42, at 470.

⁷⁰ Gilmore, *supra* note 43, at 1057; Warren, *supra* note 42, at 469 (quoting from Blackstone: "[I]t is expedient, that the buyer, by taking proper precautions, may, at all events be secure of his purchase, otherwise all commerce between man and man must soon be at an end.").

⁷¹ For a discussion of Factor's Acts as the first "significant breach in common law property theory," see Gilmore, *supra* note 43, at 1057–58; see also 2 WILLISTON ON SALES §§ 318, 319 (rev. ed. 1948); Warren, *supra* note 42, at 471.

⁷² See Gilmore, *supra* note 43, at 1059–60; Warren, *supra* note 42, at 470–72. The general rule that one without good title could not transfer good title did not apply if the owner consented to the transfer in question—an agent could transfer good title. Gilmore, *supra* note 43, at 1057; Warren, *supra* note 42, at 470 n.10. At first this exception was limited to scenarios where the owner *expressly* consented to the transfer *in question*. Warren, *supra* note 42, at 470 n.10. Over time, however, the courts began to *infer* the owner's consent, by estopping the owner from denying he or she had consented, in a variety of situations where the court concluded that the owner was responsible for the third party's belief that the party in possession of the property was authorized to sell the goods: (a) where an owner permitted a party to fraudulently acquire possession (this led to the well-known distinction between void title and voidable title—the notion of voidable title further supported the marketability of goods and further eroded the common law rule favoring absolute ownership of property), see Gilmore, *supra* note 43, at 1059–60; (b) where an owner transferred possession of the property to an agent and expressly authorized the agent to sell the goods—though not to the particular transferee with whom the agent dealt, Warren, *supra* note 42, at 470–72; and (c) where an owner entrusted goods to an agent who regularly dealt in such goods (this development culminated in Uniform Commercial Code § 2-403, U.C.C. § 2-403 (1977)). Gilmore, *supra* note 43, at 1057–58; Warren, *supra* note 42, at 470–72.

⁷³ The implied intent/estoppel approach developed by the common law courts ultimately was codified in the Uniform Sales Act and the UCC. See UNIF. SALES ACT §§ 23, 24 (1977); U.C.C. §§ 3-302(1), 3-304(2), 8-302, 8-304(2) (1977).

With the evolution of the marketplace and the increase in commercial goods, commercial law came to trump the traditional common law property rule favoring absolute protection of ownership.⁷⁴ A party with less than good title *could* pass good title to a good faith purchaser. The exception became the norm—at least as applied to commercial goods. For economic and equitable reasons, the law shifted from protecting ownership to protecting market transactions—from protecting owners to protecting third parties who purchased commercial goods in good faith and for valuable consideration.⁷⁵

2. Expansion of the Good Faith Purchaser Doctrine

Although the good faith purchaser doctrine originated with the birth of the modern marketplace and the sale of commercial goods, over time it took on a life of its own. Armed with the doctrine's economic and equitable justifications, courts and legislatures began to apply the doctrine to virtually all transactions, regardless of the type of property or the representative acting on behalf of the owner.⁷⁶ As long as the owner entrusted the property to an agent, bailee, employee, or similar party acting on the owner's behalf, and that party improperly sold the property to a good faith purchaser, the economic needs of the capitalistic system and the equities with respect to the good faith purchaser favored protecting the transferee.⁷⁷ The expansion of the good faith purchaser doctrine

⁷⁴ Warren, *supra* note 42, at 492.

⁷⁵ This change in the law also represents a shift away from a Paretian approach to more of a Kaldor-Hicks approach to efficiency. See *supra* notes 55–59 for a discussion of these two models. Although some individual property owners may have been worse off under the exceptions to the rule of *nemo dat quod non habet*, society as a whole was better off. The erosion of the common law rule was necessary to permit and promote market transactions, which led to the rise of commercialism and the industrial revolution. See Catherine L. Fisk, *Lochner Redux: The Renaissance of Laissez-Faire Contract in the Federal Common Law of Employee Benefits*, 56 OHIO ST. L.J. 153, 189 (1995).

⁷⁶ Gilmore, *supra* note 43, at 1057 (“The triumph of the good faith purchaser has been one of the most dramatic episodes in our legal history.”).

⁷⁷ *Id.* Compared to the common law *nemo dat* approach, the good faith purchaser doctrine shifts much of the risk of a wrongful transfer of property from the buyer to the owner. (As long as the buyer acts in good faith, even if the agent improperly transfers the property, the buyer is protected. The owner will bear the risk of loss.) This creates an incentive for owners to be more careful in selecting the party who is going to act on their behalf. See *infra* notes 206–09. Generally, as long as the party purporting to transfer the property has the express power to sell, the implied authority to sell, or the apparent authorization to sell, the good faith purchaser takes good title. See *supra* notes 71–76 and accompanying text. The growth of the good faith purchaser doctrine shows increasing acceptance by the

beyond commercial goods further eroded the traditional common law rule favoring absolute protection of ownership.

3. The Law of Trusts Distinguished

The economic pressures and equitable arguments that led to the change in the law with respect to commercial goods did not apply to the law of trusts. The typical common law trust was funded with real property, not commercial goods.⁷⁸ The typical purpose of the common law trust was to *preserve* the trust property.⁷⁹ Transfers of trust property to third parties were to be discouraged, not encouraged.⁸⁰ The common law courts continued to apply the traditional common law rule favoring absolute protection of the owner—the trust beneficiaries. The courts continued to impose a broad duty of inquiry on a third party interested in dealing with a trustee, requiring the third party to determine the trustee's authority to transfer the property and whether the transfer constituted a breach of trust.⁸¹ A third party who dealt with a trustee continued to do so at his or her own risk.⁸²

In addition, although in theory the expanded good faith purchaser doctrine applied to a third party who dealt with a trustee, in practice the doctrine added little protection. The courts distinguished trustees from other parties acting on behalf of an owner.⁸³ Agents, bailees, and similar parties acting on behalf of an owner were deemed to have certain inherent or apparent powers over the property in their possession and control.⁸⁴ Because of these

courts of the Kaldor-Hicks approach to efficiency. See *infra* notes 94–97 and accompanying text.

⁷⁸ See William F. Fratcher, *Trustees' Powers Legislation*, 37 N.Y.U. L. REV. 627, 631–32, 657–58 (1962); Langbein, *supra* note 28, at 632.

⁷⁹ BOGERT, *supra* note 27, § 1; Jesse Dukeminier & James E. Krier, *The Rise of the Perpetual Trust*, 50 UCLA L. REV. 1303, 1336 (2003); Langbein, *supra* note 28, at 633, 640.

⁸⁰ See Dukeminier & Krier, *supra* note 79, at 1336; see also Fratcher, *supra* note 78, at 658 (“With such trusts [early common law trusts], narrow construction of express powers and reluctance to find implied powers were beneficial to the primogenitary heir and ordinarily reflected the true intention of the settlor.”); Langbein, *supra* note 28, at 640 (“Stakeholder trustees did not need to transact.”).

⁸¹ See Langbein, *supra* note 28, at 640–42.

⁸² Inasmuch as the typical common law trust was funded with real property, and the purpose of the trust was to preserve the real property for future beneficiaries, the chilling effect created by the common law rule of strict liability for third parties who participated in a breach of trust was consistent with the nature and served the purpose of the common law trust. See *supra* notes 78–79 and accompanying text.

⁸³ BOGERT, *supra* note 27, §§ 11–15.

⁸⁴ 2A C.J.S. *Agency* §§ 128–45, 386 (1997).

inherent or apparent powers, a third party who dealt with them was free to assume that the party acting on behalf of the owner had the power to transfer the property in question.⁸⁵

In contrast, historically a trustee had no inherent powers over the trust property,⁸⁶ but only those powers expressly granted by the settlor or those powers necessarily implied in light of the trust's purpose.⁸⁷ Once a third party knew or should have known that he or she was dealing with a trustee, the third party was charged with knowledge of the default rule that the trustee had no inherent powers and was *not* authorized to transfer the trust property absent express or implied authorization.⁸⁸ For all practical purposes, the third party was charged with the presumption that the proposed transaction constituted a breach of trust, absent express authorization. A third party interested in dealing with a trustee had to inquire diligently into the express terms of the trust to confirm that the trustee was authorized to engage in the proposed transaction.⁸⁹ If the third party failed to inquire, it was charged with knowledge of the scope of the trustee's powers.⁹⁰ Third parties were also charged with proper construction of the trust's terms.⁹¹ The good faith purchaser doctrine had no meaningful application to a third party who knew or should have known that it was dealing with a trustee.⁹² If a third party participated in a transaction with a trustee and the transaction constituted a breach of trust, for all practical purposes, the third party was strictly liable.⁹³

4. Economic Analysis of the Rise of Commercialism and the Good Faith Purchaser Doctrine

The evolution of commercial law and the expansion of the good faith purchaser doctrine reflect a shift in the thinking of the common law courts. Instead of focusing only on the parties to the transaction

⁸⁵ *Id.*

⁸⁶ RESTATEMENT (SECOND) OF TRUSTS § 186 (1959); *see also* Langbein, *supra* note 28, at 627.

⁸⁷ Fratcher, *supra* note 78, at 627 (citing RESTATEMENT (SECOND) OF TRUSTS § 186).

⁸⁸ *Id.* at 645.

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² Langbein, *supra* note 28, at 641 (stating that "trust law purported to protect the bona fide purchaser of trust assets, but as a practical matter made it 'very difficult to qualify as a *bona fide* purchaser'" (quoting William F. Fratcher, *Trust, in* 6 INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW § 98, at 80 (1973))).

⁹³ 4 SCOTT & FRATCHER, *supra* note 27, § 297.4 (4th ed. 1989).

(the more Paretian approach), the economic benefits of the marketplace convinced the courts to shift to the Kaldor-Hicks approach, with its emphasis on the *net* benefit to society—the more utilitarian approach.⁹⁴ With the development of markets in commercial goods, there were substantial economic benefits to be gained from assuming that an owner authorized the proposed transaction and from protecting a good faith purchaser even if the seller did not have good title. As applied to commercial goods, the courts concluded the economic benefits generated by changing the law were sufficient to compensate owners of property who were harmed as a result of the change. From a Kaldor-Hicks perspective, the rise of commercial law and the expansion of the good faith purchaser rule were efficient.⁹⁵

Even from a Kaldor-Hicks perspective, however, it was not efficient to apply such rules to the common law trust. Commercial goods, by their nature, are intended to be transferred. The overwhelming majority of owners of commercial goods intends that the goods be transferable and prefers the rules concerning transfers of such property be broadened to facilitate such transfers and to encourage the growth of commercial markets. Promoting such transfers generated substantial benefits which justified abandoning the common law approach. Common law trusts, on the other hand, were intended to *preserve* trust property.⁹⁶ Most common law settlors did *not* want their trustees to have broad powers over the trust property. Granting trustees greater powers would likely lead to more breaches of trust, not to substantial benefits. The common law courts' decision to keep a trustee's powers limited to those expressly granted by the settlor and to continue imposing the broad duty of inquiry made economic sense, even from a Kaldor-Hicks approach.⁹⁷

IV. THE EVOLUTION OF THE MODERN TRUST

With the evolution of the modern trust, however, the common law approach to the law of trusts became increasingly cumbersome and expensive. The world changed from a land-based economy to a mercantile economy. The principal form of wealth changed from real property to personal property, such as stocks, bonds, certificates

⁹⁴ See HARRISON, *supra* note 58, at 59.

⁹⁵ See *supra* Part III.A.3 for a discussion of what constitutes efficiency.

⁹⁶ BOGERT, *supra* note 27, § 1; Dukeminier & Krier, *supra* note 79, at 1336; Langbein, *supra* note 28, at 633, 640.

⁹⁷ See *infra* Part V.B for a more detailed economic analysis of the efficiency of the broad duty of inquiry as applied to the common law trust.

of deposits, annuities, savings accounts, and the like.⁹⁸ The primary method of funding trusts likewise changed.⁹⁹ The purpose of the modern trust changed from *preserving* the trust property (real property) to *managing* the trust property (a fund of intangible wealth).¹⁰⁰ Proper management of the modern trust implicitly necessitates broad powers over the trust property, liberal authorization to invest the trust fund, and the ability to shift investments quickly as market conditions change.¹⁰¹ The trustee of a modern trust needs, and wants, to be a player in the marketplace. The nature and purpose of the modern trust were at odds with the common law trust rules.

A. *The Uniform Trustees' Powers Act*

It was against this historical background that Professor Fratcher, one of the preeminent wills and trusts scholars of his time,¹⁰² called for enhanced trustee's powers and investment authority to facilitate trust administration.¹⁰³ Professor Fratcher proposed that each trustee have, by virtue of his or her appointment, the "power to do whatever a prudent man would do in the management of his own property for the trust purposes."¹⁰⁴

Professor Fratcher also recognized that these enhanced powers would be meaningless without enhanced protection for a third party who dealt with a trustee. The "great barrier" to trust administration was not so much a trustee's lack of power, but rather a third party's

⁹⁸ Fratcher, *supra* note 78, at 658; *see also* Langbein, *supra* note 28, at 638.

⁹⁹ Langbein, *supra* note 28, at 638 ("The modern trust typically holds a portfolio of these complex financial assets This portfolio requires active and specialized management, in contrast to the conveyancing trust that merely held ancestral land.").

¹⁰⁰ *Id.*; *see also id.* at 637. Professor Langbein calls the modern trend "the management trust." *Id.*

¹⁰¹ Fratcher, *supra* note 78, at 658 ("He [the modern settlor] ordinarily intends that the trustee shall have all powers needed for efficient and economical management with a view to production of adequate income and enhancement of the principal for the benefit of the cestuis que trust.").

¹⁰² Professor Fratcher had a hand in drafting the Uniform Probate Code, and his article on trustees' powers legislation served as the blueprint for the Uniform Trustees' Powers Act. The Missouri Law Review paid tribute to Professor Fratcher and lauded his contributions to the field of wills and trusts upon his retirement from the faculty. *Dedication to William F. Fratcher*, 48 MO. L. REV. 313, 313-24 (1983).

¹⁰³ Professor Fratcher's article highlights the limitations and deficiencies of the common law approach to trustees' powers and trust investments, and shows how ill-suited the common law rules had become to the modern trust. *See* Fratcher, *supra* note 78, at 629-57. Professor Fratcher's frustration with the common law approach to the law of trusts is evident from the opening paragraph of his article. *See id.* at 627.

¹⁰⁴ *Id.* at 660.

trepidation because of the common law broad duty of inquiry and its strict liability for a third party who participated in a breach of trust.¹⁰⁵ Professor Fratcher called for: (1) abolition of the common law broad duty of inquiry, and (2) adoption of an actual knowledge standard of liability for a third party who participates in a breach of trust.¹⁰⁶

Professor Fratcher's article served as the blueprint for the Uniform Trustees' Powers Act ("UTPA").¹⁰⁷ The UTPA grants each trustee enhanced powers, including all the powers a prudent person would need to manage his or her own property.¹⁰⁸ The UTPA rejects the common law broad duty to inquire.¹⁰⁹ Instead, it grants a third party who deals with a trustee complete protection from liability unless the third party has *actual knowledge*, at the time of the transaction, that the proposed transaction constitutes a breach of trust.¹¹⁰ The official reporter for the UTPA acknowledged the broad protection the UTPA accorded third parties who dealt with a trustee:

It is to be noted that constructive knowledge, as distinguished from actual knowledge, is not enough. Therefore, mere suspicion that limitations exist or knowledge of facts which, if pursued, would show that limitations exist do not deprive a person of this protection. . . . The remedy for breach is limited to the trustee and a third party with actual knowledge that the trustee is exceeding his powers or improperly exercising them. Therefore, more than ever, it is important that the trustee be carefully selected, bonded, or otherwise a person of fiscal responsibility.¹¹¹

¹⁰⁵ *Id.* at 662.

¹⁰⁶ *Id.* at 662–63. Professor Fratcher opined:

Might it not be better to eliminate the duty of inquiry in all transactions with trustees and make third parties who engage or assist in such transactions liable to the cestui que trust only when they have actual knowledge that the trustee is committing a breach of trust? The duty of inquiry is rarely of real value to the cestui, yet it impedes the effective administration of every trust by delaying necessary transactions and discouraging dealings with and assistance to trustees.

Id. Professor Fratcher offered no additional support or explanation for the "no duty of inquiry/actual knowledge" standard of liability.

¹⁰⁷ See UTPA, prefatory note, 7C U.L.A. 388, 389; see also Charles Horowitz, *Uniform Trustees' Powers Act*, 41 WASH. L. REV. 1, 7 (1966).

¹⁰⁸ UTPA § 2(a), 7C U.L.A. 398 ("The trustee has all powers conferred upon him by the provisions of this Act unless limited in the trust instrument . . .").

¹⁰⁹ *Id.* § 7, 7C U.L.A. 431 ("The third person is not bound to inquire whether the trustee has power to act or is properly exercising the power . . .").

¹¹⁰ *Id.* ("[A] third person, without actual knowledge that the trustee is exceeding his powers or improperly exercising them, is fully protected in dealing with the trustee as if the trustee possessed and properly exercised the powers he purports to exercise.").

¹¹¹ Horowitz, *supra* note 107, at 28–29. Neither the official comments nor the reporter's comments to the UTPA offer any further discussion or explanation of the

B. *The Uniform Trust Code*

In 2000, the Uniform Law Commission appointed a committee to draft a new “comprehensive”¹¹² uniform law dealing with the law of trusts: the Uniform Trust Code (“UTC”). Like the UTPA, the UTC adopts the modern approach to the law of trusts. The UTC grants a trustee broad powers over the trust property¹¹³ and endorses liberal investment authority.¹¹⁴ Like the UTPA, the UTC recognizes that for these enhanced powers to be effective, third parties who deal with a trustee need more protection than they were accorded at common law. Like the UTPA, the UTC completely eliminates the common law broad duty of inquiry just because a third party knows or should know that he or she is dealing with a trustee.¹¹⁵ In the event the transaction constitutes a breach of trust, however, the UTC protects the third party from liability only if the third party acted in *good faith* and gave valuable consideration.¹¹⁶

C. *Economic Analysis of the Uniform Law Approach to the Scope of a Trustee’s Powers*

While the common law trust rules concerning a trustee’s powers and investment authority were ill-suited to the modern trust, the common law rules were not inherently incompatible with the nature and objectives of the modern trust. The common law rule that a

unusually broad protection given to a third party who deals with a trustee under the UTPA.

¹¹² See UTC, prefatory note, 7C U.L.A. 144–48 (Supp. 2004).

¹¹³ See *id.* §§ 815–16, 7C U.L.A. 244–46. Changes between the adoption of the UTPA and the UTC make the UTC’s provision granting broad powers to each trustee even more defensible. Increasingly, the trust is being used for commercial purposes. See John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165 (1997). The typical commercial trust settlor intends for the trustee to have broad powers over the trust property to facilitate its commercial purpose. The UTC also provides that a settlor cannot opt out of the broad protection accorded third parties. See UTC § 105(b)(11), 7C U.L.A. 160 (referencing section 1012, which provides protection for third parties dealing with a trustee).

¹¹⁴ See UTC, prefatory note, 7C U.L.A. 144 (Supp. 2004) (encouraging states to enact, reenact, or codify the Uniform Prudent Investor Act as Article 9 of the UTC).

¹¹⁵ *Id.* § 1012(b), 7C U.L.A. 261 (Supp. 2004) (“A person other than a beneficiary who in good faith deals with a trustee is not required to inquire into the extent of the trustee’s powers or the propriety of their exercise.”).

¹¹⁶ *Id.* § 1012(a), 7C U.L.A. 261 (Supp. 2004) (“A person other than a beneficiary who in good faith assists a trustee, or who in good faith and for value deals with a trustee, without knowledge that the trustee is exceeding or improperly exercising the trustee’s powers is protected from liability as if the trustee properly exercised the power.”).

trustee had no inherent powers was a default rule.¹¹⁷ A settlor was free to grant the trustee expressly any and all powers that the settlor wished.¹¹⁸ In addition, although the common law default rule was that the trustee had limited investment discretion,¹¹⁹ a settlor was free to grant the trustee expressly broader investment authority.¹²⁰ By expressly granting a trustee enhanced powers over the trust property and broad investment authority, the modern trust could fit within the common law trust rules—but only at increased costs.¹²¹

By adopting the default rule that a trustee had no inherent powers and limited investment authority, but permitting a settlor to opt out of such a regime, the common law took a Pareto superior/personal autonomy approach to the issue of a trustee's powers and investment authority.¹²² If a settlor, acting individually, determined that his or her trustee would be better off with broader powers and/or greater investment authority, the settlor could incur the added costs of expressly granting the trustee those powers and/or that authority. The settlor (and his or her trust) would be better off, and no one else would be worse off. Moreover, over time, as more and more settlors opted for broader powers and investment authority, the law changed to make it easier for them to do so. States adopted broad statutory lists of powers which drafters could incorporate into trust instruments,¹²³ thereby minimizing the costs associated with opting out of the common law default rule.

The UTPA and the UTC, however, automatically grant each trustee all the powers necessary to perform “every act which a prudent man would perform for the purposes of the trust”¹²⁴ In analyzing the economic merits of automatically granting a trustee broad powers over the trust property and liberal investment authority, it is important to note the bifurcated approach the UTPA and the UTC adopt. The uniform laws split the issue of the scope of a trustee's powers depending on whether one is inquiring about (1)

¹¹⁷ Fratcher, *supra* note 78, at 627 (citing RESTATEMENT (SECOND) OF TRUSTS § 186); *see also supra* notes 86–88 and accompanying text.

¹¹⁸ *See* Fratcher, *supra* note 78, at 627.

¹¹⁹ *See id.* at 634–35.

¹²⁰ RESTATEMENT (SECOND) OF TRUSTS § 186.

¹²¹ *See* Fratcher, *supra* note 78, at 658–59 (pointing out that attorneys drafting modern trust instruments were forced to include page after page of express powers and broad investment provisions that the drafter anticipated the trustee might need to carry out the objectives of the modern trust).

¹²² *See supra* Part III.A.3 for a discussion of efficiency.

¹²³ Fratcher, *supra* note 78, at 627–29.

¹²⁴ UTPA § 3(a), 7C U.L.A. 401; *see also* UTC §§ 815–16, 7C U.L.A. 244–46 (Supp. 2004).

the relationship between the trustee and the trust beneficiaries, or (2) the relationship between the trustee and a third party interested in dealing with the trustee.

1. Scope of Trustee's Powers as Between the Trustee and the Trust Beneficiaries

As applied to the relationship between the trustee and the trust beneficiaries, the uniform laws change the default rule from a trustee has *no* inherent powers to a trustee has *all* the powers a prudent person would need to manage the trust.¹²⁵ But the uniform laws permit each settlor to opt out of this approach if the settlor desires, thereby retaining settlor autonomy¹²⁶—to a degree. In so doing, the uniform laws maintain a Pareto superior approach regarding the scope of a trustee's powers between the trustee and the trust beneficiaries.

From an economic perspective, the first issue is whether the change in the default rule with respect to the scope of the trustee's powers as between the trustee and the trust beneficiaries will result in any savings. To the extent that neither default rule will please all settlors, the analysis turns on which approach a majority of settlors would prefer, and which approach would incur greater drafting costs for those settlors who decide to opt out of the default rule.¹²⁷ Inasmuch as the drafting costs of opting out of either default approach are arguably the same, the key is which approach is favored by more settlors. Professor Fratcher argued, and the drafters of the UTPA and UTC apparently agreed, that the modern settlor prefers that his or her trustee have greater powers over the trust property. Although Professor Fratcher provided no statistical evidence to support his assertion,¹²⁸ it appears to be widely accepted; this favors adopting the uniform law approach as to the scope of the trustee's powers.¹²⁹

¹²⁵ UTPA § 3(a), 7C U.L.A. 401.

¹²⁶ See Horowitz, *supra* note 107, at 12; see also *supra* notes 89–90, 117–23.

¹²⁷ Under the common law's no inherent powers approach, a settlor who wants his or her trustee to have enhanced powers over the trust property can put such powers expressly into the trust instrument. While Professor Fratcher emphasized the challenges drafters faced in drafting such trust provisions, all a settlor needs to do is expressly adopt the language set forth in the UTPA. See Fratcher, *supra* note 78, at 627, 654–55. Under the modern rule advocated by Professor Fratcher, there will be settlors who will not want their trustee to have such enhanced powers. These settlors will face similar challenges and costs in drafting around the modern default rule.

¹²⁸ See *id.* at 658.

¹²⁹ Professor Fratcher also argued that the default rule needed to be changed because courts consistently refused to give full effect to a settlor's attempt at opting

Even if one assumes that the majority of modern settlors would prefer the modern approach, however, the magnitude of the savings associated with the change in the default rule is not significant. It is only when one includes the change in the scope of the trustee's powers between the trustee and a third party that the savings associated with the change in the scope of a trustee's powers become significant. This is because that change directly affects a third party's duty to inquire. Although Professor Fratcher and the drafters of the UTC gave only cursory treatment to the third party's duty to inquire, from an economic perspective that is a key provision, if not *the* key provision, of modern trust law.¹³⁰

2. Scope of a Trustee's Powers as Between the Trustee and a Third Party

With respect to the scope of a trustee's powers between the trustee and a third party, the UTPA and the UTC grant each trustee

out of the common law default rule. *See id.* at 629 n.11, 634–35, 637–39, 657–58 & 660. There is the risk of litigation, however, over an individual's intent anytime a party attempts to opt out of a default rule. Professor Fratcher failed to expressly assert or prove that there was anything special about the common law default rule which made the costs of litigation associated with it any greater than one would expect under the UTPA default approach. But see *infra* notes 193, 220 & 227 for a discussion of Professor Alexander's argument that there is something special about the courts' interpretation of settlors' attempts to opt out of the common law rule.

¹³⁰ Even where a settlor expressly granted his or her trustee broad powers and liberal investment authority, a third party wishing to deal with the trustee was obliged to start with the assumption that the trustee had no such powers, and had to undertake the broad common law duty to inquire. *See* Fratcher, *supra* note 78, at 662–63. The duty remained a burdensome, time-consuming, and expensive obstacle for third parties who wished to deal with a trustee. *Id.* Trustees were unable to consummate transactions quickly because third parties were required to stop and inquire into the express terms of the trust to determine if the transaction was authorized. *Id.* at 663. Such delays increased the transaction costs of doing business with a trustee. The Uniform Fiduciaries Act ("UFA") and the UCC provided some relief with respect to the problem of trying to fit the modern trust into the common law rules. As to transactions that come within their scope, third parties are absolved of the common law broad duty to inquire. *See* U.C.C. §§ 3-302, 3-305 (1977); U.F.A. §§ 4, 6–9 (1990); Peter T. Wendel, *Examining the Mystery Behind the Unusually and Inexplicably Broad Provisions of Section Seven of the Uniform Trustees' Powers Act: A Call for Clarification*, 56 MO. L. REV. 25, 26–27, 59 (1991). Third parties are entitled to presume that the transaction is authorized unless there are facts present that would cause a reasonable person to think otherwise. *See id.* at 60. The scope of the uniform acts, however, is limited to those commercial instruments the market for which necessitates that the parties be able to deal with each other quickly and with minimal investigation into whether they are authorized to engage in such transactions. To the extent economic pressure was building to revise the law of trusts, this pressure stemmed more from the common law broad duty of inquiry than it did from the trustee's lack of inherent powers.

all the powers a prudent man would need to manage the trust,¹³¹ and a settlor is *not* permitted to opt out of this rule.¹³² In adopting such an approach, the uniform laws reject the common law Pareto superior/personal autonomy approach in favor of the Kaldor-Hick's approach. No doubt, there are, and will be, settlors who would prefer that their trustee *not* have the broad powers granted under the uniform law approach—settlors who believe that the enhanced powers put the trust property and settlor's intent at greater risk. But these settlors have no option vis-à-vis third parties. As applied to these settlors, the uniform law approach is not efficient from a Pareto superior perspective. Whether the uniform law approach is efficient under the Kaldor-Hicks approach depends on whether the savings of inherently granting each trustee such broad powers exceed the harm.

In assessing this issue, the analysis must address the third party's duty to inquire. If a settlor were permitted to opt out of the rule regarding the scope of the trustee's powers, third parties would have to inquire as to the scope of each trustee's powers before dealing with that trustee.¹³³ For all practical purposes the common law broad duty of inquiry, with all of its inherent costs, would still apply. As long as a settlor is not permitted to opt out of the modern uniform law approach, third parties can assume that the trustee has the right to engage in the proposed transaction—thereby abolishing the broad duty to inquire just because one knows or should know that he or she is dealing with a trustee. While there are obvious savings associated with eliminating the common law broad duty of inquiry, the question is whether eliminating the duty improves efficiency. Eliminating the broad duty of inquiry will increase the potential for a breach of trust. Whether eliminating the duty improves efficiency requires a more

¹³¹ UTPA § 2(a), 7C U.L.A. 398; *see also* UTC §§ 815–16, 7C U.L.A. 244–46 (Supp. 2004).

¹³² Horowitz, *supra* note 107, at 28–29; *see also* UTC § 105(b)(11), 7C U.L.A. 160 (Supp. 2004). Expressly requiring each and every trustee to have such powers constitutes a fundamental change in trust law. Historically, the essence of the trust has been *the particular settlor's* intent; each trust is unique. The settlor's intent controls the extent of each beneficiary's interest in the trust, the scope of the trustee's fiduciary duties to the beneficiaries, and the ability of a third party to deal with the trustee; personal autonomy ruled. *See* RESTATEMENT (SECOND) OF TRUSTS §§ 128, 164 & 186 (1959); BOGERT, *supra* note 27, § 1; 1 SCOTT & FRATCHER, *supra* note 27, §§ 1–2 (4th ed. 1987). Under the UTPA's approach to trustee's powers, the individual settlor's intent is replaced by a generic trustee's intent with respect to a third party's dealing with the trustee. Individualized settlor's intent is sacrificed in the interest of Kaldor-Hicks efficiency. *See supra* notes 58–62 and accompanying text for a discussion of the Kaldor-Hicks approach.

¹³³ Only by inquiring into the scope of the trustee's powers could the third party tell if the settlor had opted out of the default rule.

detailed analysis of the costs and benefits associated with the common law broad duty of inquiry.

V. ECONOMIC ANALYSIS OF THE DUTY OF INQUIRY

A. *Economic Primer on Expected Costs of Harm and Efficiency*

Economists assume that harm is generally bad and should be minimized if it can be done so efficiently. If a breach of trust were to occur, it would cause harm. The expected harm of a breach of trust is a function of the monetary cost of a breach, if it were to occur, discounted by the probability of a breach occurring:¹³⁴

$$\text{Expected Cost of Breach} = \text{Cost of Breach} \times \text{Probability of Breach}$$

The probability of a breach of trust corresponds directly to the level of precautions taken to minimize the risk: the greater the level of precautions, the lower the probability of a breach; the lower the level of precautions, the greater the probability of a breach.¹³⁵ The level of precautions, and who takes them, in turn is a function of the standard of liability the law imposes on the parties involved.¹³⁶

Precautions, however, are added costs.¹³⁷ In determining the total social costs associated with a risk, the analysis must include the costs of the precautions taken by the parties to minimize the probability of a breach.¹³⁸ From an economic perspective, the goal is to *minimize* the total expected social costs associated with the risk of a breach of trust;¹³⁹ that is, to minimize (1) the expected cost of a breach, if it were to occur, and (2) the costs of the precautions taken to minimize the probability of a breach occurring:¹⁴⁰

¹³⁴ COOTER & ULEN, *supra* note 3, at 300.

¹³⁵ From an economic perspective, it is not efficient to eliminate completely the probability of a breach because at some point the added marginal cost incurred in reducing the probability of a breach will exceed the added marginal benefit gained by doing so. At that point it is inefficient to continue to take precautions to try to minimize the probability of a breach. *Id.* at 301–02.

¹³⁶ Laws create incentives for parties to behave in a particular manner, and standards of liability create incentives for parties to take precautions to minimize the risk of harm. If a standard of liability places the risk of loss on a particular party, it creates an incentive for that party to take precautions to minimize that risk. Different standards of liability create different incentives with respect to both which party or parties will take precautions and the level of precautions taken. *Id.* at 302–11.

¹³⁷ *Id.* at 300 (“Taking precaution often involves the loss of money, time, or convenience.”).

¹³⁸ *Id.* at 300–01.

¹³⁹ *Id.* at 301.

¹⁴⁰ This formula constitutes a rather simplified model of the total possible social costs associated with a breach of trust. There are other factors that could be

$$\begin{aligned} & \textit{Total Expected Social Costs} = \\ & (\textit{Cost of Breach} \times \textit{Probability of Breach}) + \textit{Cost of Precautions} \end{aligned}$$

Efficiency is promoted when the total expected social costs are reduced.

Holding a third party liable for participating in a breach of trust creates an incentive for taking added precautions against a breach. If a breach of trust occurs, the trustee is liable.¹⁴¹ The trustee's liability creates an incentive for a trustee not to commit a breach of trust. From an economic perspective, the issue is whether it is worthwhile to also hold liable the third party who participated in the breach—i.e., whether the added costs inherent in the standard of third party liability so reduce the probability of a breach that it produces a net reduction in the total expected social costs associated with a breach of trust. That question requires a detailed analysis of (1) the assumed magnitude of the cost of a breach of trust if it were to occur; (2) the assumed magnitude of the change in the probability of a breach of trust with and without the standard of liability; and (3) the assumed magnitude of the costs of the precautions associated with the standard of liability.

B. Economic Analysis of the Broad Duty to Inquire as Applied to the Common Law Trust

The common law imposed a broad duty of inquiry on a third party who knew or should have known that he or she was dealing with a trustee.¹⁴² Moreover, the common law charged the third party with proper construction of the trust instrument.¹⁴³ For all practical purposes, a third party who dealt with a trustee was strictly liable if the transaction turned out to constitute a breach of trust.¹⁴⁴ This strict liability approach placed the risk of loss associated with a breach of trust on the third party.¹⁴⁵ Placing all of the cost of harm on the

included in a more complex economic model, including how the standard of liability affects the level of activity in question and the administrative costs inherent in the standard of liability. COOTER & ULEN, *supra* note 3, at 311–13, 320–23. For a detailed discussion of administrative costs, see *infra* note 158 and accompanying text; Parts VI.A.3 & VI.B.

¹⁴¹ See *supra* note 36 and accompanying text.

¹⁴² See *supra* note 50 and accompanying text.

¹⁴³ See *supra* note 50 and accompanying text.

¹⁴⁴ See *supra* note 50 and accompanying text.

¹⁴⁵ See COOTER & ULEN, *supra* note 3, at 303. As applied to the risk that a breach of trust will occur, this assumes that the third party cannot recover from the trustee. If the third party can recover from the trustee, the effect of the strict liability standard is to shift the administrative costs associated with the recovery from the trust

third party created an incentive for third parties to engage in a broad inquiry into the trustee's powers and authority to engage in the proposed transaction in order to minimize the risk of loss associated with a potential breach of trust.¹⁴⁶ While the costs inherent in the broad duty of inquiry were not insignificant at common law, imposing this duty on third parties was nevertheless efficient because it reduced the total, social expected costs associated with a breach of trust.

First, under the common law assumptions and conditions, the total cost of the precautions—the costs inherent in the broad duty of inquiry—was assumed to be relatively low. The common law norm was for personal transactions conducted face-to-face between a buyer and seller who typically knew each other.¹⁴⁷ Requiring third parties to inquire into the trustee's powers under such circumstances imposed relatively minimal costs. In addition, common law courts assumed that the duty of inquiry would not arise that often. Trustees were not supposed to transact with third parties very often. The purpose of the common law trust was to *preserve* the trust property.¹⁴⁸ Hence the total cost of the common law broad duty of inquiry was assumed to be relatively low.

On the other hand, at common law the savings associated with the broad duty of inquiry were substantial. First, the cost of a breach of trust, if it were to occur, was assumed to be significant. The common law trust typically was funded with a family's ancestral lands.¹⁴⁹ If a breach of trust were to occur, it would presumably involve the whole trust asset. The costs associated with such a breach would be substantial.¹⁵⁰ In addition, the common law assumed a high probability that a proposed transaction by a trustee would constitute a breach of trust. A trustee was not supposed to be engaging in transactions involving the trust property.¹⁵¹

Because the assumed cost of a breach of trust was substantial, and the probability that a proposed transaction with a trustee constituted a breach of trust was high, it is easy to see why the

beneficiaries to the third party. This latter scenario greatly reduces the magnitude of the risk/cost being imposed on the third party.

¹⁴⁶ *Id.*

¹⁴⁷ See *supra* note 45 and accompanying text.

¹⁴⁸ See *supra* note 79 and accompanying text.

¹⁴⁹ See Fratcher, *supra* note 78, at 657–58; see also BOGERT, *supra* note 27, § 1.

¹⁵⁰ Moreover, because the typical common law trustee was an individual, there was a greater risk that the trustee would be judgment proof. See *infra* notes 166–68 and accompanying text.

¹⁵¹ See *supra* notes 80–82 and accompanying text.

common law courts concluded that the savings associated with the broad duty of inquiry more than offset its costs. Even a relatively small change in the probability of a breach would result in a substantial savings in the *expected* cost of a breach. The common law courts assumed, intuitively, that imposing the common law broad duty of inquiry would significantly reduce the probability of a breach. Under the common law conditions, the savings gained from the reduction in the total expected social cost of a breach of trust exceeded the costs inherent in the broad duty of inquiry.

Under common law assumptions, the common law broad duty of inquiry and its chilling effect¹⁵² upon third parties interested in dealing with a trustee promoted efficiency by reducing the probability of a breach of trust at a relatively low cost.¹⁵³ The broad duty of inquiry served its purpose well as applied to the common law trust.

C. *Economic Analysis of the Broad Duty to Inquire as Applied to the Modern Trust*

Although the broad duty of inquiry was efficient as applied to the common law trust, it is inefficient as applied to the modern trust. Again, the efficiency of a standard of liability turns on the cost of precautions incurred under the standard as compared to the savings generated by the reduction in the probability of a breach occurring.

1. The Cost of the Broad Duty of Inquiry Under the Modern Trust

Under modern trust conditions, the costs associated with the common law broad duty to inquire increase substantially because of (1) changes in the parties involved in the transaction, and (2) changes in the nature of the property typically involved in the transaction. At common law the norm was face-to-face transactions between parties who typically already knew each other.¹⁵⁴ Inquiring into the scope of a trustee's powers under such circumstances was relatively simple. The modern trust transaction, on the other hand,

¹⁵² Professor Fratcher went so far as to call the broad duty of inquiry "the great barrier" to third parties dealing with a trustee. Fratcher, *supra* note 78, at 662. The extent to which a standard of liability affects the underlying level of activity can affect the economic analysis as well. See COOTER & ULEN, *supra* note 3, at 312. As applied to the common law trust, reducing the number of transactions with the trustee increased efficiency and furthered the settlor's intent by helping to preserve the trust property.

¹⁵³ See *supra* note 67 and accompanying text.

¹⁵⁴ See *supra* note 45 and accompanying text.

presumes that the parties have never met and may be thousands of miles apart. Inquiring into the scope of a trustee's powers under such circumstances is more difficult—and more expensive. In addition, under the common law conditions, the typical trust asset was real property.¹⁵⁵ Rarely do transactions involving real property have to be consummated quickly. The time inherent in the inquiry, in and of itself, did not add costs to the transaction. In contrast, the typical modern trust asset is usually some form of intangible property interest—stocks, commercial paper, etc.¹⁵⁶ Transactions involving such assets need to be consummated quickly.¹⁵⁷ Delays can result in added administrative costs, and increased costs due to lost opportunities and changes in value.¹⁵⁸ For all of these reasons, the cost of imposing the common law broad duty to inquire is significantly higher under modern trust conditions.

In addition, there has been a substantial increase in the frequency with which the duty to inquire arises. The nature and purpose of the modern trust—the *management* of the fund of assets—assumes that a trustee will participate in the marketplace on a regular basis.¹⁵⁹ Compared to the common law trust, the number of transactions between a modern trustee and third parties has increased exponentially. Yet under the common law broad duty of inquiry, each time a third party is interested in dealing with a trustee, the third party would have to engage in an extensive, time consuming, and expensive inquiry into the scope of the trustee's powers and the terms of the trust to determine if the transaction is proper.¹⁶⁰ The total cost of the broad duty of inquiry is substantially greater as applied to the modern trust.

In light of the nature and purpose of the modern trust, Professor Fratcher's assertion, that the common law broad duty of

¹⁵⁵ See Fratcher, *supra* note 78, at 657–58; see also BOGERT, *supra* note 27, § 1.

¹⁵⁶ Langbein, *supra* note 28, at 638.

¹⁵⁷ See Fatima Akadaff, *Application of the United Nations Convention on Contracts for the International Sale of Goods (CISG) to Arab Islamic Countries: Is the CISG Compatible with Islamic Principles?*, 13 PACE INT'L L. REV. 1, 22 (2001) (“Commercial and financial transactions by their nature require flexibility, rapidity, and evolution . . .”); see also Janine S. Hiller & Don Lloyd Cook, *From Clipper Ships to Clipper Chips: The Evolution of Payment Systems for Electronic Commerce*, 17 J.L. & COM. 53, 53 (1997).

¹⁵⁸ See Akadaff, *supra* note 157, at 22.

¹⁵⁹ Langbein, *supra* note 28, at 641 (“The need for active administration of the modern trust portfolio of financial assets rendered obsolete this [the common law] scheme of disempowering the trustee to transact with the trust property. The modern trustee conducts a program of investing and managing the assets that requires extensive discretion to respond to changing market forces.”); see also Fratcher, *supra* note 78, at 658–59.

¹⁶⁰ Fratcher, *supra* note 78, at 664.

inquiry “impedes the effective administration of every trust by delaying transactions and discouraging dealings with and assistance to trustees,” is defensible.¹⁶¹ But what Professor Fratcher failed to analyze was whether there are benefits derived from the reduction in the expected cost of a breach of trust which offset the increased costs under modern trust conditions.

2. The Benefit of the Broad Duty of Inquiry as Applied to the Modern Trust

Not only have the costs associated with the common law broad duty of inquiry increased significantly under modern trust conditions, the benefits associated with the duty have decreased substantially. Under the common law conditions, even a relatively small reduction in the probability of a breach generated substantial savings because the common law assumed that the cost of a breach was high.¹⁶² Under modern trust conditions and assumptions, however, (1) the assumed cost of a breach is significantly lower, and (2) the reduction in the probability of a breach because of the duty of inquiry is significantly lower.

The assumed cost of a breach is lower because of the nature of the modern trust res. Instead of the trust holding one asset, the family ancestral lands, the norm is for the trust to hold a diversified portfolio of assets.¹⁶³ Even if a proposed transaction involving one of those assets constitutes a breach of trust, the percentage of the trust property at risk is much lower than under the common law conditions. Thus the assumed cost of a breach under modern trust conditions is substantially lower than it was at common law.¹⁶⁴

Moreover, under the modern trust conditions and assumptions, the probability that a proposed transaction constitutes a breach has

¹⁶¹ *Id.* at 663. As Professor Fratcher, and before him, Professor Scott, argued so well, as applied to the modern trust, the broad common law duty of inquiry is overprotective of trust beneficiaries and unduly hinders and increases the costs of third parties who deal with a trustee. See Austin Wakeman Scott, *Participation in a Breach of Trust*, 34 HARV. L. REV. 454, 481 (1921). In addition, strict liability would reduce a third party's willingness to transact with a trustee, further increasing the inefficiency of applying the common law broad duty of inquiry to the modern trust. See COOTER & ULEN, *supra* note 3, at 312; see also *supra* note 152 and accompanying text.

¹⁶² See *supra* notes 152–53 and accompanying text.

¹⁶³ Langbein, *supra* note 28, at 638.

¹⁶⁴ Moreover, the cost of a breach must factor in the risk that the trust beneficiaries cannot achieve full recovery. The risk that the trust beneficiaries will not be able to achieve full recovery from the trustee is much smaller under modern trust conditions because of the evolution of the corporate trustee with “deeper pockets.” See *supra* note 150 and *infra* note 166 and accompanying text.

decreased. Under modern trust conditions, there is an inherently lower probability that a trustee will engage in a breach of trust—even without a duty to inquire. Because the purpose of the modern trust is to manage a fund of assets, it is far more likely that a settlor has authorized the proposed transaction.¹⁶⁵ In addition, the evolution of the modern trust has been accompanied by the evolution of the professional trustee,¹⁶⁶ often a corporate trustee.¹⁶⁷ The professional trustee reduces the risk of an *inadvertent* breach of trust because the professional trustee has more knowledge of, expertise in, and an overall better understanding of, the trust administration process.¹⁶⁸ The professional trustee also reduces the risk of an *intentional* breach of trust because the professional trustee is typically a corporate trustee subject to multiple layers of supervision and auditing.¹⁶⁹ Under modern trust conditions, the probability of a breach of trust, even without a duty to inquire, is substantially lower than under common law conditions. Because the probability of a breach of trust is substantially lower even without a duty of inquiry, the added reduction in the probability of a breach as a result of imposing a

¹⁶⁵ See *supra* notes 102–06, 131–33 and accompanying text.

¹⁶⁶ Langbein, *supra* note 28, at 638 (“Connected to the change in the nature of trust assets from realty to financial assets, and in the function of trusteeship from stakeholding to management, has come a change in the identity of trustees. Trustees of old were unpaid amateurs, that is, family and community statesmen who lent their names and their honor to a conveyancing dodge Private trustees still abound, but the prototypical modern trustee is the fee-paid professional, whose business is to enter into and carry out trust agreements.”).

The evolution of the corporate trustee also reduces the cost of a breach. If a professional trustee were to engage in a breach of trust, such a trustee typically has deeper pockets, ensuring that the trust beneficiaries will be able to recover full damages from the trustee without needing to sue the third party. See *id.* at 639. But the prevalence of the corporate trustee is unclear. There are no statistics indicating how widely it is used. While it is the norm for the commercial trust, anecdotal evidence indicates that its use for more traditional private trusts appears to be more common on the east coast than the west coast. In addition, the use of the corporate trustee has its own costs—the corporate trustee’s fees and possibly the costs of legal counsel and requiring the trustee to post bond. See Dukeminier & Krier, *supra* note 79, at 1303, 1337–38; Fratcher, *supra* note 78, at 662–63.

¹⁶⁷ Langbein, *supra* note 28, at 638 (“In the United States these institutional trustees are commonly corporate fiduciaries”); see also *id.* at 640.

¹⁶⁸ *Id.* at 638 (stating that “the prototypical modern trustee is the fee-paid professional These entities thrive on their expertise in investment management, trust accounting, taxation, regulation, and fiduciary administration”).

¹⁶⁹ The individual trust officer in charge of a particular trust must account for his management of the trust to his supervisors on a regular basis. VICTOR P. WHITNEY, TRUST DEPARTMENT ADMINISTRATION AND OPERATIONS §§ 3.07[5], 4.02[1]–[2], 9.03[1][d], 10.02[2], 10.04–10.07, 15.18–15.19 (2005).

broad duty to inquire is significantly smaller.¹⁷⁰ Under modern trust conditions and assumptions, the savings in the expected cost of a breach of trust derived from a broad duty of inquiry are relatively small.

3. Economic Conclusion

As applied to the modern trust, the costs of the common law broad duty of inquiry exceed its benefits. It is overly protective of trust beneficiaries, cumbersome, and substantially increases transaction costs. The UPTA and the UTC approaches, which eliminate the common law broad duty of inquiry when one simply knows or should know that he or she is dealing with a trustee, are more efficient.¹⁷¹ From a doctrinal perspective, the only way to abolish the common law broad duty of inquiry is to permit third parties to assume that a trustee has the power to engage in the proposed transaction. Such an assumption is possible only if: (1) each trustee is granted all the powers a prudent person would need

¹⁷⁰ Before concluding that it would be efficient to eliminate the third party's duty to inquire, however, the analysis must take into consideration that there are costs associated with eliminating the duty. Intuitively, eliminating the duty to inquire will increase the frequency of breaches. Eliminating the duty of inquiry will also shift the risk of loss to the trust beneficiaries, who lack the means to effectively take steps to minimize this risk *ex ante*. See *supra* note 67 and *infra* notes 204–18 and accompanying text. Under modern trust conditions and assumptions, however, this increase in frequency should be minimal and the cost of a breach is lower than it was at common law.

¹⁷¹ If the benefits of eliminating the common law broad duty of inquiry so clearly exceed the benefits of keeping it, one might ask why so few states adopted the UTPA. What the UTPA failed to take into consideration was that many of the benefits it provided had already been achieved under the UFA and the UCC. See *supra* note 130 and accompanying text. In transactions where the common law rule was the most cumbersome and expensive—where the transaction needed to be consummated relatively quickly—statutory action had already been taken to remove the broad duty of inquiry. The issue then becomes whether the added benefits of extending that approach to all transactions involving a trustee exceed the costs of completely eliminating the rule. Included in the costs are the incalculable costs of discarding the individual settlor's intent in favor of a generic settlor's intent as to the scope of the trustee's powers, and the macro cost of eliminating one of the few remaining legal arrangements where personal autonomy remained paramount. See *supra* note 132 and accompanying text. The analysis becomes much more difficult under these conditions. This difficulty is complicated by the fact that unlike commercial goods, for which it is easier to assume that virtually all owners have the same intent with respect to the scope of their agents' powers, the class of settlors is not so uniform. While some settlors no doubt want their trustees to have broad and expansive powers, owners of protective trusts and trusts to preserve property arguably would prefer the more traditional common law approach; hence the adoption history of the UTPA and the current debate over the UTC.

to manage his or her own property, and (2) the settlor is *not* permitted to opt out of this assumption.¹⁷²

D. Economic Analysis of the UTC Good Faith, Limited Duty of Inquiry

Although the UTC rejects the common law broad duty of inquiry just because a third party knows or should know that it is dealing with a trustee, the UTC does not completely eliminate the duty of inquiry. While the UTPA provides that third parties are not liable unless they have actual knowledge that the proposed transaction constitutes a breach of trust, the UTC protects third parties who deal with a trustee as long as the third party acts in good faith and gives valuable consideration.¹⁷³ Good faith is not the same as actual knowledge. Good faith includes actual *and* constructive knowledge.¹⁷⁴ Actual knowledge does not include constructive knowledge.¹⁷⁵ An actual knowledge standard imposes no duty to inquire, even where suspicious circumstances indicate that the transaction *might* constitute a breach of trust.¹⁷⁶ A good faith standard, which the UTC adopts, imposes a duty to inquire under such circumstances.¹⁷⁷ In light of the added costs inherent in the UTC's limited duty of inquiry, the question that logically follows is whether the good faith standard promotes efficiency.

¹⁷² While the Kaldor-Hicks approach to efficiency requires that settlors not be permitted to opt out, if a particular settlor were concerned that the trust beneficiaries were not adequately protected from the risk that the trustee might engage in a breach of trust, the settlor could require the trustee to post bond. See Fratcher, *supra* note 78, at 663.

¹⁷³ UTC § 1012(a), 7C U.L.A. 261 (Supp. 2004).

¹⁷⁴ See Wendel, *supra* note 130, at 30–35; see also Robert B. Edesess, Jr., *The End of Innocence: An Actual Knowledge Threshold for Intermediaries Holding Fiduciaries'/Clients' Assets*, 2 DEPAUL BUS. & COM. L.J. 377, 387–88 (2004). A number of rules distinguish actual knowledge from good faith. If there were no difference between the two, there would be no reason for statutes to distinguish them. See also MASS. GEN. LAWS ANN. ch. 201B, § 4 (West 2004) (stating that the death of a principal who has executed a power of attorney does not invalidate the acts of the attorney who, without “actual knowledge” of such death, acts in “good faith” under the power).

¹⁷⁵ See *supra* note 111 and accompanying text (quoting the official reporter for the UTPA acknowledging that the actual knowledge standard does not include constructive knowledge).

¹⁷⁶ See Wendel, *supra* note 130, at 27–28. States that have adopted provisions of the Uniform Trustees' Powers Act have expressly rejected the view that the term “actual knowledge” incorporates “constructive knowledge.” See *Wetherill v. Bank IV Kansas, N.A.*, 145 F.3d 1187 (10th Cir. 1998); *Collier v. Trustmark Nat'l Bank*, 678 So. 2d 693, 697 (Miss. 1996); *Adler v. Manor Healthcare Corp.*, 9 Cal. Rptr. 2d 732 (Ct. App. 1992).

¹⁷⁷ The exact scope of the duty will depend upon whether courts construe the UTC's good faith standard as objective or subjective. See *infra* note 261 and accompanying text.

1. The Cost of the Limited Duty of Inquiry Under the Good Faith Requirement

As compared to the actual knowledge/no duty of inquiry standard under the UTPA, the UTC's good faith/limited duty of inquiry standard admittedly imposes higher costs of precautions on third parties dealing with a trustee. The key to the economic analysis, however, is the magnitude of those costs. The duty of inquiry under the good faith standard is a *limited* duty. The mere fact that one is dealing with a trustee is not sufficient to trigger the duty. The duty arises only where the third party suspects, or has reason to suspect,¹⁷⁸ that the proposed transaction may be inappropriate.¹⁷⁹ This constitutes only a small fraction of the proposed transactions involving a trustee.¹⁸⁰ The probability that the duty to inquire will arise is much closer to that of the actual knowledge/no duty of inquiry regime than it is to the common law broad duty of inquiry scheme. Absent reason to believe otherwise, the third party is permitted to presume that the trustee is authorized to engage in the proposed transaction.¹⁸¹

2. The Benefits of the Limited Duty of Inquiry Under the Good Faith Requirement

While the good faith/limited duty of inquiry standard will generate greater transaction costs/costs of precaution than the actual knowledge/no duty of inquiry approach under the UTPA, it will also generate greater savings. If a third party believes or has reason to believe that the proposed transaction might constitute a breach of trust, there is a significantly higher probability that the proposed transaction does, in fact, constitute a breach of trust. If the proposed transaction does constitute a breach of trust, permitting the

¹⁷⁸ This depends on whether one adopts a subjective or objective standard of good faith. See *infra* note 261.

¹⁷⁹ See 2 JOHN NORTON POMEROY, A TREATISE ON EQUITY JURISPRUDENCE § 753 (4th ed. 1918).

¹⁸⁰ The costs inherent in this limited duty to inquire are considerably lower than those inherent in the common law broad duty to inquire. Under the common law duty, each and every third party who was interested in dealing with a trustee had to inquire into each and every transaction to ascertain if the transaction was appropriate. Fratcher, *supra* note 78, at 664. Assuming that the costs of inquiry are the same under the common law and the UTC standard, the key is that the frequency of this type of transaction under the UTC is significantly lower than the frequency under the common law duty of inquiry. So while the net cost is greater than under the UTPA standard, it is significantly lower than under the common law approach (particularly as applied to the modern trust).

¹⁸¹ See UTC § 1012, 7C U.L.A. 261.

transaction to go forward would result in significant harm to the trust beneficiaries and should be discouraged. Imposing a limited duty of inquiry where the third party suspects or has reason to suspect that the transaction may constitute a breach of trust will reduce the probability that a trustee will engage in a transaction that constitutes a breach of trust, thereby reducing the expected costs associated with a breach of trust.¹⁸² The issue that arises is whether these savings are greater than the costs inherent in imposing a limited duty of inquiry.

3. Economic Conclusion

Whether imposing the limited duty of inquiry results in a *net* reduction in the total expected social costs associated with a breach of trust is difficult to determine, especially in comparison to the UTPA's actual knowledge/no duty of inquiry standard. The good faith/limited duty of inquiry approach will result in fewer breaches of trust, but at a slightly higher cost. The actual knowledge/no duty of inquiry standard will result in more breaches of trust, but at a lower administrative cost. It is difficult to assign quantitative numbers to the relevant variables,¹⁸³ so it is impossible to determine definitively which approach is more efficient. Nevertheless, the historical success of the good faith/limited duty of inquiry standard in other areas of law tends to support the conclusion that the limited duty of inquiry is

¹⁸² Under the UTC limited duty of inquiry, the probability that the transaction constitutes a breach of trust is high, even as applied to the modern trust, due to the suspicious circumstances that gave rise to the duty.

¹⁸³ It is impossible to quantify the relevant variables: the respective rate of breach under the two approaches and the respective costs inherent in each approach. The costs associated with the good faith limited duty of inquiry depend primarily upon (1) how often the duty to inquire arises, and (2) the costs associated with the inquiry. See *supra* notes 178–81 and accompanying text. The costs associated with the no duty of inquiry approach depend primarily upon (1) the increased costs resulting from the increased number of breaches, and (2) the added costs of posting bond (depending on how often a settlor would require bond). Fratcher, *supra* note 78, at 662–63.

While it is impossible to say whether the actual knowledge/no duty of inquiry standard or the good faith/limited duty of inquiry standard is more efficient, there is no doubt that the good faith standard has an additional benefit—it is more equitable. From a purely *equitable* perspective, it makes no sense to protect a third party who deals with a trustee and who has reason to suspect that the proposed transaction is improper, but nonetheless intentionally decides not to investigate so as to avoid acquiring actual knowledge that the transaction constitutes a breach of trust. 2 POMEROY, *supra* note 179, at §§ 397–404, 687–88; Wendel, *supra* note 130, at 63. Permitting a third party to escape liability under such circumstances arguably imposes an additional cost: societal disapproval and lack of respect for the legal system. Assuming it is impossible to say which approach is more efficient, equitable considerations favor adopting the good faith approach.

the more efficient standard.¹⁸⁴ The general rule is that a third party who deals with an agent in an unauthorized transaction is liable unless the third party qualifies as a good faith purchaser.¹⁸⁵

Moreover, the prevailing economic analysis holds that splitting the liability between the parties who can take precautions to minimize the risk of breach is the most efficient approach.¹⁸⁶ A breach of trust is a bilateral risk in that both parties, the settlor who selects the trustee and the third party who deals with the trustee, can take precautions to minimize the risk of a breach. Under the common law approach, which allocated all of the cost associated with a breach of trust to the third party who participated in the breach, a settlor had no incentive to take precautions to minimize the risk of a breach.¹⁸⁷ Similarly, under the UTPA's actual knowledge approach, which allocates all of the costs associated with a breach of trust to the trust beneficiaries, a third party who deals with a trustee has no incentive to take precautions to minimize the risk of a breach.¹⁸⁸ The good faith standard, however, which bifurcates the risk of loss, creates

¹⁸⁴ The UCC employs the good faith standard of liability to an area of law that involves a high volume of transactions, and where timely consummating the transaction is also important. U.C.C. §§ 3-302(1), 3-304(2), 8-302, 8-304(2) (1977). The UCC good faith standard of liability has worked well, deterring breaches at an acceptable cost. One can only assume that the same would be true if the good faith standard were to apply to third parties interested in dealing with a trustee.

In addition, all things being equal, it makes sense to put the burden of proof on the party who is in the best position to produce the evidence. See Edward W. Cleary, *Presuming and Pleading: An Essay on Juristic Immaturity*, 12 STAN. L. REV. 5, 12 (1959) ("The nature of a particular element may indicate that evidence relating to it lies more within the control of one party, which suggests the fairness of allocating that element to him."); Bruce L. Hay & Kathryn E. Spier, *Burdens of Proof in Civil Litigation: An Economic Perspective*, 26 J. LEGAL STUD. 413, 419 (1997) (arguing that in order to minimize the costs to the parties, the most efficient approach would be to put the burden of proof on the party in control of the information). This reduces the costs of discovery and ensures that an incentive is created to produce all the relevant evidence for the jury to consider, thereby maximizing the chances that the jury will reach the correct verdict. See Bruce L. Hay, *Allocating the Burden of Proof*, 72 IND. L.J. 651, 654 (1997) ("We will assume that the court's objective in allocating the burden of proof is to minimize two types of costs—more precisely, the sum of the two costs, which we will call process costs and error costs. Process costs consist of the resources spent by each party in attempting to secure his preferred result in the case (by presenting evidence if the case is resolved through litigation . . .). Error costs consist of the disadvantageous results produced by an outcome favoring one party when the evidence supports the other.") (footnote omitted); see also POSNER, *supra* note 1, at 552.

¹⁸⁵ See 3 AM. JUR. 2D *Agency* § 289 (2002); 2A C.J.S. *Agency* §§ 461–62 (2003).

¹⁸⁶ COOTER & ULEN, *supra* note 3, at 300–11; Cooter, *supra* note 3, at 6–8, 27–28, 44.

¹⁸⁷ COOTER & ULEN, *supra* note 3, at 303; Cooter, *supra* note 3, at 6, 27.

¹⁸⁸ COOTER & ULEN, *supra* note 3, at 304; Cooter, *supra* note 3, at 5–6, 27–28.

an incentive for bilateral precautions.¹⁸⁹ All things being equal, the good faith limited duty of inquiry appears to be the most efficient standard of liability for a third party dealing with a trustee.

VI. THE HIDDEN COSTS OF THE UTC'S GOOD FAITH STANDARD

But when it comes to a third party who deals with a trustee, all things are not equal. The economic model developed so far has focused on the two principal variables in the expected social costs inherent in a breach of trust—the expected cost of a breach and the expected costs of the precautions. While these are the key costs involved in the analysis, there are other, indirect costs. When all things are equal, these additional indirect costs tend to cancel each other out. When all things are not equal, however, these added costs may affect which approach is the most efficient.¹⁹⁰

A. *Hindsight Bias*

In adopting laws, judicial realism counsels that one should consider how people naturally behave.¹⁹¹ Courts and juries¹⁹² are naturally biased in favor of trust beneficiaries and against trustees and third parties who deal with a trustee.¹⁹³ This natural bias stems from a

¹⁸⁹ Cooter, *supra* note 3, at 6–8, 27–28, 44; *see also* COOTER & ULEN, *supra* note 3, at 300–11.

¹⁹⁰ COOTER & ULEN, *supra* note 3, at 316–20; Cooter, *supra* note 3, at 37.

¹⁹¹ *See* Roscoe Pound, *The Call for a Realist Jurisprudence*, 44 HARV. L. REV. 697, 697 (1931) (“[T]he new juristic realists hardly use realism in a technical philosophical sense. By realism they mean fidelity to nature, accurate recording of things as they are, as contrasted with things as they are imagined to be, or wished to be, or as one feels they ought to be.”); *see also* Timothy S. Hall, *Legal Fictions and Moral Reasoning: Capital Punishment and the Mentally Retarded Defendant After Penry v. Johnson*, 35 AKRON L. REV. 327, 360 (2002) (“O’Connor’s opinion requires a certain level of legal realism; that is, a concern for what juries are actually thinking . . .”) (emphasis added); Karl N. Llewellyn, *Some Realism About Realism—Responding to Dean Pound*, 44 HARV. L. REV. 1222, 1235–36 (1931) (in describing some of the “common points of departure” that distinguished the realist movement, stating that realists saw “[t]he conception of law as a means to social ends and not as an end in itself; so that any part needs constantly to be examined for its purpose, and for its effect, and to be judged in the light of both and of their relation to each other”).

¹⁹² Historically, trust beneficiaries were not entitled to a trial by jury because their claims against the trustee for breach of fiduciary duty, and/or against the third party for participating in the breach, were equitable in nature. There are exceptions to this rule, however, and there appears to be a modern trend evolving under which trust beneficiaries are increasingly receiving the right to a jury trial. *See* BOGERT, *supra* note 27, § 870; 3 SCOTT & FRATCHER, *supra* note 27, §§ 197–98 (4th ed. 1988); *see also In re Messer Trust*, 579 N.W.2d 73, 79 (Mich. 1998).

¹⁹³ Professor Alexander, an expert in the field of behavioral law and economics, was one of the first to write on this phenomenon. He described hindsight bias as follows:

number of factors inherent in the historical nature of the trust and the trust relationship which distinguish the trustee from an agent.

First, while settlors may have entered the “modern trust” era, most people still hold the “common law” view of the trust. The typical person (judge or juror included) thinks that the typical trust is used to help people who need protecting—the elderly, widows, minors, and orphans.¹⁹⁴ The typical person extends that protective purpose to the trust property. It too needs to be protected to ensure that the trust beneficiary is adequately protected. Protecting the trust property favors preserving it.¹⁹⁵ Transactions involving the trust property should be kept to a minimum and should be entered into only with great caution.

The typical person extends the protective purpose of the trust to the trustee–trust beneficiary relationship as well. Although most

Cognitive psychologists have described the hindsight bias as individuals’ tendency to consistently exaggerate what, in foresight, they could have anticipated. It is the persistent tendency of people to believe that what they know *ex post* was eminently knowable *ex ante*. Or, as one psychologist puts it, “[p]eople believe that others should have been able to anticipate events much better than was actually the case.”

Gregory Alexander, *A Cognitive Theory of Fiduciary Relationships*, 85 CORNELL L. REV. 767, 782–83 (2000) (quoting Baruch Fischhoff, *For Those Condemned to Study the Past: Heuristics and Biases in Hindsight*, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 335, 341 (Daniel Kahneman et al. eds., 1982)). While theoretically hindsight bias can arise in virtually every case, Professor Alexander asserted that trustees are routinely subjected to hindsight bias because of their position of dominance over the trust beneficiaries. *Id.* at 775, 777. Although Professor Alexander declined to elaborate on the factors that constitute their position of dominance, they arguably are the factors discussed herein. See notes 191–214 and accompanying text. This hindsight bias is not so much against the trustee as it is in favor of the trust beneficiaries. Thus, if a third party has participated in the breach of trust, the hindsight bias will apply to both the trustee and the third party.

¹⁹⁴ One could argue that this view of who constitutes the typical trust beneficiary is not limited to laypeople. During a law school faculty workshop presentation, I asked the faculty in attendance to identify the typical trust beneficiary. The faculty present rattled off the individuals listed above—the elderly, widows, and orphans. This view is also reflected in an early comment on the newly adopted Uniform Fiduciaries Act: “The rules with regard to fiduciaries must of necessity be strict, since they are generally placed in a position where the incentive to act dishonestly is great, and since their principals are often inexperienced people, incompetent to protect their own interests.” Current Legislation, *The Uniform Fiduciaries Act*, 24 COLUM. L. REV. 661, 668 (1924) (emphasis added) [hereinafter *The Uniform Fiduciaries Act*].

¹⁹⁵ The typical layperson’s assumptions about a trust and its purpose are consistent with the common law view of the typical trust. See *supra* notes 78–82 and accompanying text. Although one can make a strong argument that the layperson’s assumptions about a trust are not accurate as applied to the modern trust, the fact remains that the typical judge and juror will bring these assumptions to a trial concerning a third party’s liability for participating in a breach of trust.

people do not understand what a trustee is, per se,¹⁹⁶ or what a fiduciary relationship is, per se, most people do understand that it is a special relationship. They understand that trusts are different from other legal arrangements where one party acts for another.¹⁹⁷ The typical person translates the concept of fiduciary duties into a vague duty to protect trust beneficiaries.¹⁹⁸ This vague understanding of trusts and fiduciary duties is then applied to a third party who deals with a trustee. The third party knows or should know that trusts are for the benefit of someone who needs special protection. In deciding whether a proposed transaction with a trustee is appropriate, the third party should consider the protective nature of trusts.¹⁹⁹

Second, courts and juries have a natural bias in favor of trust beneficiaries because the trust beneficiaries do not select the trustee.²⁰⁰ In the classic three-party transaction, a third party is dealing with an agent who is acting on behalf of an owner. If the agent enters into an unauthorized transaction, there is the equitable and economic consideration that the owner should be responsible for picking a bad agent.²⁰¹ The owner was in the best position to

¹⁹⁶ See Jeanne Trahan Faubell, Book Review, 91 LAW LIBR. J. 441, 479 (1999) (reviewing JULIE A. CALLIGARO, ARRANGING YOUR FINANCIAL AND LEGAL AFFAIRS: A STEP-BY-STEP GUIDE TO GETTING YOUR AFFAIRS IN ORDER (1998)) (“[I]n the chapter on ‘Legal Affairs Estate Planning,’ she briefly discusses the living trust, using the terms ‘trust,’ ‘trustee,’ and ‘for the benefit of the beneficiary,’ without ever defining them. I doubt that most laypersons really understand what these terms mean . . .”).

¹⁹⁷ See BOGERT, *supra* note 27, §§ 11–38.

¹⁹⁸ See *supra* notes 194–95 and accompanying text.

¹⁹⁹ The protective nature of trusts is also evident in some of the legal writings describing trusts and the role of trustees and other fiduciaries. See *The Uniform Fiduciaries Act*, *supra* note 194, at 668 (discussing the protective nature of fiduciary relationships and stating, “Nor can we shut our eyes to the fact that public policy, as expressed in judicial decisions over an extended period of time, has favored the imposition of such burdens [on third parties dealing with a fiduciary] in order that the interest of beneficiaries might have an additional degree of protection”).

²⁰⁰ The settlor, not the beneficiaries, selects the trustee. See RESTATEMENT (SECOND) OF TRUSTS § 3 (1959). Assuming the settlor is not also a beneficiary, the beneficiaries have no right to participate in selecting the trustee. See *id.*

²⁰¹ As Professor Morris stated:

[A]ltering the principal’s behavior is the primary deterrence consideration expressed in the agency case law. According to *Greenberg I*’s summary of that law, this is because it is the principal who selects, hires and controls the agent. “[Cases] hold that as between the employer of a dishonest agent and a stranger (a customer or a holder in due course), the employer bears the responsibility for it—for it, at least, could select and monitor the agent. Exposure to liability then induces the employer to take cost-justified precautions.” As the authority cited in *Greenberg I* explains, agency law generally prefers to provide incentives for principals to select and monitor their agents with

avoid the problem by selecting a better agent.²⁰² With respect to trusts, however, this argument does not apply. The settlor, not the trust beneficiaries, selects the trustee.²⁰³ Courts and juries are reluctant to hold trust beneficiaries responsible for the wrongful acts of a trustee they did not choose.²⁰⁴ The third party, on the other hand, had the power to decide whether to deal with this trustee. The third party is in a better position to prevent a breach of trust than are the trust beneficiaries.²⁰⁵

due care, rather than to require strangers to take additional precautions with agents.

Andrew J. Morris, *Clarifying the Imputation Doctrine: Charging Audit Clients with Responsibility for Unauthorized Audit Interference*, 2001 COLUM. BUS. L. REV. 339, 370 (internal citations omitted); *see also* Grease Monkey Int'l, Inc. v. Montoya, 904 P.2d 468, 477 (Colo. 1995) ("The rationale behind this rule is that it 'place[s] the risk that an agent may abuse his authority for his own benefit on the principal, rather than on the [innocent third party].' Thus, the rule provides an incentive for a principal to select reliable agents." (quoting Willey v. Mayer, 876 P.2d 1260, 1266 (Colo. 1994) ("There are several policy reasons why it is preferable to place the risk that an agent may abuse his authority for his own benefit on the principal, rather than on the holder in due course who takes without notice of the principal-agent relationship. First, this rule increases the principal's incentive to exercise care in selecting honest and reliable agents. Second, the principal is in a better position to supervise the agent's conduct than is the holder in due course."))).

²⁰² See Morris, *supra* note 201, at 370.

²⁰³ See RESTATEMENT (SECOND) OF TRUSTS § 3.

²⁰⁴ See BOGERT, *supra* note 27, § 882.

It should be noticed, however, that the principal selects his agent and retains him at will, while the beneficiary merely accepts a trustee appointed by the settlor or a court and ordinarily has no authority of his own motion to direct or remove the trustee. The beneficiary is entitled to rely on the assumption that the trustee will perform his duty as to labeling trust property and conveying only for trust purposes. It is more reasonable to expect the principal to be familiar with the method employed by the agent in handling his property and the transactions of the agent from day to day than it is to expect a beneficiary to watch and check the trustee as to method of title holding and as to impending sales and mortgages by the trustee.

... If the beneficiary has had no notice that the trustee was intending to sell, mortgage, or pledge in breach of trust and that the trustee was in a position to do this without giving notice of the trust to the intended purchaser, it is difficult to see how it can be said reasonably that the deception of the innocent purchaser was the fault of the beneficiary.

Id.

²⁰⁵ See *id.* ("There is no duty on the beneficiary to watch the trustee for the benefit of third persons who may deal with the trustee. The creditor of the trustee, or purchaser under him, is not entitled to assume that if the property is held in trust the beneficiary knows of the way in which the title is kept by the trustee and knows of the reliance of creditors and purchasers on a claim of ownership or power to convey on the part of the trustee."); *see also* Wetherill v. Bank IV Kansas N.A., 145 F.3d 1187, 1192 (10th Cir. 1998) (acknowledging that it would have been easier for the third

Third, courts and juries have a natural bias in favor of trust beneficiaries because trust beneficiaries have no control over a trustee. In the classic three-party transaction, after an owner appoints an agent, the owner has an ongoing duty to supervise the agent's activities.²⁰⁶ If the agent enters into an unauthorized transaction, the third party who dealt with the agent can argue that the owner knew or should have known that the agent was entering into the transaction,²⁰⁷ and that the owner should have done a better job supervising the agent.²⁰⁸ And if an owner fears that the agent is a "bad" agent, the owner can and should remove the agent before the agent enters into an unauthorized transaction.²⁰⁹

Again, however, these arguments do not apply with equal effectiveness to trust beneficiaries. One of the principal reasons a settlor uses a trust is to free the trust beneficiaries from the administrative hassles of holding and managing the property.²¹⁰ Trust beneficiaries are not expected to exercise the same level of supervision over a trustee that an owner is expected to exercise over

party to have detected the breach of trust, but declining to impose liability on the third party because the jurisdiction applied the actual knowledge standard).

²⁰⁶ See, e.g., Morris, *supra* note 201; see also BOGERT, *supra* note 27, § 882; *infra* note 208 and accompanying text. See generally A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS (3d ed. 2003).

²⁰⁷ See *supra* notes 203–06 and accompanying text; *infra* notes 208, 211–13.

²⁰⁸ See *supra* notes 203–06 and accompanying text; *infra* notes 211–13; see also *Airlines Reporting Corp. v. Incentive Internationale Travel, Inc.*, 566 So. 2d 1377, 1379 (Fla. Dist. Ct. App. 1990) ("Because the principal-agent relationship is based upon the trust and confidence of the principal in the agent, and because the principal is legally liable for the acts of his agent, when a principal no longer has the necessary confidence in the agent and is no longer willing to be liable for the agent's acts, the principal can protect itself by revoking and terminating the agency relationship . . ."); POLINSKY, *supra* note 206, at 130–32 ("If the principal is made strictly liable for the harm, she will have the appropriate incentive to monitor and control her agents . . . [I]t still is desirable to make the principal liable for harm, to give the principal proper incentives to control her agents in any way she can."); *supra* notes 200–01, 203 and accompanying text; *infra* text accompanying note 210.

²⁰⁹ *Airlines Reporting*, 566 So. 2d at 1379.

²¹⁰ See JESSE DUKEMINIER & STANLEY M. JOHANSON, WILLS, TRUSTS, AND ESTATES 379 (5th ed. 1995) ("The settlor may want to be relieved of the burdens of financial management."); see also Major Joseph E. Cole, *Essential Estate Planning: Tools and Methodologies for the Military Practitioner*, ARMY LAW., Nov. 1999, at 12 ("Furthermore, if the grantor is looking for professional management or just relief from the headaches inherent in the management of trust property, [revocable living trusts] can also be useful to serve that purpose while still providing income to the grantor during the grantor's lifetime. The grantor can have another manage the assets for his benefit without irrevocably giving up control of the assets since the grantor retains the ultimate power of revocation of the trust.").

an agent.²¹¹ And trust beneficiaries have no control over a trustee.²¹² Trust beneficiaries cannot remove a trustee absent cause.²¹³ While trust beneficiaries have little control *ex ante* over a trustee's actions, a third party who is contemplating dealing with a trustee has complete control *ex ante* over whether to deal with a particular trustee. Compared to the trust beneficiaries, the third party is in a better position to prevent a breach of trust.²¹⁴

1. Historical Evidence of Hindsight Bias

There is historical evidence to support the claim that courts and juries are biased in favor of trust beneficiaries. Professor Fratcher, in his article calling for each trustee to be granted enhanced powers, discussed the history behind settlors' attempts at increasing the scope of a trustee's powers. Professor Fratcher subtly, but repeatedly, criticized the courts for their bias against such attempts. Even where a settlor expressly granted enhanced powers to his or her trustee, the courts tended to construe such powers narrowly to protect the interests of trust beneficiaries.²¹⁵ In addition, although the traditional rule was that a trustee had all powers either expressly given *or necessarily implied* in light of the trust purposes,²¹⁶ courts of equity were reluctant to infer such powers.²¹⁷ No doubt this judicial reluctance

²¹¹ See BOGERT, *supra* note 27, § 15 ("An agent is subject to the control and direction of his principal, whereas neither the settlor nor the beneficiary of a trust has such a power unless it was expressly reserved or granted in the trust instrument. Agency is formed with the thought of constant supervision and control by the principal. Trust is based on the idea of discretion in the trustee and guidance by the settlor or beneficiary only to the limited extent expressly provided in the trust instrument."); *see also id.* § 882 ("There is no duty on the beneficiary to watch the trustee for the benefit of third persons who may deal with the trustee.").

²¹² See BOGERT, *supra* note 27, § 882 ("It may be urged that a trustee is like an agent and that a beneficiary who gives his trustee apparent or actual authority to convey free of equities should be bound by his grant of power It should be noticed, however, that the principal selects his agent and retains him at will, while the beneficiary merely accepts a trustee appointed by the settlor or a court and ordinarily has no authority of his own motion to direct or remove the trustee.").

²¹³ See RESTATEMENT (THIRD) OF TRUSTS § 37 (2003); BOGERT, *supra* note 27, § 527; 3 SCOTT & FRATCHER, *supra* note 27, §§ 107, 107.3 (4th ed. 1988). While the UTC expands the power of trust beneficiaries to remove a trustee, the power still does not come close to the degree of control a principal has over an agent. UTC § 706, 7C U.L.A. 221-22.

²¹⁴ See *The Uniform Fiduciaries Act*, *supra* note 194, at 668 ("[I]t may be argued with great force that the third party who deals with a fiduciary is in a situation which affords him an opportunity to investigate and satisfy himself as to the [fiduciary's] good faith, whereas the principal may not be in a position to protect himself.").

²¹⁵ See Fratcher, *supra* note 78, at 629 n.11, 634-35, 637-39, 657-58 & 660.

²¹⁶ See *id.* at 627.

²¹⁷ See *id.* at 627, 630-32, 634 & 657-58.

was due to the courts' view that trust beneficiaries are in need of special protection and the law of trusts should be construed and applied accordingly.²¹⁸

In addition, the traditional approach to a trustee's liability for trust investments further supports the position that courts exercise hindsight bias in favor of trust beneficiaries. At common law, a trustee's investments were viewed in isolation and each investment had to be assessed in light of the terms and purpose of the trust.²¹⁹ Because each investment decision was assessed after the fact, trustees were routinely subject to hindsight bias.²²⁰

²¹⁸ See *The Uniform Fiduciaries Act*, *supra* note 194, at 668 (discussing the protective nature of fiduciary relationships and stating, "Nor can we shut our eyes to the fact that public policy, as expressed in judicial decisions over an extended period of time, has favored the imposition of such burdens [on third parties dealing with a fiduciary] in order that the interest of beneficiaries might have an additional degree of protection"); see also Dukeminier & Krier, *supra* note 79, at 1336. This attitude arguably was consistent with the common law trust and the intent of the common law settlor—to preserve real property for future beneficiaries. See *id.* Whether it is consistent with the modern trust and the intent of the modern settlor is questionable, but it highlights the tension of the modern trust. No doubt the settlor's primary concern is the interest of the trust beneficiaries. The argument, however, is that at the macro level this interest is best served by facilitating transactions between the trustee and third parties, even if that increases the risk of a breach of trust. See Fratcher, *supra* note 78. Therein lies the tension of the modern trust. In the event the trust is an investment-oriented commercial trust, the interest in facilitating trust transactions arguably triumphs. In the event the trust is a more traditional trust in favor of trust beneficiaries who need protection, however, one would assume that the typical settlor would prefer to protect the trust beneficiaries' interests rather than facilitate trust transactions. This difference raises the issue of the degree to which the UTC drafting committee was influenced by the increasing role of commercial trusts, as opposed to the more traditional family trust, and to the extent these two types of trusts differ, which should be assumed to be the model modern trust for trust law purposes? Alternatively, should there be different laws for the different types of trusts?

²¹⁹ Edward C. Halbach, *Trust Investment Law in the Third Restatement*, 77 IOWA L. REV. 1151, 1151–52 (1992).

²²⁰ See Alexander, *supra* note 193, 782–83 ("Under this rule, courts are supposed to judge prudence *ex ante* as opposed to *ex post*. As Professor Rachlinski has articulated, however, the truth is that the law governing the liability of trustees for improperly investing trust assets is best described as an instance of courts falling prey to the hindsight bias.") (internal quotation marks and alteration omitted). See generally Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, in BEHAVIORAL LAW AND ECONOMICS 95–115 (Cass R. Sunstein ed., 2000). Historical hindsight bias against a trustee is also evident in the literature discussing the modern trend portfolio approach to trust investment, which emphasizes that the portfolio approach eliminates subjecting the trustee to after-the-fact assessment of individual investment decisions. See RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. b (1992) ("The trustee's compliance with these fiduciary standards is to be judged as of the time the investment decision in question was made, not with the benefit of hindsight or by taking account of developments that occurred after the time of a decision to make, retain, or sell an investment."); see also Robert Aalberts & Percy Poon, *The New*

In light of the historical evidence that courts have displayed a natural bias in favor of trust beneficiaries when interpreting and applying settlor's intent with respect to the scope of a trustee's powers, it is reasonable to assume that courts and juries will be equally biased in favor of trust beneficiaries and against third parties when applying the good faith standard.

2. Hindsight Bias Is Facilitated by the Nature of the Good Faith Standard

The fact that courts and juries have a natural bias in favor of trust beneficiaries is particularly relevant because of the fact-sensitive and *ex post* nature of determining liability under the good faith standard. The fact finder's task is to determine the third party's state of mind²²¹ based upon what the party knew, or should have known,²²² at the time he or she entered into the transaction with the trustee. Whether the third party acted in good faith is an extremely soft, fact-sensitive inquiry with plenty of room for interpretation of the evidence.²²³ The court or jury is free to discount the third party's testimony as to his or her state of mind if it determines that the testimony is self-serving.²²⁴ There will almost always be evidence and

Prudent Investor Rule and the Modern Portfolio Theory: A New Direction for Fiduciaries, 34 AM. BUS. L.J. 39, 64 (1996).

²²¹ BLACK'S LAW DICTIONARY 693 (6th ed. 1990) ("In common usage, this term [good faith] is ordinarily used to describe that *state of mind* denoting honesty of purpose . . . and, generally speaking, means being faithful to one's duty or obligation.") (emphasis added); see also *Stanfield v. Osborne Indus., Inc.*, 643 P.2d 1115, 1124 (Kan. Ct. App. 1982) ("Whether a party acts in good faith depends not only on the facts and circumstances but also on his *state of mind*.") (emphasis added).

²²² This distinction depends on whether one takes the subjective or objective approach to good faith. See *infra* note 261 and accompanying text.

²²³ See *Citizens First Nat'l Bank v. Bluh*, 656 A.2d 853, 856-57 (N.J. Super. Ct. App. Div. 1995) ("[T]he law exacts good faith from those dealing with knowledge of the representative capacity of another and imposes the obligation to make inquiry into the propriety of a transaction when it appears that the security offered is not being applied for the benefit of the estate. . . . Such cases are fact sensitive." (quoting *Petras v. Zaccone*, 311 A.2d 751, 753 (N.J. Super. Ct. App. Div. 1973))); *State v. Moreau*, 670 A.2d 608, 612 (N.J. Super. Ct. App. Div. 1995) ("'Good faith,' as a concept, carries with it many different definitions and is almost always highly fact sensitive. Certainly, good faith contemplates 'honesty of purpose and integrity of conduct with respect to a given subject.'"); *Cook v. Zions First Nat'l Bank*, 919 P.2d 56, 60-61 (Utah Ct. App. 1996) ("'[G]ood faith and fair dealing are fact sensitive concepts, and whether there has been a breach of good faith and fair dealing is a factual issue, generally inappropriate for decision as a matter of law." (quoting *Republican Group v. Won-Door Corp.*, 883 P.2d 285, 291 (Utah Ct. App. 1994))).

²²⁴ Gail Hollister, *Using Comparative Fault to Replace the All-or-Nothing Lottery Imposed in Intentional Torts Suits in Which Both Plaintiff and Defendant Are at Fault*, 46 VAND. L. REV. 121, 139 (1993) ("Subjective intent can exist only in the mind of the actor, yet no jury is required to accept the actor's self-serving testimony as to his intent.").

arguments that can be made to support both sides of the issue.²²⁵ In addition, the jury is assessing the evidence after the fact, and hindsight is always “20–20.”²²⁶ Where a transaction constitutes a breach of trust and the trust beneficiaries have been harmed, all ambiguities and doubts will be resolved against the third party who dealt with the trustee. For all practical purposes, the fact-sensitive, good faith standard of liability, when coupled with hindsight bias, will be tantamount to strict liability—the common law standard of liability—but without notice to third parties who deal with a trustee of the real potential for liability involved.²²⁷

3. Hindsight Bias and Costs of Administration

From an economic perspective, society's goal is to minimize the total expected social costs associated with a breach of trust.²²⁸ Although the simple economic model discussed up to this point has focused on the costs of precautions and the expected cost of harm, a

²²⁵ See *supra* note 223 and accompanying text.

²²⁶ See Alexander, *supra* note 193, at 782–83; Brett McDonnell, *Esops' Failures: Fiduciary Duties When Managers of Employee-Owned Companies Vote to Entrench Themselves*, 2000 COLUM. BUS. L. REV. 199, 244 (“Furthermore, there's the danger of 20–20 hindsight vision—judges see a case after events happened, yet they must try to determine whether an action was justified given the information available at the time of the decision.”); Rachlinski, *supra* note 220, at 95.

²²⁷ See Alexander, *supra* note 193, at 778 (“That association [the power imbalance and the susceptibility of the trust beneficiaries] in turn affects the inferences that judges draw about the fiduciary. The fiduciary's (perceived) power superiority, combined with the difficulty of actually detecting abuses of power, leads judges to draw inferences against fiduciaries. Moreover, because fiduciaries . . . are expected to protect their charges when beneficiaries experience losses, judges are apt to blame the responsible fiduciary. Consequently, judges will resolve questions of doubt against the fiduciary.”) Juries arguably are just as susceptible to hindsight bias as are the courts, if not more so. See *id.* at 783 (“Courts have a pronounced propensity to evaluate the prudence or imprudence of a trustee's investment decision on the basis of information that the trustee could not have known at the time she made the decision. In trust litigation, trustees who are sued because their trust investments turned sour and resulted in losses to the beneficiaries have the unenviable challenge of starting out at the bottom of a deep hole.”). Applying Professor Alexander's analysis to a third party who deals with a trustee and where, after the fact, it turns out the transaction constituted a breach of trust, the third party will “have the unenviable challenge of starting out at the bottom of a deep hole” while trying to convince the judge or jury that it acted in good faith.

Once third parties realize that the good faith standard, when coupled with hindsight bias, is tantamount to strict liability, third parties will resort to the common law's broad duty of inquiry to make sure that the trustee is authorized to engage in the proposed transaction. See COOTER & ULEN, *supra* note 3, at 316–20. While this approach is rational on an individual basis, it is inefficient overall for the reasons given above. See *supra* notes 154–61 and accompanying text.

²²⁸ See *supra* note 140 and accompanying text.

more complete economic analysis should include the administrative costs involved in resolving disputes over which party will bear the loss associated with a breach of trust.²²⁹ Because the UTC's good faith standard is a soft, fact-sensitive standard similar to a negligence standard, it will, by nature, involve greater administrative costs as compared to the broad duty of inquiry under the common law approach or the UTPA's actual knowledge standard.²³⁰ Moreover, while random errors in the adjudicative process are assumed to cancel each other out, excessive and repetitive errors in one direction or the other do affect the economic analysis and the conduct of the parties.²³¹ This is why the risk of hindsight bias needs to be factored into the economic analysis of the efficiency of the UTC's good faith standard of liability.

Hindsight bias will result in increased costs for third parties dealing with a trustee because a court or jury will erroneously hold a third party liable for participating in a breach of trust. The effect of repetitive, biased application of a good faith standard is thus to hold third parties liable where they otherwise would not be. The de facto result is that the good faith standard will, in practice, be applied more like strict liability.²³² Third parties will come to recognize the bias and will respond accordingly—they will take precautions consistent with a strict liability standard.²³³ As a result, third parties will over-invest in precautions, conducting a broad inquiry before dealing with a trustee. While efficient from an individual third party's perspective, such a high level of precautions is not efficient from society's perspective. Once the additional costs of error due to hindsight bias are factored into the economic analysis, a strong argument can be made that the actual knowledge standard of liability is more efficient than the good faith standard.²³⁴

B. *Increased Costs of Litigation*

Even if hindsight bias were not a consideration,²³⁵ a good faith standard of liability substantially increases litigation costs for third

²²⁹ See COOTER & ULEN, *supra* note 3, at 320–23.

²³⁰ *Id.*

²³¹ *Id.* at 319–20.

²³² *Id.*

²³³ *Id.*

²³⁴ Most courts construe actual knowledge as imposing a high standard of proof—so high that there is little chance for hindsight bias. See *infra* notes 239–41 and accompanying text.

²³⁵ Hindsight bias may not be a consideration if the third party can overcome it (or if the court is not as susceptible to it) or, more likely, if the bias simply does not

parties dealing with a trustee. Anytime a trust beneficiary sues a trustee for breach of trust, if a third party was even remotely involved in the underlying activity the third party will be added to the suit as a matter of course.²³⁶ If the claim against the third party is without merit, the third party can file a motion for summary judgment.²³⁷ The third party's chances of prevailing on this motion directly affect the litigation costs associated with dealing with a trustee.

1. The Actual Knowledge Standard

Under the UTPA's actual knowledge standard of liability, the third party has a very good chance of prevailing on a motion for summary judgment if the third party has been added to the suit as a matter of course and there is little evidence to support the claim against it.²³⁸ Most courts impose a high pleading standard for actual knowledge. Because of this high threshold, courts are more inclined to rule as a matter of law that a plaintiff/trust beneficiary has *not* adequately alleged facts which warrant putting the third party

apply. One of the features of the modern trust is the increasing use of commercial trusts. Langbein, *supra* note 113. In such situations, there should not be any hindsight bias. To the extent hindsight bias is not present in all trust cases, the issue becomes whether it is better to assume it will be present or not in drafting a law that will apply to all cases. There are no definitive statistics on which type of trust is more common: a traditional trust with sympathetic trust beneficiaries or a modern commercial trust. It is difficult to say, therefore, how often hindsight bias will arise. Virtually all of the reported cases that arose under the UTPA, however, involved trusts where hindsight bias would have arisen. *See infra* notes 245–46 and accompanying text. A strong case can be made that if there is going to be a breach of trust, it is more likely to involve a traditional, protective personal trust with sympathetic trust beneficiaries. Hence, in drafting the law, the more likely scenario should control.

²³⁶ Even if the trust beneficiaries do not have a strong claim against the third party, they typically will add the third party to the complaint for discovery purposes, and possibly even for strike-suit settlement purposes. For a discussion of the concept of strike-suits, see John H. Langbein, *Living Probate: The Conservatorship Model*, 77 MICH. L. REV. 63, 66 n.14 (1978).

²³⁷ Alternatively, the party might file a motion to dismiss; but the motion for summary judgment is more likely. *See infra* notes 242–44 and accompanying text.

²³⁸ To obtain summary judgment, the court must find that there is no genuine issue of material fact. FED. R. CIV. P. 56. In assessing the likelihood that a court will grant a motion for summary judgment, an important factor is who bears the burden of proof. Martin Louis sums up this consideration as follows:

If the movant bears the burden of proof—either because he is the plaintiff or because he is asserting an affirmative defense—then he must establish all essential elements of the claim or defense. If the movant does not bear the burden of proof, then he can obtain summary judgment simply by showing the nonexistence of any essential element of the opposing party's claim or affirmative defense.

Martin B. Louis, *Federal Summary Judgment Doctrine: A Critical Look Analysis*, 83 YALE L.J. 745, 747 (1974).

through the time, hassle, and costs of a trial.²³⁹ The high pleading threshold also serves to deter trust beneficiaries from adding the third party to the suit in the first place. Under the UTPA, very few cases have been brought against a third party for participating in a breach of trust, and in almost all of them, the third party prevailed on its motion for summary judgment.²⁴⁰ Prevailing on a motion for summary judgment allows the third party to minimize the potential litigation costs associated with dealing with a trustee.

2. Good Faith Standard

Under a good faith standard of liability, however, there is (1) a greater probability that a third party will be sued, and (2) a much lower chance of prevailing on a motion for summary judgment. Good faith is such a fact-sensitive standard that the plaintiff bears a very low threshold of evidence to get his or her day in court. This low threshold implicitly encourages plaintiffs to bring claims under a good faith standard, as evidenced by the multitude of cases under the different UCC good faith provisions.²⁴¹ In addition, courts are very reluctant to grant a motion for summary judgment under a good faith standard.²⁴² As a result, under a good faith standard of liability,

²³⁹ In actual knowledge cases, the issue is fairly black and white—the defendant must prove only that he or she had no actual knowledge. *Wetherill v. Bank IV Kansas*, 145 F.3d 1187, 1192 (10th Cir. 1998) (applying a literal definition to the term “actual knowledge,” and recognizing the higher evidentiary standard which was intended to be applied to such transactions); *Collier v. Trustmark Nat’l Bank*, 678 So. 2d 693, 696–97 (Miss. 1996); *Huber v. Magna Bank*, 959 S.W.2d 812 (Mo. Ct. App. 1997); *see also* *Edwards v. Northwestern Bank*, 250 S.E.2d 651, 656 (Ark. Ct. App. 1979) (“Determining whether or not a bank acted with ‘actual knowledge’ that a fiduciary was committing a breach of his obligation presents little difficulty.”).

²⁴⁰ *See, e.g., Wetherill*, 145 F.3d at 1192; *Vournas v. Fidelity Nat’l Title Ins. Co.*, 86 Cal. Rptr. 2d 490, 497 (Ct. App. 1999); *Collier*, 678 So. 2d at 696–97; *Huber*, 959 S.W.2d at 812.

²⁴¹ *See* Lori J. Henkel, Annotation, *Bank’s Liability for Breach of Implied Contract of Good Faith and Fair Dealing*, 55 A.L.R. 4TH 1026 (1987); Andrea G. Nadel, Annotation, *What Constitutes Taking Instrument in Good Faith, and Without Notice of Infirmities or Defenses, to Support Holder-in-Due-Course Status, Under UCC § 3-302*, 36 A.L.R. 4TH 212 (1985); Jay M. Zitter, Annotation, *What Constitutes “Good Faith” Under UCC § 1-208 Dealing with “Insecure” or “At Will” Acceleration Clauses*, 85 A.L.R. 4TH 284 (1991).

²⁴² As a general rule, if a defendant must prove that he acted in good faith, he bears the burden of proof to establish all elements of his defense on a very fact-sensitive issue—his state of mind. *Percival v. Bruun*, 622 P.2d 413, 414 (Wash. Ct. App. 1981) (“Much depends on the credibility of the witnesses testifying as to their own state of mind. In these circumstances, the jury should be given the opportunity to observe the demeanor, during direct and cross-examination, of the witnesses whose states of mind are at issue. In short, good faith in general . . . is almost always a question for determination by the fact-finder rather than the court on a motion for summary judgment.”) (internal citations omitted); *see also* FED. R. CIV. P. 56; *Dobson v. Harris*, 530 S.E.2d 829, 837 (N.C. 2000).

a third party who deals with a trustee faces the potential for significantly increased litigation costs.

The increased litigation costs associated with a good faith standard will only be exacerbated under the UTC. The UTC fails to define good faith.²⁴³ The UTC also fails to indicate who bears the burden of proof.²⁴⁴ Instead, the UTC expressly provides in subsection 1012(e) that “[c]omparable protective provisions of other laws relating to commercial transactions or transfer of securities by fiduciaries prevail over the protection provided by this section.”²⁴⁵ Subsection (e) casts a large shadow over the UTC’s good faith standard of liability. Most states have a plethora of laws relating to commercial transactions, some with overlapping and conflicting protective provisions. Rarely will a state *not* have another law that governs the transaction in question.

The drafters of the UTC apparently decided that instead of attempting to create a uniform standard of liability for third parties dealing with a trustee, the Code would simply adopt whatever standard of liability would otherwise apply if the transaction did not involve a trustee—a rather novel, “chameleon-like” approach to a

²⁴³ The official comment to section 1012 expressly acknowledges that the “Code does not define ‘good faith’ for purposes of [the] section.” See UTC § 1012 cmt., 7C U.L.A. 261.

²⁴⁴ In that respect, the drafters of the UTC appear to have followed the lead of the original UCC, although these deficiencies in the UCC have been highly criticized. The original version of the UCC defined good faith, but it had different definitions for different scenarios. For a discussion of the wide range of opinions as to what constitutes good faith, and the UCC drafters’ reluctance to address which party should bear the burden of proof, see Irma S. Russell, *Reinventing the Deal: A Sequential Approach to Analyzing Claims for Enforcement of Modified Sales Contracts*, 53 FLA. L. REV. 49, 53 n.11, 67–71 (2001); see also Ronald J. Allen & Robert A. Hillman, *Evidentiary Problems in—and Solutions for—the Uniform Commercial Code*, 1984 DUKE L.J. 92. The revised UCC provides one definition for good faith, but this definition does not apply to Article 5. See U.C.C. REV. ART. 1 § 1-201, 1 U.L.A. 10–13 (Supp. 2004). The definition requires both subjective good faith and objective good faith. *Id.*; see also *infra* note 260 and accompanying text. This definition, however, has not been widely adopted to date.

²⁴⁵ UTC § 1012(e), 7C U.L.A. 261. The comment to section 1012 elaborates on this point:

This Code does not define “good faith” for purposes of this and the next section. Defining good faith with reference to the definition used in the State’s commercial statutes would be consistent with the purpose of this section, which is to treat commercial transactions with trustees similar to other commercial transactions.

Id. § 1012 cmt. Both of these provisions fail to indicate directly what is meant by “commercial” transactions or statutes. For a discussion of the ambiguity inherent in the root word “commerce,” see Grant S. Nelson & Robert S. Pushaw, *Rethinking the Commerce Clause: Applying First Principles to Uphold Federal Commercial Regulations but Preserving State Control over Social Issues*, 85 IOWA L. REV. 1, 14–25 (1999).

“uniform” law. While it is likely that the controlling state law will apply some shade of good faith, there are varying definitions.²⁴⁶ This will lead to a “moving target” approach, with different standards within each state depending on the transaction, and different standards among the states depending on each state’s commercial statutes.²⁴⁷

Subsection 1012(e) also casts doubt on the validity of the UTC’s distinction, in subsection 1012(a), between a third party who “assists” a trustee and a third party who “deals” with a trustee.²⁴⁸ Typically, state laws do not draw this distinction. To the extent subsection 1012(e) undermines subsection 1012(a), the added protection the UTC appears to give third parties who only “assist” a trustee may be illusory, depending on a state’s laws relating to commercial transactions. The UTC’s ambiguity will lead to even greater litigation costs.

The logic underlying the UTC approach to section 1012 appears to be that the only relevant variable is the *nature* of the transaction, not the parties to the transaction. That logic, however, overlooks not only the potential for hindsight bias based on the *parties*, but also the Uniform Fiduciaries Act (“UFA”).²⁴⁹ Approximately half of the states have adopted the UFA.²⁴⁹ The UFA provides special protection for third parties who deal with a fiduciary, including a trustee, not

²⁴⁶ See *infra* notes 259–63 and accompanying text; see also *supra* note 244 for a discussion that is critical of the original version of the UCC for failing to give a uniform definition of good faith. The UTC approach to good faith is even more open-ended, expanding the confusion inherent in the term itself to include all references to the phrase “good faith” in all of a state’s laws relating to commercial transactions.

²⁴⁷ There are a multitude of laws that may apply depending on the jurisdiction: the Uniform Commercial Code, the Uniform Fiduciaries Act, the Uniform Sales Act, the Uniform Warehouse Receipts Act, the Uniform Bills of Lading Act, the Uniform Stock Transfers Act, the Uniform Partnership Act, the Uniform Contract Law, the Uniform Law on the International Sale of Goods, and the Uniform Law on the Formation of Contracts for the International Sale of Goods, etc. This list is not exhaustive, and it says nothing of the non-uniform laws that may apply. Even if a court were to refer only to the UCC, it is unclear which UCC definition of good faith would apply. See *supra* note 244 for a discussion of the ambiguity with respect to “good faith” in the UCC alone. If the trust is governed by one state’s laws, but the third parties are located in—and the transaction occurs in—another state, questions will arise as to which state’s laws should control; this will produce the antithesis of a “uniform” law.

²⁴⁸ See UTC § 1012(a), 7C U.L.A. 261. To the extent the UTC recognizes that parties who merely “assist” a trustee are entitled to greater protection, the best way to achieve that objective is to grant these parties protection as long as they do not have actual knowledge of a breach, regardless of whether one rejects the actual knowledge standard as applied to those who deal with a trustee.

²⁴⁹ See UNIF. FIDUCIARIES ACT (UFA), 7A U.L.A. 364 (2002).

because of the nature of the transaction, but because of the parties to the transaction. The UFA provides, as a general rule, that a third party who deals with a trustee in a whole host of commercial transactions is not liable for participating in a breach of trust unless the third party has actual knowledge of the breach or acts in bad faith.²⁵⁰ The UTC's express provision that "[c]omparable protective provisions of other laws relating to commercial transactions . . . prevail over the protection provided by this section" arguably means that in states that have adopted the UFA, for transactions that come within the scope of the UFA, the UFA's "actual knowledge or bad faith" standard, not the UTC's good faith standard, applies to the third party who dealt with the trustee.²⁵¹ Yet for other transactions with a trustee that do not come within the scope of the UFA, the UTC's good faith standard applies—unless the state has another law with a different protective provision.

The ambiguity and uncertainty inherent in section 1012 creates a legal quagmire that will result in substantial litigation costs for third parties who deal with a trustee,²⁵² and which will undermine the Code's goal to provide a uniform approach to the law of trusts.²⁵³

C. Economic Conclusion

From an economic perspective, the UTC's good faith standard is inefficient as compared to the UTPA's actual knowledge standard of liability. The soft nature of the good faith standard increases the

²⁵⁰ See generally *id.*

²⁵¹ For example, see *County of Macon v. Edgcomb*, 654 N.E.2d 598, 601–02 (Ill. App. Ct. 1995), where the court acknowledged the different protective standards under the UFA and the UCC and held that the UFA provision controlled. One can only assume—based on its express provisions—that if this jurisdiction were to adopt the UTC, the UFA's actual knowledge or bad faith standard would still control as to those transactions with trustees that are within the scope of the UFA.

²⁵² The ambiguity inherent in section 1012's good faith standard also lessens the chance that the parties to any litigation involving it will be able to reduce their litigation costs by settling. Without a good understanding of the respective legal status of each party's position, there is less of a chance that the parties will agree on a common valuation upon which they could settle. See Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEGAL STUD. 399, 449–50 (1973). The vast uncertainty as to the meaning of the law also increases the chances of an erroneous decision following litigation. *Id.* at 450.

²⁵³ Although section 1012 of the UTC creates more uncertainty about the standard of liability for third parties who participate in a breach of trust, there is one aspect of section 1012 that is certain—it does not adopt or apply an actual knowledge standard of liability. See *supra* notes 173–77 and accompanying text. In light of the success of the actual knowledge standard under the UTPA, one would have expected the drafters of the UTC to have done a better job of explaining why they were changing the standard of liability.

probability of litigation. If sued, it is extremely unlikely that the third party will prevail on a motion for summary judgment, even if the claim against the third party lacks merit. Coupled with the historical judicial bias in favor of trust beneficiaries, the good faith standard of liability is tantamount to strict liability.²⁵⁴ The third party faces a significant risk of erroneously being held liable. The third party's best chance of prevailing is on appeal—a daunting route that only further increases the potential litigation costs. The increased litigation and error costs associated with the UTC's good faith standard of liability cast serious doubt on its efficiency. In a perfect economic world, an actual knowledge standard of liability would thus be more efficient. It minimizes (1) the risk of hindsight bias, and (2) the litigation costs associated with dealing with a trustee.

VII. EFFICIENCY OF BAD FAITH VERSUS GOOD FAITH

While a law and economics analysis of the issue of what should be the standard of liability for a third party participating in a breach of trust supports the conclusion that the actual knowledge standard is the most efficient, in the real world values and considerations other than efficiency often enter into the analysis.²⁵⁵ Equitable considerations in particular can be influential,²⁵⁶ and the good faith standard is admittedly more equitable than the actual knowledge

²⁵⁴ See Rachlinski, *supra* note 220, at 100.

²⁵⁵ See POSNER, *supra* note 1, at 27, 29–31 (explaining that it is unclear what those values are as applied to the issue of a third party's liability for participating in a breach of trust, and that the drafting process that led to the adoption of section 1012 of the UTC does not disclose them); see also Rubin, *supra* note 2, at 51; *supra* note 183 and accompanying text. In addition, the law and economics literature acknowledges that statutory laws tend naturally to be more *inefficient* than judicially created doctrines. See POSNER, *supra* note 1, at 27. A simple explanation of why this may be true can be found in section 1012 of the UTC. When an issue is being litigated, it is the sole focus of the parties and the court. The issue is thoroughly briefed and argued. The court spends a considerable amount of time considering all the possible ramifications of its ruling. In contrast, the UTC is a comprehensive attempt at codifying almost all of the law of trusts. See UTC, prefatory note, 7C U.L.A. 143–47 (Supp. 2004). Section 1012 is only one section out of almost one hundred, and this count does not include the many, detailed subsections. One possibility is that not much attention was paid to section 1012. The Committee also might have reasoned that there is no difference between good faith, actual knowledge, or bad faith standards; although the law as it has developed does not support this explanation. See *supra* notes 173–77, 239–241 and accompanying text. Unfortunately for third parties who end up being sued for participating in a breach of trust, the governing standard of liability seems not to have been a focus of the drafting Committee's attention.

²⁵⁶ For several works discussing the question of whether the law does, and should, favor equity or efficiency, see *Symposium on Efficiency as a Legal Concern*, 8 HOFSTRA L. REV. 485 (1980).

standard.²⁵⁷ Where a third party suspects that a proposed transaction may constitute a breach of trust, permitting the third party to proceed with impunity is inequitable.²⁵⁸ To the extent one believes that the economic analysis is inconclusive, imposing a limited duty of inquiry on third parties interested in dealing with a trustee has the added benefit of being more equitable. To the extent one favors imposing a limited duty of inquiry on a third party interested in dealing with a trustee, however, a bad faith standard of liability is a more efficient way of imposing the limited duty of inquiry.

A. *Good Faith Versus Bad Faith Standards of Liability*

At an abstract level, the good faith and bad faith standards of liability are one and the same. Many courts define good faith as the absence of bad faith.²⁵⁹ Other courts define bad faith as the absence of good faith.²⁶⁰ Both standards focus on the party's state of mind²⁶¹ and on whether there is reason to suspect that the conduct in question is inappropriate.²⁶² Both standards, in essence, impose a limited duty of inquiry under the appropriate fact pattern. But while

²⁵⁷ See *supra* note 183.

²⁵⁸ See *supra* note 183.

²⁵⁹ See *Thomas v. Sullivan*, No. 90-2058, 1991 U.S. App. LEXIS 896 (4th Cir. Jan. 23, 1991) (unpublished opinion); *In re Piper's Alley Co.*, 69 B.R. 382, 385 (Bankr. N.D. Ill. 1987); *Kuron v. Hamilton*, 752 A.2d 752, 758 (N.J. Super. Ct. App. Div. 2000).

²⁶⁰ These two standards are simply flip sides of the same coin. See *Sec. Mut. Cas. Co. v. Affiliated FM Ins. Co.*, 471 F.2d 238, 242 (8th Cir. 1972); *Stetzer v. Dunkin' Donuts, Inc.*, 87 F. Supp. 2d 104, 114 (D. Conn. 2000); *Cassady-Pierce Co. v. Burns*, 169 B.R. 563, 567 (Bankr. W.D. Penn. 1994).

²⁶¹ Whether these standards should be defined objectively or subjectively is the subject of much debate. See Patricia L. Heatherman, *Good Faith in Revised Article 3 of the Uniform Commercial Code: Any Change? Should There Be?*, 29 WILLAMETTE L. REV. 567, 579 (1993); Allen R. Kamp, *Uptown Act: A History of the Uniform Commercial Code: 1940-49*, 51 SMU. L. REV. 275, 322 (1998); Donald B. King, *Major Problems with Article 2A: Unfairness, "Cutting Off" Consumer Defenses, Unfiled Interests, and Even Adoption*, 43 MERCER L. REV. 869, 877 (1992). If the standards are defined subjectively, it arguably is possible that a person may have no state of mind with respect to an issue if he or she was not aware of the issue, regardless of whether the person should have been aware. Under the objective approach, if the party should have been aware of the issue, he or she will be charged with the appropriate state of mind.

²⁶² RESTATEMENT (SECOND) OF TRUSTS § 297 cmts. a-g (1959). If there is reason to suspect that the proposed conduct or transaction is wrongful, but the party fails to investigate, the party acts in bad faith. "A finding of bad faith is warranted where (one acts) knowingly and recklessly." *Barnes v. Dalton*, 158 F.3d 1212, 1214 (11th Cir. 1998). If there is nothing inappropriate about the proposed transaction and there is no reason to suspect otherwise, the party acts in good faith. See *In re Interstate Cigar Co.*, 285 B.R. 789, 797 (Bankr. E.D.N.Y. 2002) (defining "'good faith' as 'lack of actual knowledge of actual fraud' . . . or 'lack of knowledge of circumstances requiring further investigation'").

good faith and bad faith are conceptually and legally flip sides of the same standard, there are a couple of important practical differences between the two.²⁶³

1. Burden of Proof

If a party bears the burden of proof on an element of a rule, the burden creates a de facto presumption.²⁶⁴ If the plaintiff bears the burden of proof as to an element, the burden creates a presumption that the defendant *is not* liable unless the plaintiff can meet its burden.²⁶⁵ If the defendant bears the burden of proof as to the element, the burden creates a presumption that the defendant *is* liable unless the defendant can overcome the presumption.²⁶⁶

The general rule is that a good faith standard of liability puts the burden of proof on the party claiming to have acted in good faith.²⁶⁷ The party must prove that he or she was “without notice of any suspicious circumstances which would put a reasonable person on inquiry.”²⁶⁸ If the party fails to meet the burden of proof, the party

²⁶³ See Russell, *supra* note 244, at 74 (“The distinction between the good faith and bad faith standards often seems to be a matter of allocating the burden of proof.”). In addition, “the choice of a good faith or a bad faith standard is more than a semantic distinction; it influences the focus of the court’s inquiry and, in close cases, may determine which party prevails.” *Id.* at 54.

²⁶⁴ PETER CLARK, CODE PLEADING § 96, at 609 (2d ed. 1947) (“One who must bear the risk of getting the matter properly before the court, if it is to be considered at all, has to that extent the dice loaded against him.”); see also Hay, *supra* note 189, at 654 (“In this setting, the burden of proof is a default rule instructing the court what to do if neither party presents the evidence. If the plaintiff has the burden of proof, she loses if no evidence is presented; if the defendant has the burden, he loses if no evidence is presented.”).

²⁶⁵ *Id.*

²⁶⁶ *Id.*

²⁶⁷ 92A C.J.S. *Vendor and Purchaser* §523 (1997) (“As a general rule, the person relying on the defense of a bona fide purchaser for value without notice normally has the burden of proving that defense.”); see also 77 AM. JUR. 2D *Vendor and Purchaser* § 524 (2002); BOGERT, *supra* note 27, § 881 (“Some divergence of judicial opinion has been expressed with regard to the burden of proving that the legal holder is or is not a bona fide purchaser. It would seem that ordinarily the necessity to prove not only the acquisition of legal title, but also the payment of value therefor, and innocence at the time of payment and of getting title, should rest upon the party who claims that he is a bona fide purchaser for value in the technical sense The defendant should be required to go on and complete the proof of his defense by supplying the additional elements of payment of value and innocence. These are facts peculiarly within his knowledge.”). It is assumed that under the UTC a third party will most likely bear the burden of proof, but the issue is open to debate. See *supra* note 244 and *infra* note 271 and accompanying text.

²⁶⁸ Caruso v. Parkos, 637 N.W.2d 351, 359 (Neb. 2002).

loses.²⁶⁹ The UTC provision that protects a third party who “in good faith and for value”²⁷⁰ deals with a trustee reads as if it is establishing an affirmative defense. The burden of proof appears to be on the third party.²⁷¹ If the courts follow the general rule, the burden of proof will be on the party seeking protection—the third party. The good faith standard of liability will create a presumption of liability if the transaction constitutes a breach—a presumption that the third party can overcome only by proving that he or she acted in good faith.²⁷²

Where the standard of liability is a bad faith standard, the general rule is that the party asserting bad faith bears the burden of

²⁶⁹ *Id.* Meeting this burden is particularly difficult because the party must prove a negative—that it was without notice of suspicious circumstances. See *supra* note 263 and accompanying text.

²⁷⁰ UTC § 1012(a), 7C U.L.A. 261. The UTC fails to state which party has the burden of proof with respect to the issue of the third party’s acting in good faith and for value. See UTC § 1012 & cmt., 7C U.L.A. 261 (Supp. 2004). The phrasing of the statutory provision, however, arguably supports the general rule that the burden rests with the third party who claims to be a good faith purchaser. See *supra* note 269. From an economic perspective, because the overwhelming majority of transactions between trustees and third parties do not constitute a breach of trust, at first blush it appears illogical to adopt a rule of law that starts with the presumption that the third party is liable if the transaction, in fact, constitutes a breach of trust. Because the overwhelming majority of the transactions between a modern trustee and third party do not constitute a breach of trust, it would appear to be more logical to place the burden of proof on the party challenging that probability. “A further factor which seems to enter into many decisions as to allocation is a judicial, i.e., wholly nonstatistical, estimate of the probabilities of the situation, with the burden being put on the party who will be benefited by a departure from the supposed norm.” Cleary, *supra* note 184, at 12–13 (“Since the plaintiff is the party seeking to disturb the existing situation by inducing the court to take some measure in his favor, it seems reasonable to require him to demonstrate his right to relief.”); see also Hay, *supra* note 184, at 655–56. In addition, a rule that reduces the incentive for trust beneficiaries to challenge such transactions would promote overall efficiency. Placing the burden of proof on the plaintiff (i.e., the trust beneficiaries in this scenario) would increase the costs of litigation for the trust beneficiaries, thereby decreasing the incentive for trust beneficiaries to sue a third party when a transaction does not turn out as well as they had hoped. This would promote overall efficiency. On the other hand, placing the burden of proving good faith on the third party decreases the costs of litigation for frustrated trust beneficiaries, thereby increasing the probability that they will bring suit when the trust transactions turn out poorly for them. Cleary, *supra* note 184, at 11–12. Applying this reasoning to trust transactions, the burden of proof arguably should be on the plaintiff to show that the third party acted in bad faith.

²⁷¹ Cleary, *supra* note 184, at 11–12.

²⁷² See POSNER, *supra* note 1, at 603–04 (“The preponderance-of-the-evidence standard that governs civil cases directs the trier of fact to find in favor of the party (usually though not always the plaintiff) who has the burden of proof *if that party’s version of the disputed facts is more probably true than the other party’s version.*”) (emphasis added).

proof.²⁷³ A bad faith standard of liability creates a de facto presumption that the defendant is not liable.²⁷⁴ If the plaintiff cannot carry his or her burden of proof, the plaintiff loses. As applied to a third party who dealt with a trustee, a bad faith standard of liability would put the burden of proof on the trust beneficiaries to prove that the third party acted wrongfully in dealing with the trustee.²⁷⁵

2. Costs of Litigation

A bad faith standard of liability also increases the chances that a third party who is sued without merit can minimize the litigation costs by prevailing on a motion for summary judgment. Although bad faith, like good faith, is a fact-sensitive issue that appears inappropriate for resolution on a motion for summary judgment,²⁷⁶ a number of courts have granted a third party's motion for summary judgment under the Uniform Fiduciaries Act on the grounds that the plaintiff did not offer adequate evidence showing that the third party acted in bad faith.²⁷⁷ There is theoretical support for the courts distinguishing motions for summary judgment under a bad faith standard from motions for summary judgment under a good faith standard. Commentators have argued that courts should take into consideration whether the moving party bears the burden of proof, and that courts should be more willing to grant the motion where the movant does *not* bear the burden of proof.²⁷⁸

²⁷³ Cases decided based on the Uniform Fiduciaries Act clearly establish that the plaintiff bears the burden of proving that the third party acted in bad faith. If the plaintiff is unable to carry its burden the plaintiff loses. *See* Commercial Sav. Bank of Sterling v. Baum, 327 P.2d 743, 745 (Colo. 1958) (“The burden of proof is on the plaintiff to establish actual knowledge and bad faith.”); Union Bank & Trust Co. v. Girard Trust Co., 161 A. 865, 868 (Pa. 1932) (“As the instrument was good on its face, there was no apparent reason for inquiry; it remained good until shown to have been taken in ‘bad faith,’ and the burden of proving that was on plaintiff.”); *see also* *In re Broadview Lumber Co.*, 118 F.3d 1246, 1251 (8th Cir. 1997) (stating that in order to establish liability, the plaintiff “must establish that Mansfield was a fiduciary, that Mansfield breached his fiduciary duty, and that Mercantile [the third party who dealt with the alleged fiduciary] had either actual knowledge of the breach or sufficient facts such that its conduct amounted to bad faith.”).

²⁷⁴ *See supra* notes 265–67 and accompanying text.

²⁷⁵ *See supra* notes 265–67 and accompanying text.

²⁷⁶ *See supra* note 242 and accompanying text; *see also* *New Jersey Title Ins. Co. v. Caputo*, 748 A.2d 507 (N.J. 2000).

²⁷⁷ *See In re Bishop, Baldwin, Rewald, Dillingham & Wong, Inc.*, 751 P.2d 77 (Haw. 1988); *Hosselton v. K's Merch. Mart, Inc.*, 617 N.E.2d 797 (Ill. App. Ct. 1993); *Gibson v. Citizens Nat'l Corp.*, No. 2003-CA-000243-MR, 2004 WL 1486941 (Ky. Ct. App. July 2, 2004); *Nations Title Ins. of N.Y., Inc. v. Bertram*, 746 N.E.2d 1145 (Ohio Ct. App. 2000); *Levy v. First Pa. Bank N.A.*, 487 A.2d 857 (Pa. Super. Ct. 1985).

²⁷⁸ *See, e.g.,* *Louis, supra* note 244, at 748.

B. A Bad Faith Standard Offsets Hindsight Bias

A bad faith standard of liability would go a long way towards countering the natural bias courts and juries have in favor of trust beneficiaries and against a third party who deals with a trustee. The bad faith standard forces the trier of fact to start with a presumption that the third party acted in good faith.²⁷⁹ The trust beneficiaries would bear the burden of proving that the third party acted in bad faith.²⁸⁰ As a general rule, bad faith requires more than mere negligence; bad faith requires that the third party “disregard circumstances that are suggestive of a breach [of fiduciary duty] and are sufficiently obvious such that it is in bad faith to remain passive.”²⁸¹ Other courts have defined bad faith as requiring a “subjective deliberate desire to evade knowledge because of belief or fear that inquiry would disclose vice or defect in the transaction, an intentional closing of the eyes or stopping of the ears.”²⁸² Moreover, a bad faith standard of liability increases the chances that the third party might be able to minimize the litigation costs by prevailing on a motion for summary judgment. Even if unsuccessful on the motion, although the bad faith standard arguably is just as soft and open to hindsight bias as the good faith standard, the bad faith standard still requires the court or jury to find that the third party acted in bad faith; the good faith standard simply requires the court or jury to conclude that the third party did not persuade them that it acted in good faith. At a minimum, the “no bad faith” standard gives the third party a fighting chance at trial. In light of the hindsight bias in favor of trust beneficiaries, a bad faith standard would decrease the potential for erroneously imposed liability.²⁸³ Given the UTC’s objective, which is to treat persons dealing with a trustee as if they

²⁷⁹ See *supra* notes 265–67 and accompanying text.

²⁸⁰ See *supra* notes 275–77 and accompanying text.

²⁸¹ *In re Broadview Lumber Co.*, 118 F.3d 1246, 1251 (8th Cir. 1997) (defining “bad faith” as it is used in Missouri’s Uniform Fiduciaries Law); see also *United States v. Manchester Farming P’ship*, 315 F.3d 1176, 1185 (9th Cir. 2003) (defining “bad faith,” for purposes of recovering attorney’s fees, as “not simply bad judgment or negligence, but rather [as] impl[y]ing the conscious doing of a wrong because of dishonest purpose or moral obliquity . . . [and] contemplat[ing] a state of mind of affirmatively operating with furtive design or ill will”).

²⁸² *Attorneys Title Guar. Fund v. Goodman*, 179 F. Supp. 2d 1268, 1277 (D. Utah 2001); see also *UNR-Rohn, Inc. v. Summit Bank*, 687 N.E.2d 235, 239 (Ind. Ct. App. 1997) (“‘Bad faith’ is the antithesis of good faith.”).

²⁸³ In the event one concludes that the “no bad faith” standard does not adequately counter the jury’s natural bias in favor of the trust beneficiaries, then the standard that one should favor is the “no duty of inquiry/actual knowledge” standard of liability as recommended by Professor Fratcher. See Fratcher, *supra* note 78, at 662–63.

were engaged in a transaction not involving trust property,²⁸⁴ a bad faith standard of liability does a better job of promoting that objective than does the good faith standard of liability because the former takes into consideration the natural bias courts and juries will have in favor of trust beneficiaries.

VIII. CONCLUSION

The UTC grants broad powers to each trustee and abolishes the common law broad duty of inquiry. The net effect, vis-à-vis third parties interested in dealing with a trustee, is to turn each trustee into an agent. Having transformed the trustee, the UTC then applies the prevailing standard of liability for third parties interested in dealing with an agent. Third parties are protected as long as they act in good faith. The problem is that the UTC does not give trust beneficiaries the same power and control over the trustee that a principal has over an agent. Courts and juries intuitively recognize the inequity of holding trust beneficiaries responsible for the actions of their trustee when the trust beneficiaries neither select nor control the trustee. Courts and juries will couple hindsight bias with the fact-sensitive good faith standard to apply a de facto strict liability standard to third parties who participate in a breach of trust.

The most efficient way to counter the natural bias courts and juries have in favor of trust beneficiaries is to adopt an actual knowledge standard of liability. It is inequitable, however, to allow third parties who intentionally decide not to investigate suspicious facts to prevail over trust beneficiaries. A good argument can be made that a bad faith standard of liability best balances the competing economic and equitable considerations. Those jurisdictions that are inclined to adopt the UTC should consider revising section 1012 to provide that a third party who deals with a trustee is not liable unless he or she had actual knowledge of the breach or acted in bad faith. Those jurisdictions that are inclined to

²⁸⁴ UTC, Overview of Uniform Trust Code, 7C U.L.A. 145–47 (Supp. 2004); UTC § 1012 cmt., 7C U.L.A. 229 (Supp. 2004). The UFA employs a “no liability absent actual knowledge or bad faith” standard of liability. *See supra* notes 249–51 and accompanying text. The UFA has proved successful in facilitating transactions between third parties and fiduciaries. The UFA has successfully balanced the needs of protecting beneficiaries, while at the same time protecting the interests of third parties who deal with fiduciaries. The UFA permits third parties to deal with fiduciaries as they would other agents acting on behalf of a principal. Just as the “no liability absent actual knowledge or bad faith” standard has been successful in permitting third parties to deal with fiduciaries, the “no liability absent actual knowledge or bad faith” standard would permit third parties to deal with trust property as if the property were not held by a trustee.

adopt the most efficient approach should consider Professor Fratcher's actual knowledge standard.

In those jurisdictions where the Uniform Trust Code's good faith standard is adopted,²⁸⁵ from a law and economics perspective one would predict greater use of trust protectors. A trust protector is a relatively new development, used primarily in offshore asset protection trusts.²⁸⁶ A trust protector can be given complete control over the trust, including the power to terminate the trust or replace the trustee if he or she deems it appropriate.²⁸⁷ Inasmuch as the Uniform Trust Code shifts more of the risk of loss to the trust beneficiaries, law and economics would predict settlors of private trusts to respond by increasingly appointing trust protectors to facilitate greater control and supervision over the trustee—thereby facilitating greater precautions on behalf of the trust beneficiaries to offset the increased risks they now bear.²⁸⁸ Where a trust protector is appointed, however, interesting issues will arise as to the scope of the trust protector's duty to monitor and supervise the trustee.²⁸⁹ No doubt some trust protectors will charge a fee for their services. In addition, in the event of a breach of trust, trust beneficiaries will sue the trust protector in addition to suing the third party who

²⁸⁵ Or even where the UTPA's actual knowledge standard applies, for that matter.

²⁸⁶ A trust protector is typically used in the offshore asset protection trust setting to help insulate the settlor from creditor's claims and the risk of an unsavory trustee. Robert T. Danforth, *Rethinking the Law of Creditors' Rights in Trusts*, 53 HASTINGS L.J. 287, 309–10 (2002). Typically a settlor appoints a trust protector who is friendly to the settlor and who it is assumed will follow the settlor's requests and do what is best for the settlor. Elena Marty-Nelson, *Taxing Offshore Asset Protection Trusts: Icing on the Cake?*, 15 VA. TAX REV. 399 (1996); Fredrick J. Tansill, *Asset Protection Trusts (APTS): Non-Tax Issues*, in INTERNATIONAL TRUST & ESTATE PLANNING 311, 345 (7th Annual ALI-ABA Advanced Course of Study 2003), available at WL SK024 ALI-ABA 311.

²⁸⁷ Edward C. Halbach, Jr., *Uniform Acts, Restatements, and Trends in American Trust Law at Century's End*, 88 CAL. L. REV. 1877, 1916 (1999).

²⁸⁸ The Uniform Trust Code authorizes the use of trust protectors. UTC § 808(b)–(d), 7C U.L.A. 236 (Supp. 2004). The trust beneficiaries can even be given the power to appoint successor trust protectors, thereby further solidifying the relationship between the trust protector and the trust beneficiaries and maximizing the probability that the trust protector will take precautions to protect the interests of the trust beneficiaries from a breach of trust. Madeline J. Rivlin, *Dynasty Trusts*, in PRACTICING LAW INST., ESTATE PLANNING AND ADMINISTRATION 947, 961 (Practicing Law Inst. Tax Law and Estate Planning Course Handbook Series 2003), available at WL 325 PLI/Est 947. The use of trust protectors will also reduce the dominance the trustee holds over the trust beneficiaries, thereby reducing the potential for hindsight bias—or possibly expanding it to include the trust protector. See *supra* note 193.

²⁸⁹ The Uniform Trust Code provides that the default rule is that a trust protector owes the relevant parties a fiduciary duty, but the settlor may opt out of the default rule. UTC § 808 cmt., 7C U.L.A. 236–37 (Supp. 2004).

participated in the breach of trust. The use of trust protectors will only further increase the costs of administration associated with the good faith standard.

Maybe Professor Fratcher was not so wrong after all.