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THE FUNCTIONS OF TRUST LAW: A COMPARATIVE LEGAL AND ECONOMIC ANALYSIS

HENRY HANSMANN*

UGO MATTEI**

In this Article, Professors Henry Hansmann and Ugo Mattei analyze the functions served by the law of trusts and ask, first, whether the basic tools of contract and agency law could fulfill the same functions and, second, whether trust law provides benefits that are not provided by the law of corporations. The authors' analysis is motivated in part by the increasing interest in the trust, a familiar feature of common-law jurisdictions, in a number of civil law countries, and in part by the important role that trusts, for example pension and mutual funds, have come to play in capital markets. The authors conclude that the important contribution of trust law lies not in its well-recognized role of ordering, via default rules of contract, the relationships among parties to the trust; rather, the principal benefit of trust law lies in its ordering of relationships between these parties and third parties with whom they deal, relationships that cannot be rearranged easily by contract. Particularly, trust law allows the parties to the trust to partition off a discrete set of assets for separate treatment in relationships formed with creditors. The essential role of the trust, therefore, is to perform a property law-like, rather than a contract law-like, function. Moreover, the trust provides flexibility in organizational structure unavailable under even the more liberal business corporation statutes. The authors close by noting the convergence of trust and corporate law and questioning whether the roles performed by the two organizational types could just as well be served by a single legal form.

INTRODUCTION

Students of comparative law have long considered the private trust to be one of the major features distinguishing the English-inspired common law legal systems from the civil law systems of conti-

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nental Europe.¹ In common law jurisdictions, the trust is among the most important creations of the law of equity; for hundreds of years it has played a vital role in organizing transactions of both a personal and a commercial character. In the civil law countries, in contrast, the private trust does not exist as a general form; indeed, its central elements run counter to important tenets of civil law doctrine.

The simultaneous existence of these contrasting regimes naturally raises some basic questions: What is the role of the law of trusts? Does that body of law perform a vital function in the common law countries, facilitating an important set of socially beneficial transactions that would be difficult or impossible without trust law? Or is the law of trusts just an anachronism, originally devised to compensate for the defects of the ill-formed English law of half a millennium ago, but largely superfluous in modern common law systems with flexible general rules of contract and agency? Similarly, from the perspective of the civil law countries, would adoption of the trust be a significant reform, filling an important gap that remains in their legal institutions, or would it, on the contrary, add little that is useful to existing legal doctrine?

Interestingly, these basic questions have largely been ignored by contemporary legal scholars. While there is an extensive legal literature on the institution of the trust, that literature—whether domestic or comparative in focus—tends to be doctrinal rather than broadly functional in perspective.²

A better understanding of the functions of trust law has substantial practical importance today. This is particularly obvious in Europe. Increasing numbers of civil law countries have adopted trust-like institutions,³ and important efforts are underway to promote recognition

¹ See, e.g., René David & John E.C. Brierley, *Major Legal Systems in the World Today* 322-24 (2d ed. 1978) (analyzing trusts and noting doctrinal uniqueness).

² Important exceptions are John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 Yale L.J. 625 (1995), which we discuss in Part III.B infra, and Anthony Ogus, *The Trust As Governance Structure*, 36 U. Toronto L.J. 186 (1986). See also Antonio Gambaro, *Il Trust in Italia e Francia*, in 1 *Scritti in Onore di Rodolfo Sacco* 495 (Paolo Cendon ed., 1994); Hein Kötz, *Trust und Treuhand* (1963).

³ See *infra* note 31. It has been argued that the relative efficiency of the trust in comparison with its civil law counterparts explains the tendency toward importation of the trust into the civil law. See Gambaro, *supra* note 2. Gambaro applies the model developed in Ugo Mattei & Francesco Pulitini, *A Competitive Model of Legal Rules*, in *The Competitive State* 207 (Albert Breton et al. eds., 1991) (suggesting competitive model for describing relationship between sources of law). See generally Ugo Mattei, *Efficiency in Legal Transplants: An Essay in Comparative Law and Economics*, 14 *Int'l Rev. L. & Econ.* 3 (1994) (arguing that efficiency is reason for changes in legal systems, and trend toward adoption of trusts in particular).

by nontrust jurisdictions of trusts formed in other countries.⁴ One reason for this is the increasing pressure within the European Community to reduce the barriers among the private law systems of the member states and particularly between the common law and civil law systems.⁵ Another reason is the demand for suitable legal forms for professional management of invested funds. Some observers feel the trust is likely to become the most important contribution of the common law tradition to the European system of private law.⁶

It is not only the Europeans, however, who can benefit from a better understanding of the functions of trust law. In the United States, academic commentary and law school curricula continue to focus on the private trust in its historical role as a device for intrafamily wealth transfers. Today, however, that role is relatively trivial. Vastly more important is the enormous—though commonly neglected—role that private trusts have come to play in the American capital markets.⁷ To take just the most conspicuous examples, pension funds and mutual funds, both of which are generally organized as trusts, together now hold roughly forty percent of all United States equity securities

⁴ Such recognition is promoted most conspicuously by the Convention on the Law Applicable to Trusts and On Their Recognition, reproduced in 2 *Actes et documents*, Proceedings of the Fifteenth Session 361 (1985), which was adopted at the Hague in 1985. For comments, see generally Alfred E. von Overbeck, Explanatory Report, 2 *Actes et documents*, Proceedings of the Fifteenth Session 370 (1985) (providing history and section by section commentary on Convention); Emmanuel Gaillard & Donald T. Trautman, *Trusts in Non-Trust Countries: Conflicts of Laws and the Hague Convention on Trusts*, 35 Am. J. Comp. L. 307 (1987) (describing Convention and surrounding law). As of March 1997, the Hague Convention has been ratified by Australia, Canada, Italy, Malta, the Netherlands, and the United Kingdom.

⁵ Apart from the efforts of harmonization carried out by the European Union, it is noteworthy that recent years have brought the founding of two new international legal periodicals that are expressly devoted to European private law and that seek to develop a better dialogue among European private law scholars: the *European Review of Private Law*, published in English, French, and German; and the *ZEuP* (*Zeitschrift für Europäisches Privatrecht Manuscripte*), published mostly in German. For a survey of these projects, see Mauro Bussani & Ugo Mattei, *The Common Core Approach to European Private Law*, 3 Colum. J. Eur. L. 339 (1997/1998).

⁶ An example is offered by the working group at the University of Nijmegen Law Faculty (Netherlands), comprised of lawyers from most European countries and headed by Professors Bas Kortmann and Rick Verhagen, which is in the process of elaborating "Principles of European Trust Law" that are intended to serve as guidelines for adoption by civil law jurisdictions (either through the legislature or the courts) of legal institutions based on the common law experience with the trust.

⁷ A recent and important exception to the general neglect of the new commercial trusts is John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 Yale L.J. 165 (1997) (arguing that trusts have become predominately commercial). See also Steven Schwarcz, *Unlocking the Mystery of Commercial Trusts as Business Organizations* (unpublished manuscript, on file with authors).

and thirty percent of corporate and foreign bonds.⁸ Similarly, turning from the demand side to the supply side of the securities markets, asset securitization trusts are now the issuers of a large fraction of all outstanding American debt securities—more than \$2 trillion worth.⁹

A clear understanding of the functions served by the law of trusts offers insight not only into these and other rapidly growing institutions at the core of our capital markets, but also into the functions of organizational law in general. The private trust is among the simplest of the forms of enterprise organization provided for in the law and thus makes a particularly convenient focus for study. An analysis of the trust offers important perspective on more complex forms of organization, including partnerships and corporations in their assorted forms, as well as new organizational types (such as limited liability companies) that have recently appeared on the legal scene.

The common law divides trusts into two broad types: private trusts and charitable trusts. While European law has strongly resisted the private trust, it offers a relatively close substitute for the charitable trust in the form of the civil law foundation.¹⁰ Moreover, the existing literature has arguably gone further in exploring the functional role of the charitable trust and its close cousin, the nonprofit corporation, than it has in exploring the private trust.¹¹ For both these reasons, we confine our focus here to private trusts.

We begin with an overview of the conceptual and historical differences between the common law and the civil law systems that have led one system to adopt the trust while the other has not. We also explore briefly the various civil law institutions that function as substitutes for the trust. We then turn to the principal subject of our inquiry, namely the general economic functions served by a separate law of trusts. This latter inquiry is divided into two parts.

First, we ask what the law of trusts adds to the law of contract and agency. That is, what useful relationships can be established with the law of trusts that cannot be established with roughly similar ease using

⁸ See Bureau of the Census, U.S. Dep't of Commerce, Statistical Abstract of the United States 1996, at 523 tbl.806 (1996). Only 14 years earlier, in 1980, private pension funds and mutual funds held only 20% of equities (though 35% of bonds), see *id.*, and the percentage of mutual funds organized as trusts was also much lower, see Langbein, *supra* note 7, at 187-88.

⁹ See Roy C. Smith & Ingo Walter, *Global Banking* 201 fig.7-6 (1997) (charting growth in securitization).

¹⁰ See Piero Verrucoli, *Non-Profit Organizations*, in 28 *Studi di Diritto Comparato* 1, 77-91 (Mauro Cappelletti ed., 1985).

¹¹ See, e.g., Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. Pa. L. Rev. 497, 520-22 (1981) (examining role of trusts in nonprofit corporate law); Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 Yale L.J. 835 (1980) (providing economic analysis of nonprofit organizations).

just the more basic tools of contract and agency law? In very general terms, our answer is that the most important contribution of the law of trusts is that it facilitates the partitioning of assets into bundles that can conveniently be pledged separately to different classes of creditors. Of particular importance in this respect is the use of trust law to shield trust assets from claims of the trustee's personal creditors. This function of trust doctrine becomes most obvious when examining the trust in comparative perspective, and illustrates the value of comparative study in exploring the role of law. In contrast, the function of trust law that is the primary subject of the literature in the common law countries, namely the creation and enforcement of fiduciary duties, seems a relatively unimportant reason for maintaining a separate law of trusts.

The partitioning of assets among creditors that is provided by trust law is much the same as that provided by a business corporation. The second basic question we address, therefore, is what trust law adds to the law of corporations. That is, what can one do with a trust that one cannot easily do with a business corporation (a legal form that did not exist when the law of trusts originally evolved)? Indeed, the private trust—and particularly its most important modern variant, the business trust—has today evolved to the point where the question might better be put the other way around: What can one do with corporate law that one cannot do with just the law of trusts? While we offer some partial answers to these latter questions, complete answers would require a more elaborate examination of the roles of different types of legal entities than we are prepared to develop here; for the moment, we must content ourselves with simply framing the questions clearly.

I

CONTRASTING APPROACHES TO TRUST-LIKE RELATIONSHIPS

In a prototypical Anglo-American trust, three parties are involved: the "settlor" transfers property to the "trustee," who is charged with the duty to administer the property for the benefit of the "beneficiary." Any of these three roles may be played by more than one person. Also, the same person may play more than one of the three roles. In particular, the settlor and the beneficiary may be the same person, in which case the trust involves a simple delegation of responsibility for managing property from the settlor/beneficiary to the trustee.

Since, in what follows, we shall often be concerned with efforts to construct trust-like relationships in the absence of trust law, it will be

helpful to have generic labels for the three characteristic parties to such relationships—labels that do not carry with them the legal implications of the terms “settlor,” “trustee,” and “beneficiary.” Consequently, unless we are clearly talking about a situation in which the law of trusts applies, we shall refer to the three parties to a trust-like relationship as the “Transferor” (who performs the settlor-like role), the “Manager” (who performs the trustee-like role), and the “Recipient” (who occupies the beneficiary-like role). Likewise, we shall refer to the property that the Transferor transfers to the Manager, to be managed on behalf of the Recipient, as the “Managed Property.”

A. *The Common Law Approach*

The Anglo-American concept of the trust, together with the equity jurisprudence of which it forms a part, is the fortuitous product of the peculiar historical path followed by English law. The writ system, around which the jurisdiction of the common law courts was organized during the reign of Henry II, became rigid toward the end of the thirteenth century, largely precluding the creation of new writs. All common law remedies had to be worked out within the structure of the existing writs. At the time, covenants were not enforceable unless made under seal, and remedies like injunctions and specific performance were unavailable. With the exception of the obsolete legal procedures of the writ of right, the pecuniary award was the only remedy available in a court of law, and it was available for only a very limited number of causes of action.¹² According to the conventional account, the writ system led to frequent acts of injustice, and when the situation became intolerable, the Chancellor began to grant relief in the form of in personam orders to the wrongfully sanctioned defendant.¹³ By the fifteenth century, the Court of Chancery had formed and developed its own remedial devices. The dual common law/equity system, typical of Anglo-American law, was born.¹⁴

Prior to the intervention of equity, an effort to create an enforceable trust-like relationship under the common law would have failed. The Manager would have become the full owner of the Managed Property and her obligation to administer that property for the advan-

¹² See A.W.B. Simpson, *A History of the Common Law of Contract* 4-7 (1975) (discussing origins of contract against background of common law writ system). The classic historical reconstruction is still F.W. Maitland, *The Forms of Action at Common Law* (1936).

¹³ See J.H. Baker, *An Introduction to English Legal History* 112-33 (3d ed. 1990) (outlining development of Chancery court).

¹⁴ For a full treatment of the gradual development of the trust as an institution of property, see 2 D.E.C. Yale, *Lord Nottingham's Chancery Cases* 88-207 (1961).

tage of the Recipient would have been purely moral: Because she was the full owner, neither the Transferor nor the Recipient could have claimed anything against the Manager in a common law court. In contrast, equity ultimately recognized that, while the Manager was the owner at law, her right was restricted by another property interest, that of the Recipient.¹⁵ Recipients therefore were provided with equitable remedies against an unfaithful Manager. This system of rights and remedies was described by saying that the Manager (trustee) had legal ownership, while the Recipient (beneficiary) had equitable ownership.¹⁶

This subdivision of property rights caused little conceptual difficulty in the common law system, which, from an early stage, recognized that property rights need not be concentrated in the hands of a single owner, but rather could be divided among more than one individual, either in time (estates) or in content (incidents of tenure). Since the beneficiaries were considered property owners, and not holders of mere contractual rights, it naturally followed that they could claim their interests against everybody (except against a purchaser for value without notice of the trust) and obtain proprietary remedies. On the other hand, since the trustee held legal title to the trust property, his transfers of property were not impaired by the existence of the trust.¹⁷ Rather, when the trustee exchanged the trust property for other property, the beneficiary's interest and the trustee's duties attached to the new property received in the exchange. Moreover, if the trustee wrongfully transferred trust property to somebody other than a purchaser in good faith without notice of the trust, then, through the remedy called "tracing," the beneficiary's property interest continued to attach to the transferred property, and the transferee was considered to hold the property and all of its proceeds in trust for the beneficiary, who was the equitable or beneficial owner of the property.¹⁸

B. *The Civil Law Approach*

Continental law evolved along a very different path. The development of the law was not in the hands of practitioners organized

¹⁵ A forerunner of equity in this respect was the canon law. R.H. Helmholz, *The Early Enforcement of Uses*, 79 Colum. L. Rev. 1503, 1504-05 (1979), shows that ecclesiastical courts were available to sanction directions given by testators to hold property according to the testator's will.

¹⁶ For an early example of this system, see J.H. Baker & S.F.C. Milsom, *Sources of English Legal History* 103-05 (1986).

¹⁷ For discussion, see Michele Graziadei & Bernard Rudden, *Il diritto inglese dei beni e il trust: dalle res al fund*, 1992 Quadrimestre 458.

¹⁸ See David & Brierley, *supra* note 1, at 324.

around a centralized system of justice.¹⁹ Rather, academic lawyers in the universities were the leading force in the development of the law. The law itself was to be found not in a register of writs, but in the *Justinian compilation*.²⁰ A dual legal system never arose. A general theory of contract as a source of obligations was developed early on by scholars, and the notion of obligation remained central to continental legal theory. Consequently, in the continental legal tradition it was obligation that played the most important role in framing trust-like arrangements.²¹ This was facilitated by the fact that, in the continental systems, the remedy of specific performance came to be available for the enforcement of any kind of obligation arising from contract, delict, or unjust enrichment.²²

Despite its substantial generality and flexibility, however, the civil law of obligations did not evolve to fully encompass trust-like arrangements. On the contrary, the civil law developed important taboos that would be violated by trust law rules of the form that evolved in England. In particular, trust doctrine runs counter to the so called unitary

¹⁹ See John P. Dawson, *The Oracles of the Law* 148-262 (1968) (discussing Germany's commitment to legal science); Alan Watson, *The Making of the Civil Law* 23-38 (1981) (discussing role of academics, rather than practitioners, in defining development of law).

²⁰ See Dawson, *supra* note 19, at 122-24; Watson, *supra* note 19, at 32-33. The whole compilation, in its different parts, became the basis of continental jurisprudence beginning with its revival in the twelfth century. See generally Stephen Kuttner, *The Revival of Jurisprudence, in Renaissance and Renewal in the Twelfth Century* 299 (Robert L. Benson & Giles Constable eds., 1982).

²¹ See Reinhard Zimmermann, *The Law of Obligations* 1-31 (1990) (describing origins of obligation based law). Despite these differences, one may wonder whether some civil law institutions provided a source of inspiration for the work of the English Chancery. The late nineteenth century historiographical tradition—represented, for example, by O.W. Holmes, Jr., *Early English Equity*, 1 *Law Q. Rev.* 162, 163-64 (1885)—wrote about a possible connection between the Germanic *Salmann* and the English *feofee* to use. More recently, scholars have reconsidered the relationship between *fideicomissa*, *feofement* to uses, and trusts. See H. Patrick Glenn, *Le trust et le jus commune*, in *Common Law d'un siècle l'autre* 87 (Pierre Legrand, Jr. ed., 1992), available in English translation in H. Patrick Glenn, *The Historical Origins of the Trust, Aequitas and Equity: Equity in Civil Law and Mixed Jurisdictions* 749 (Alfredo Mordechai Rabello ed., 1997); David Johnston, *The Roman Law of Trusts* 283-86 (1988). More generally, scholars have started to consider patterns of influence of civilian thinking on insular England. An excellent essay discussing the changing thinking patterns in England during the nineteenth century on the origins of the concept of trust is Michele Graziadei, *Changing Images of the Law in XIX Century English Legal Thought*, in *The Reception of Continental Ideas in the Common Law World 1820-1920*, at 115, 115 (Mathias Reimann ed., 1993).

²² For current law, see, e.g., § 241 BGB (providing German law); C.c. Art. 2930 (providing Italian law). The French Civil Code adopts a milder version of this principle. See C. Civ. Art. 1143, 1144. See generally Rudolf B. Schlesinger et al., *Comparative Law* 665 (1988) (stating that concept that obligations can be specifically enforced has been adopted by most civil law systems). For the historical perspective, see Zimmermann, *supra* note 21, at 773.

theory of property rights.²³ During the French revolution, divided property rights came to be considered characteristic of feudalism. As a consequence, it was thought that the number of restricted property rights had to be strictly controlled and limited. The *numerus clausus* theory was developed, stating that divided interests in property must be strictly confined to a small number of well-defined types, such as servitudes on real property, mortgages, and usufructs.²⁴ Although this theory was largely the product of the folklore and ideology of the French revolution and lacked a well articulated general rationale, it enjoyed tremendous success and continues to have a strong influence on the civil law. Since the particular division of property rights embodied in the private trust cannot be fit within any of the limited forms of divided property rights recognized by the civil law, the trust has been considered an impermissible arrangement.²⁵

This is not to say that European law makes no provision for the formation of trust-like relationships.²⁶ To begin with, European law has various special purpose institutions that serve as substitutes for the trust in certain well-defined situations. These include, for example, special guardianship institutions to manage assets on behalf of minors or incompetents.²⁷ In addition, for a more general class of transactions that do not fall within the narrow confines of these spe-

²³ See John Henry Merryman, Ownership and Estate: Variations on a Theme by Lawson, 48 Tul. L. Rev. 916, 938-43 (1974) (arguing that trusts do not exist in civil law regimes because they are unnecessary).

²⁴ For the parallel developments in the common law world, see Bernard Rudden, Economic Theory v. Property Law: The *Numerus Clausus* Problem, in Oxford Essays in Jurisprudence 239 (John Eekelaar & John Bell eds., 3d ser. 1987) (describing tension between economic theory of property rights and law).

²⁵ It is not true that the civil law is *always* more hostile to divided property rights than is the common law. A conspicuous example of the reverse involves authors' and artists' "moral rights," which give artists a degree of control over works they create even after those works have been sold by the artist and repeatedly resold by one subsequent owner to another. Moral rights have long been recognized in many civil law jurisdictions, but, until the enactment of recent legislation, have been unenforceable in common law jurisdictions, where they have been considered inconsistent with the common law's general rejection of servitudes on chattels. See Henry Hansmann & Marina Santilli, Authors' and Artists' Moral Rights: A Comparative Legal and Economic Analysis, 26 J. Legal Stud. 95, 95-99, 141-43 (1997) (discussing adoption of moral rights doctrine by United States).

²⁶ The classic treatment remains Pierre LePaille, Civil Law Substitutes for Trusts, 36 Yale L.J. 1126 (1927) (describing how civil law systems reach results intended by trust system).

²⁷ In Italian law, for example, these are the *curatore* (for a moderate incompetent) and the *tutore* (for a complete incompetent). These institutions essentially follow the same insolvency rules as do common law trusts and thus avoid the problems of insolvency, discussed infra Part II.B, that are encountered in the civil law by fiduciary transactions for legally competent beneficiaries.

cial institutions, contractually based relationships can be established that have some of the attributes of a trust.

The most general of these relationships is the "romanistic fiduciary transaction," or *fiducia*. This device is essentially a creation of legal scholars that has found its way into the case law, rather than a relationship explicitly recognized by the civil codes.²⁸ It is typically created by means of a contract between the Transferor and the Manager. In the paradigmatic case, the Transferor formally transfers the property involved to the Manager, who becomes the legal owner of the property, while at the same time the two parties enter into a contract under which the Manager becomes the agent of the Transferor and promises to manage the property for the benefit of the Recipient, who becomes a third party beneficiary of the contract. Because, following the dictates of the civil law regime, the Recipient has no property rights in the Managed Property, enforcement of the Transferor's contract with the Manager is the only means of control over the Managed Property that is available to either the Transferor or the Recipient. Nevertheless, since that contract can be specifically enforced under the law of European civil law countries, the Recipient can obtain a degree of protection that is similar in some respects to the protection available in the common law trust. For example, he can regain possession of the Managed Property upon the expiration of the arrangement as long as the property still remains in the Manager's possession—that is, it has not been transferred by the Manager to a third party purchaser.

Under this arrangement, the Manager is the sole owner of the Managed Property. This means that she has the capacity to transfer it or otherwise contract for its use in any way. The natural consequence is that a third party who acquires Managed Property from an unfaithful Manager is always protected, even when he knows that the Manager is acting in bad faith. To deal with this problem, legal theory and case law have evolved in some civil law countries to provide trust-like remedies through which the Managed Property can sometimes be recovered from a third party who acquired it in bad faith from an unfaithful Manager, though the scope of this protection is generally not as broad as that afforded by the trust.²⁹ Another important difference

²⁸ See Helmut Coing, 2 Europäisches Privatrecht 23 (1989). Coing associated the full fledged development of *fiducia* to the nineteenth century German scholar Regelsberger. See id.

²⁹ The basis for these developments in Italian law, which are limited to movables, are the provisions of the Civil Code dealing with mandate (agency). See C.c. art. 1703, 1705-07. The seminal work on the subject is Pier Giusto Jaeger, *La Separazione del Patrimonio*

between the fiducia and the common law trust involves the treatment of insolvency—a subject we shall return to in detail below.

Strong evidence that the fiducia and other civil law institutions for establishing trust-like relationships³⁰ do not provide completely adequate substitutes for the common law trust can be found in the fact that, despite the very peculiar institutional setting in which the law of trusts developed, the trust has come to be adopted in a number of jurisdictions beyond the core common law countries.³¹ Further evi-

Fiduciario nel Fallimento (1968). Swiss law on this point is close to Italian law. See Co art. 401.

German law has greater difficulties with this problem. So far as the relationship is governed by the provisions in the commercial code dealing with commission contracts, the Transferor may have a claim against the third party transferee. See § 392(2) HGB. The commercial code, however, is applied only in transactions between merchants. The "commission agent" is a particular type of merchant under German law, professionally buying and selling property. For a discussion of the commission agent's role in different legal systems, see M.G., Commissione (contratto di) in diritto comparato, III Digesto delle Discipline Privatistiche 178 (4th ed. 1988). The situation is different in ordinary nonprofessional trust-type relationships, which are governed by the Civil Code. The courts hold that, under the Civil Code, a claim against a third party transferee is not available if the Managed Property in question was acquired by the Manager from some other third party—as in the common situation when the Manager sells some of the Managed Property and uses the proceeds to acquire other property to replace it. See J. von Staudinger, Kommentar zum Bürgerlichen Gesetzbuch mit Einführungsgesetz und Nebengesetzen, Introduction to §§ 929 ff., Rz. 324 ff. (Dieter Henrich ed., 12th ed. 1988). According to several scholars, however, the Recipient may be able to attack fraudulent dealings by the Manager with third parties in bad faith on the grounds afforded by the general provision of § 242 BGB. For discussion of this theory, see Martin Hensler, Treuhandgeschäft—Dogmatik und Wirklichkeit, 196 Archiv für die civilistische Praxis 37 (1996). Despite the contrary advice of some scholars, see Kötz, *supra* note 2, at 138, the courts have denied the beneficiary a right *in rem* if the transferee had merely constructive notice of the breach, see 32 Neue Juristische Wochenschrift 1471 (1968); Wertpapiermitteilungen 525, 527 (1977).

³⁰ One of these alternative civil law institutions is the donation with charge or under condition, which permits the Transferor to transfer property to the Manager upon the condition that she will carefully manage it for the benefit of the Recipient or that she will carry out other wishes of the Transferor. This device allows a considerable amount of flexibility.

It is available, for example, for two-party transactions in which the Transferor and the Recipient are the same person. It requires a notarial form and opens to the Recipient the possibility of specific performance against the Manager/donee. The donation under condition is also subject to some difficulties, however. The Transferor retains substantial freedom to revoke the gift for nonperformance of the charge or condition, which may interfere with the use of the device to transfer an entitlement to the Recipient on which the latter can rely. Given the absence of a developed body of trust law, duties of the Manager/donee must be specified *ex ante* in considerable detail. Furthermore, courts may decide that the charge attached to the donation is so heavy as to change substantially the nature of the donation. Consequently, this alternative approach to creating trust-like relationships is less attractive than it may appear at first glance. See LePaille, *supra* note 26, at 1136-37.

³¹ In particular, many mixed jurisdictions, including Louisiana, Quebec, and Scotland, although intent upon protecting their civil law heritage, have permitted the use of trusts. A number of South American civil law jurisdictions have also adopted the trust by legislation, as have Japan, Lichtenstein, and Israel. See generally Maurizio Lupoi, Trusts (A. Giuffrè ed., 1997). For a detailed description of civil law jurisdictions that have received the trust,

dence can be found in The Hague Convention on the Law of Trusts, to which a group of civil and common law countries became parties in 1985.³² The Convention establishes choice of law rules providing for recognition, in nontrust jurisdictions, of trusts and trust law from foreign jurisdictions. The principal rationale for the Convention, as well as the principal difficulty in its drafting and the principal source of resistance to its adoption, was the general absence in civil law countries of legal institutions analogous to the common law trust.³³

It remains to ask, however, just what, in general terms, the law of trusts offers that is fundamental.

II ECONOMIC ANALYSIS OF THE TRUST

In common law countries, it is in principle possible to construct a trust-like arrangement using the same approach that is generally employed in the civil law countries: The Transferor conveys to the Manager the title to the Managed Property, while at the same time entering into a contract with the Manager under which the Manager agrees to manage the property for the benefit of the Recipient. Moreover, in contrast to the situation five hundred years ago, today the common law of contract (at least in the United States) no longer differs strongly from its civil law counterpart in those areas most relevant to trust-like relationships, such as specific performance and protection of third party beneficiaries.³⁴ Consequently, as a crude generalization, the situation in civil law countries today with respect to trust-like relationships is roughly what the situation would be in the United States and similar common law regimes if there were no special law of trusts, but only the more general legal tools of contract and agency.

It follows that the question "What advantages would civil law countries gain from adopting the trust?" is roughly the same as the question "What are the advantages for the United States today of having the trust among the law's recognized forms?" For simplicity, in the discussion that follows, we shall generally address the question in the latter form. That is, we shall ask: "What useful relationships can

see William F. Fratcher, Trust, 6 International Encyclopedia of Comparative Law 93-104. Indeed, even France, the most proud and insular of civil law jurisdictions, recently gave serious consideration to amending its Civil Code to include "*fiducie*," the traditional French translation of the word "trust," though ultimately the proposed reform was rejected. See Pierre Decheix, *La fiducie ou du sens des mots*, Recueil Dalloz, Chroniques 35 (1997). Recently, Russia also has considered seriously, but ultimately rejected, the trust as a general form.

³² See supra note 4.

³³ See, e.g., Gaillard & Trautman, *supra* note 4, at 307-12.

³⁴ See *infra* text accompanying notes 49-53.

be established under the law of private trusts that cannot as easily be established using just the general law of contract and agency?"³⁵

At its core, a trust involves contractual relationships. The institution of the trust offers a set of standard terms for those relationships—in effect, default terms that will be implied in the absence of explicit language to the contrary in the parties' contract. The utility of the trust as a legal institution turns on the efficiency of having this set of standard terms, which in turn generally requires two things: (1) the standard terms must be efficient in themselves, which is roughly to say that they are the terms that the parties would agree to if they could bargain costlessly between themselves; and (2) the transaction costs of negotiating at least some of those standard terms would be significantly higher if the parties could employ only the basic law of contract and agency. In short, the trust is a useful legal form if it reduces in an important way the transaction costs of contracting. (To be sure, this formulation is a bit too simple;³⁶ we shall refine it further below.)

To see whether and how the law of trusts meets this test, we shall examine, in turn, the principal transactional relationships affected by a trust. For convenience, we can categorize these relationships into several groups: (A) relationships among the three principal parties—the Transferor, the Manager, and the Recipient; (B) relationships between the principal parties and their various personal creditors; (C) relationships between the principal parties and creditors who have claims against the Managed Property; (D) relationships between the principal parties and purchasers or donees of the Managed Property; and (E) relationships among successive Recipients. For illustration, we shall refer generally to simple situations in which all three of the principal parties are individuals, as in the traditional use of the trust for intrafamily transfers of wealth. In Part III we then examine, for further illustration, several of the principal types of commercial trusts.

In discussing the utility of trust law for contractual relationships, we shall initially ignore the ways in which the use of the trust form

³⁵ The essay by Ogus, *supra* note 2, also explores the role and structure of trust law from an economic point of view. Ogus—whose principal focus is the English law of trusts—is less concerned, however, with the extent to which trust law permits the establishment of useful relationships that could not easily be replicated without it. Rather, he tends to take the structure of the law as given and asks what purposes can usefully be served by the institution of the trust. Moreover, to the extent that he inquires into the special transaction cost savings offered by trust doctrine, Ogus focuses principally on fiduciary duties and devotes little attention to the creditors' rights issues that we argue here are of primary importance. Yet Ogus's essay is thoughtful and insightful and is generally consistent with the analysis we offer here.

³⁶ On the economics of default rules generally, see Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 3 S. Cal. Interdisciplinary L.J. 389, 397-413 (1993).

affects the tax consequences (or other regulatory consequences) of relationships. Those tax consequences, while often highly important in determining where the trust form is employed, are largely definitional: Use of the trust form has particular tax consequences simply because the tax law dictates those consequences; often, other consequences might have been chosen just as easily. Our principal concern here, instead, is with the effect of trust law on the basic transaction costs of relationships. We do, however, deal briefly with taxation in Part V.

A. Relationships Among the Principal Parties

1. Transferor and Manager

With respect to the contractual relationship between the Transferor and the Manager, the role of the law of trusts in providing a standard set of default terms is conspicuous. So long as the parties characterize the relationship they wish to establish as a "trust," or even if they just make clear their intention to create a trust-like relationship,³⁷ the law of trusts automatically inserts a variety of standard terms into their agreement. These terms comprise the core of the trust relationship. They include the powers of the Manager, such as the authority to incur expenses in the administration of the Managed Property and the power to lease, mortgage, or sell the Managed Property where appropriate.³⁸ They also include the duties of the Manager, such as the duty to preserve the Managed Property and render it productive, and to pay income to the Recipient.³⁹ Among those duties are the Manager's fiduciary duties: the duty of care (duty to exercise reasonable care and skill)⁴⁰ and the duty of loyalty (the duty not to deal with the Managed Property contrary to the Recipient's interests).⁴¹ Although the language of trust law generally describes these duties as being owed to the Recipient (in trust language, the "beneficiary"), they are undertaken by the Manager in the first place to satisfy the (perhaps altruistic) desires of the Transferor, and hence are effectively terms in the agreement between Transferor and Manager.

These default terms are unquestionably a convenience. They are not, however, a necessity. If the law of trusts did not exist, the Transferor and the Manager still could establish between themselves—and by extension, between the Manager and Recipient—all of the obliga-

³⁷ See Restatement (Second) of Trusts §§ 23-24 (1959) (setting forth forms in which intention to create trust can be manifested).

³⁸ See id. §§ 186-96.

³⁹ See id. §§ 169-85.

⁴⁰ See id. § 174.

⁴¹ See id. § 170.

tions that are at the core of the private trust. Specifically, as we noted above, this could be accomplished as it typically is now under the civil law, by having the Transferor transfer to the Manager the title to the Managed Property, while simultaneously entering into a contract with the Manager under which the latter agrees to serve as the Transferor's agent, administering the Managed Property for the benefit of the Recipient. Absent the law of trusts, the latter contract would have to spell out all of the obligations to be undertaken by the Manager for the benefit of the Transferor and, particularly, the Recipient. But this is not a complicated task, and could presumably be accomplished relatively easily through the use of privately drafted contracts employing standardized terms. The simplest approach to creating such a contractual version of the trust law duties, of course, would just be to insert into the contract between the Transferor and the Manager the same language concerning the Manager's duties that presently appears in the sections of the Restatement of Trusts describing a trustee's duties.

This is true, in particular, for the fiduciary duties of the Manager. The duty of loyalty, for example, consists of a straightforward promise on the part of the Manager not to engage in self-interested transactions involving the trust property. That promise—together with any appropriate level of detail about what is to be deemed a self-interested transaction—can simply be inserted into the Manager's contract with the Transferor (and, by extension, the Recipient). The same is true for the disgorgement penalty that the law of trusts generally imposes for breach of the duty of loyalty: In the absence of trust law, the Manager's contract with the Transferor could simply state directly that, if the Manager breaches the obligation to refrain from self-interested transactions, then the Manager must pay over, as stipulated damages, not only all losses suffered by the trust but also all profits derived by the Manager from the prohibited transactions.

That is not to deny that, by providing default rules concerning the Manager's obligations, the law of trusts offers some real efficiencies. These efficiencies are much the same as those offered by other standard form default rules provided by the law of contracts. To begin with, those rules save effort in drafting contracts. More importantly, they help assure that important terms are not neglected when the contract is written. And to the extent that the parties seek to deviate from the conventional contractual form, default rules provided by law put the burden on the parties to be explicit and thus help assure that both parties are aware of, and thoughtfully accept, those nonstandard terms. The practical importance of these efficiencies is difficult to assess. It is not obvious, however, that—today at least—they are partic-

ularly large. Privately prepared standard form contracts would seem to offer efficiencies nearly as great.

Some commentators have argued that legal rules imposing fiduciary duties—including, in particular, the duties imposed by the law of trusts—have a character that goes beyond mere default rules of contract. In particular, these commentators emphasize the inability of the parties involved to deviate freely from the fiduciary duties that the law prescribes.⁴² There are several reasons to believe, however, that the mandatory nature of these duties is a relatively modest contribution of the law of trusts.

First, the elements of trust law fiduciary duties that are mandatory are quite limited. The law of trusts generally permits the settlor, by provisions in the terms of the trust, to relieve the trustee of the standard duties (including the duties of loyalty and care) that the law imposes on the trustee.⁴³ The settlor's freedom in this regard is restricted only in that he cannot sanction some forms of conduct by the trustee—such as “breach of trust committed in bad faith or intentionally or with reckless indifference to the interest of the beneficiary”—that by their definition seem contrary to the interests of the settlor and that therefore would not be explicitly sanctioned by the terms of a trust if the settlor were contracting with full knowledge of what he was doing. Likewise, whatever the terms of the trust may be, the law of trusts generally permits the beneficiary to consent to deviations by the trustee from the latter's duties, subject only to (A) the modest limit—analogous to that imposed on the settlor—that the beneficiary must not have been misled and (B) the more substantial limit that, if the trustee has a conflict of interest in a transaction, the beneficiary cannot release the trustee from being held to a substantive standard of fairness in the transaction.⁴⁵

Second, these mandatory elements of trust law are *limits* on what the parties are permitted to do with trust law. They do not represent what we are primarily concerned with here—namely, ways in which the law of trusts *expands* the range of relationships that parties can create beyond those that would be available to them absent the law of trusts. Even if legally imposed fiduciary duties offer the parties involved something beyond what they can establish by contract, the par-

⁴² See Victor Budney, Contract and Fiduciary Duty in Corporate Law, 38 B.C. L. Rev. 595, 601-07 (1997) (discussing fiduciary obligations under law of trusts and agency); Tamar Frankel, Fiduciary Duties as Default Rules, 74 Or. L. Rev. 1209, 1242-51 (1995) (discussing limitations on waivers of rights to fiduciary duties).

⁴³ See Restatement (Second) of Trusts § 222(1) (1959).

⁴⁴ Id. § 222(2).

⁴⁵ See id. § 216.

ties are not entirely dependent on the law of trusts to supply those fiduciary duties. In the absence of trust law, the parties would still have available to them the fiduciary duties offered by agency law, which are quite similar to those imposed by the law of trusts.⁴⁶ Indeed, since in the absence of trust law the Manager generally would be deemed by the law to be the agent of the Transferor, the Recipient, or both, the law of agency would apply and would itself, if the parties' contract did not say otherwise, impose fiduciary duties on the Manager that are quite similar to those implied by the law of trusts.⁴⁷ To be sure, the duty of loyalty that is the default rule in trust law is slightly more rigorous than the duty implied by the law of agency.⁴⁸ This is appropriate. In trust-like relationships, the principals involved (the Transferor and the Recipient) are often in a particularly poor position to monitor the Manager in fulfilling her duties as their agent—because, for example, the Transferor is dead and the Recipient is incompetent or a child. Nevertheless, in the absence of trust law, the Transferor and the Manager would still be free to establish this stricter duty of loyalty by explicit contractual provisions that substitute such a duty for the default rule that would otherwise be imposed by agency law.

2. *Manager and Recipient*

The standard rule in trust law is that the Recipient has the power to enforce the Manager's performance of her duties.⁴⁹ The obvious rationale for this rule is that otherwise there may be no one with both the incentive and the capacity to police the Manager.

The traditional English rule of common law is that third party beneficiaries of a contract have no authority to enforce the contract.⁵⁰

⁴⁶ In fact, Professor Brudney lumps trust law and agency together in his survey of fiduciary duties in different fields of law. See Brudney, *supra* note 42, at 601-07.

⁴⁷ Compare Restatement (Second) of Agency §§ 387-98 (1958), with Restatement (Second) of Trusts § 170 (1959) (addressing duty of loyalty); Restatement (Second) of Agency § 379, with Restatement (Second) of Trusts § 174 (addressing duty to exercise reasonable care and skill).

⁴⁸ The essential distinction is that a trustee dealing with trust property on her own behalf is held to a standard of fairness even if she obtains the informed consent of the beneficiary, while such a standard of fairness is not imposed on similar transactions between an agent and his principal. Compare Restatement (Second) of Agency § 390 cmt. c (1958), with Restatement (Second) of Trusts § 170 cmt. w (1959).

⁴⁹ See Restatement (Second) of Trusts §§ 197-99 (1959).

⁵⁰ See Vernon Valentine Palmer, *The Paths to Privity: The History of Third Party Beneficiary Contracts at English Law* 22 (1992) (discussing when English position against third party beneficiary right was created); N.H. Andrews, *Does a Third Party Beneficiary Have a Right in English Law?*, 8 Legal Stud. 14 (1988) (discussing arguments supporting denial of active third party rights).

As a consequence, the law of trusts in England historically served, and still serves, the important function of permitting the creation of trust-like relationships with effective powers of enforcement—something that could not be done in the absence of trust law.⁵¹ In other jurisdictions, however, this is not the case. In the United States, for example, after 1859, the old common law restrictions on third party enforcement were gradually abandoned, with the result that today an intended third party beneficiary of a contract will be permitted to enforce that contract.⁵² Consequently, trust law in the United States is no longer necessary to achieve that result. Contract law in the civil law countries is also generous in permitting enforcement of a contract by a third party beneficiary,⁵³ with the consequence that in those jurisdictions, too, the importation of trust law doctrine would add nothing significant to the law in this regard.

B. Relationships with the Principal Parties' Personal Creditors

A more vital function of trust law lies in arranging the expectations of the personal creditors of the Transferor, Manager, and Recipient.

1. The Recipient's Creditors

One important way in which the Recipient can derive benefits from the Managed Property is to offer his interest in it as security for credit, whether the Recipient does this explicitly by pledging his interest in the Managed Property to creditors or implicitly by inducing persons to extend unsecured credit to him in reliance on the Recipient's overall wealth, which includes his interest in the Managed Property. Consequently, one would expect that the Transferor generally would wish to permit the Recipient's creditors to be able to levy on the Recipient's interest in the Managed Property in case of the Recipient's insolvency, and that the Transferor would therefore wish to provide

⁵¹ Presumably the reason for resisting third party enforcement in general was a concern that it would create a substantial risk of malicious, opportunistic, weakly argued, senseless, redundant, or conflicting litigation. Since trust-like relationships are arguably an area in which third party enforcement significantly increases incentives for contractual compliance without creating serious risks of this sort, it was a natural area in which to make an exception to the general common law rule.

⁵² See Anthony Jon Waters, *The Property in the Promise: A Study of the Third Party Beneficiary Rule*, 98 Harv. L. Rev. 1109, 1111-12 (1985) (noting that third party beneficiary's right to enforce obligation has been generally accepted since ruling in *Lawrence v. Fox*, 20 N.Y. 268 (1859)).

⁵³ See Hein Kötz, *Rights of Third Parties, Third Party Beneficiaries and Assignment*, 7 International Encyclopedia of Comparative Law 7-11 (1992) (discussing recognition of third party beneficiary contracts in civil law jurisdictions).

for this result through his contract with the Manager. Thus, it is reasonable for the law of trusts to make this result one of the standard terms that will be imputed to the parties, absent explicit provision to the contrary—as, in fact, it does.⁵⁴

On the other hand, if the Transferor is concerned that the Recipient is irresponsible and will too quickly encumber all of the Managed Property, the Transferor might wish to avoid the standard result and, instead, make the Recipient's interest in the Managed Property unavailable to the Recipient's creditors. American trust law in fact permits the settlor to do this by creating a “spendthrift trust” that bars the beneficiary's creditors from levying on the beneficiary's interest in the trust.⁵⁵ This is a reasonable arrangement, except that it runs the risk of misleading persons who extend credit to the Recipient on the basis of his apparent wealth, only to discover subsequently that this wealth is beyond their reach. The efficiency of the spendthrift trust is consequently debatable; the paternalistic protection it provides for hapless beneficiaries may not outweigh the costs it engenders by confusing creditors' expectations. Not surprisingly, therefore, the wisdom of recognizing spendthrift trusts has been a perennial subject of controversy in American legal commentary.⁵⁶ English law has refused altogether to recognize spendthrift trusts.⁵⁷

⁵⁴ See Restatement (Second) of Trusts § 147 (1959).

⁵⁵ See id. §§ 150-55.

⁵⁶ Famous and forceful criticism of the spendthrift trust was voiced long ago by Harvard Law School Professor John Chipman Gray in his book, *Restraints on the Alienation of Property*, written in response to the Supreme Court's validation of spendthrift trusts in *Nichols v. Eaton*, 91 U.S. 716 (1875). “The general introduction of spendthrift trusts would be to form a privileged class, who could indulge in every speculation, could practise every fraud, and, provided they kept on the safe side of criminal law, could yet roll in wealth.” John Chipman Gray, *Restraints on the Alienation of Property* § 262, at 174 (1883). A recent installment in the debate is Adam J. Hirsch, *Spendthrift Trusts and Public Policy: Economic and Cognitive Perspectives*, 73 Wash. U. L.Q. 1 (1995), which surveys the issues at length and argues (somewhat casually) that, whatever may have been the case in the past, spendthrift trusts today do not create serious problems for creditors in assessing a debtor's creditworthiness—or that, if they do, the resulting distortions in credit terms tend to be offset by other information problems that creditors face.

⁵⁷ The case that remains controlling to this day is *Brandon v. Robinson*, 34 Eng. Rep. 379 (Ch. 1811) (holding that creditors of bankrupt beneficiary may exercise their claims against beneficiary's trust interest, notwithstanding settlor's intention to establish spendthrift trust). England, however, has developed alternatives to the spendthrift trust, principally in the form of “discretionary trusts” and “protective trusts” that give the trustee substantial discretion concerning distributions to the beneficiary, and thus leave the beneficiary with an interest that is considered too uncertain to be reachable by the beneficiary's creditors. See George Gleason Bogert & George Taylor Bogert, *The Law of Trusts and Trustees* § 221 (2d ed. 1992) (describing discretionary and protective trusts); Erwin N. Griswold, *Spendthrift Trusts* § 367, at 330, § 429, at 375 (1936) (same).

In the United States, a third party beneficiary's enforceable interest in a contract can be assumed by a trustee in bankruptcy for the benefit of the beneficiary's creditors.⁵⁸ Thus, the default rule established under the law of trusts is replicated by contract law, and the law of trusts adds little. For the same reason, adoption of the trust would offer little in this regard to the civil law.⁵⁹ The spendthrift trust, on the other hand, appears difficult to replicate through the general tools of contract law⁶⁰—for the same reasons, presumably, that it is a controversial device in the law of trusts.

⁵⁸ The Bankruptcy Code defines the bankrupt estate as consisting of "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1) (1994). Among the debtor's legal interests that become a part of the bankruptcy estate under the Code are his choses in action and claims against third parties. These choses in action and claims clearly include rights of action based upon contract. See, e.g., *Rau v. Ryerson* (*In re Ryerson*), 739 F.2d 1423, 1425 (9th Cir. 1984) (holding that interest in contract value under appointment agreement, though contingent at time of filing, was includable within bankruptcy estate); *Buckeye Union Ins. Co. v. Four Star Constr. Co.* (*In re Four Star Constr. Co.*), 151 B.R. 817, 819-20 (Bankr. N.D. Ohio 1993) (holding that rights of action based on contract are included in bankruptcy estate although they may be contingent and not subject to possession until some later time); *Quarles House Apartments v. Plunkett* (*In re Plunkett*), 23 B.R. 392, 394 (Bankr. E.D. Wis. 1982) (holding that debtor's right to receive management fee, based on partnership agreement provision, was property of joint Chapter 11 estate of debtor and his wife); *Varisco v. Oroweat Food Co.* (*In re Varisco*), 16 B.R. 634, 637 (Bankr. M.D. Fla. 1981) (holding that broad definition of term "property of the estate" includes right created by franchise agreement). Whether a third party beneficiary has an enforceable contractual right—and hence one that clearly becomes part of the bankruptcy estate—turns on his classification as an "intended" or "incidental" beneficiary. The definition of "intended beneficiary" in this regard is broad enough to cover virtually anyone who is the Recipient in a trust-like relationship. See Restatement (Second) of Contracts §§ 302, 304, 315 (1982). For cases involving a bankruptcy trustee's assumption of a debtor's rights as a contractual third party beneficiary, see, e.g., *National Tax Credit Partners v. Havlik*, 20 F.3d 705, 707 (7th Cir. 1994) (stating that limited partnership was third party beneficiary to general partners' promise to investors to provide additional money to partnership); *Newton v. Johnson* (*In re Johnson & Assocs., Inc.*), 845 F.2d 1395, 1399 (6th Cir. 1987) (holding that debtor corporation was "intended third party beneficiary" of provision in stock sales agreement whereby debtor's former owner agreed to pay certain obligations of debtor); *Whinnery v. Bank of Onalaska* (*In re Taggatz*), 106 B.R. 983, 984 (Bankr. W.D. Wis. 1989) (holding that agreement between debtor and bank to fund unfunded portion of promissory note upon fulfillment of conditions precedent constituted contract to make loan or extend other debt financing or financial accommodations and thus was not assumable by bankruptcy trustee); *Farmer v. Crocker Nat'l Bank* (*In re Swift Aire Lines, Inc.*), 20 B.R. 286, 287 (Bankr. C.D. Cal. 1982) (letter of credit issued between bank and debtor was contract in which bankruptcy trustee of debtor's estate was beneficiary).

⁵⁹ See *Jaeger*, *supra* note 29, at 324.

⁶⁰ To avoid the consequences described in note 58, *supra*, the Transferor and the Manager might explicitly provide in their contract that, while the Recipient is intended to benefit from the Manager's performance, the Recipient is to have no powers to enforce the contract. But, even if unenforceability would be sufficient to ensure exclusion of the Recipient's interest from his estate in bankruptcy, that exclusion would come at the price of eliminating the legal accountability of the Manager to the Recipient.

2. *The Transferor's Creditors*

Under trust law, the settlor's creditors generally cannot reach the trust property so long as the settlor is not also a beneficiary of the trust.⁶¹ This is a logical result; it follows what we generally can presume to be the intent of the contracting parties (and particularly the settlor), and in general it should not mislead the settlor's creditors (who have no reason to rely on the value of the trust property in extending credit to the settlor, since title to the property is in the hands of the trustee and no material benefits are flowing to the settlor from the property).

On the other hand, trust law provides that if the settlor himself retains a beneficial interest in the trust property, then his creditors can reach his interest in that property even in the face of explicit efforts on his part to provide, in the terms of the trust, that his creditors may not reach his interest.⁶² This result, too, is logical, to prevent the settlor from intentionally or unintentionally misleading his creditors as to his ability to repay them.

As with the rights of the Recipient's creditors, however, these are apparently the results that would occur even if the parties did not have the advantage of the law of trusts, and had to rely only upon general principles of contract law.⁶³

3. *The Manager's Creditors*

Under the common law of trusts, if the trustee becomes insolvent, the trust property she administers is unavailable to satisfy the trustee's obligations to her personal creditors.⁶⁴

This arrangement has important advantages. To begin with, it is what all three of the principal parties would generally prefer. The Transferor presumably wishes to transfer the value of the trust prop-

⁶¹ This is the negative implication of Restatement (Second) of Trusts § 156 (1959) (providing that creditors can reach settlor's interest in trust where settlor is also beneficiary of trust). See also 11 U.S.C. § 541(b)(1) (1994), discussed infra note 63.

⁶² See 11 U.S.C. § 541(b)(1) (1994); Restatement (Second) of Trusts § 156 (1959).

⁶³ Absent the law of trusts, if a Transferor transfers to the Manager the title to the Managed Property, and enters into a contract with the Manager under which the latter is to manage the property exclusively for the benefit of a third party Recipient, then the only interest that the Transferor retains is a contractual right to enforce the Manager's duties toward the Recipient; he has no contractual claim on the interest or principal of the Managed Property to be levied on by the Transferor's creditors. See 11 U.S.C. § 541(b)(1) (1994) (excluding from bankruptcy estate any power that debtor may exercise solely for benefit of person other than debtor).

⁶⁴ See, e.g., *American Serv. Co. v. Henderson*, 120 F.2d 525, 530 (4th Cir. 1941); *Todd v. Pettit (In re Elliott)*, 108 F.2d 139, 140 (5th Cir. 1939); *In re Tate-Jones & Co.*, 85 F. Supp. 971, 981 (W.D. Pa. 1949); 11 U.S.C. § 541(a)(1), (d) (1994); Restatement (Second) of Trusts §§ 221, 306-08 (1959).

erty to the Recipient, free of possibilities that the transfer will be frustrated through forfeiture of the property to the Manager's creditors. To be sure, the ability to use the trust property as security for credit is one means by which the Transferor might compensate the Manager for the latter's efforts. But direct cash payments should nearly always be a superior form of compensation.

Furthermore, in typical situations in which trusts are employed, often neither the Transferor nor the Recipient is well situated to monitor the other business affairs of the Manager and, in particular, to check regularly on the Manager's solvency. Thus, they are in a poor position to control the extent to which the Manager exposes the Managed Property to claims of the Manager's creditors. (Consider, again, the classic situation in which the Transferor is dead and the Recipient is incompetent or a child.) In contrast, with the rules of trust law in effect, simple accounting measures can easily signal to the Manager's potential creditors which of the properties in the Manager's possession is held in trust and therefore is unavailable to satisfy the creditors in case of the Manager's insolvency, so that the creditors can adjust their terms of credit to reflect the amount of security available to them. Indeed, by establishing the trust as a standard form, the law of trusts makes such signaling easy: The Manager need simply use the words "in trust" when registering the property or otherwise dealing in it.

Of course, where the Manager is not careful in such signaling, there arises the possibility of inducing inappropriate reliance on the Managed Property by the Manager's creditors. In such cases, the law of trusts nevertheless favors the beneficiary. Indeed, even if the trustee intentionally breaches her duty to the beneficiary, and specifically pledges trust property as security for credit extended to the trustee by a third party creditor who is unaware that the property is held in trust, the creditor will not be permitted to enforce his security interest in the trust property. The trust property instead will remain available only to the beneficiary.⁶⁵ Even here, the law apparently presumes that the Manager's creditors are in a better position than the Recipient to look out for themselves (or, to use the conventional Calabresian terminology, that they are the cheapest cost avoiders).

In sum, where claims of the Manager's personal creditors are involved, the default rule implied by the common law of trusts appears

⁶⁵ See Restatement (Second) of Trusts § 286 (1959). The law is different in the case of third party purchasers of the legal title to trust property who act in good faith and pay reasonable value: They get good title to the trust property even if the trustee sells in breach of trust. See id. § 284. It is only those third parties to whom the breaching trustee transfers mere equitable title who are disfavored vis-à-vis the beneficiary.

to economize on total information and monitoring costs for all the contracting parties involved—the Manager, the Transferor, the Recipient, and the Manager's personal creditors.

In the absence of trust law, the result would presumably be the reverse: Since the Manager holds title to the Managed Property, the Managed Property would be presumed subject to levy by the Manager's creditors.⁶⁶ In continental European law, the latter result is in fact the general rule: The Manager is the formal owner of the Managed Property, and the Recipient has only a contractual claim on the Manager alongside the rest of the Manager's creditors. Consequently, upon the bankruptcy of the Manager, the Managed Property is thrown into the common pool of the Manager's assets and is available to satisfy claims of any of the Manager's creditors, rather than just the claims of the Recipient.⁶⁷

⁶⁶ The question "What would be the rights of the Manager's creditors in the United States, with respect to the Managed Property, absent the law of trusts?" is not entirely well-defined in American law. The relevant provision in the bankruptcy law does not explicitly refer to trusts. Rather, it states:

Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate . . . only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

11 U.S.C. § 541(d) (1994). It is well established that this rule immunizes trust property from claims of the trustee's personal creditors in bankruptcy. See the cases cited *supra* note 64. If American law were to be deprived not just of the law of trusts, but of the law of equity in general, presumably the above quoted provision would have no reference, and any property to which the bankrupt Manager holds legal title would become part of the bankruptcy estate. As noted *infra* text accompanying note 67, this is the general result in European civil law regimes, which lack both trust law in particular and the law of equity in general.

But what if one were to eliminate just the law of trusts in the United States, while retaining the law of equity? Absent trust law, as we have suggested, the natural alternative would be to transfer title to the Managed Property to the Manager and make the latter the agent of the Transferor, the Recipient, or both. Yet, "[i]f [an agent] has title, either legal or equitable, to property which he holds subject to equitable duties to deal with it for the benefit of another, he is a trustee." Restatement (Second) of Agency § 14B cmt. b (1958). Thus, to eliminate the law of trusts would seem to eliminate (by definition) the possibility of an agent who holds only legal title while the "equitable" interest lies elsewhere. While it is perfectly conceivable—and common—for a legal regime to adopt the law of trusts without adopting the law of equity in general, it is harder to know what it would mean to have the law of equity without the law of trusts.

⁶⁷ The only civil law device that might be seen as a general exception is the "Germanistic fiduciary transaction." Here, the property entrusted to the fiduciary is not applied to satisfy his general creditors, so that the settlor-beneficiary does not bear the consequences of the fiduciary's insolvency. The theory of the transaction was developed by late nineteenth century German scholarship. For one of the first detailed discussions, see Oskar Fischbach, *Treuhänder und Treuhandgeschäfte* 1-52 (1912). In this transaction, however,

In principle, even without the law of trusts the same insolvency rule concerning the Manager's personal creditors could be established by contractual means.⁶⁸ The Manager could insert into all contracts with her personal creditors terms providing that the creditors forswear any claim against the Managed Property in case of the Manager's breach. Moreover, the Manager could promise, in her contract with the Transferor, to put such terms in every personal contract into which the Manager enters. The transaction costs of this approach, however, would often be prohibitively high. Consider, as one obvious example, the difficulties that would arise when the Manager deals with other parties that themselves use standard contractual forms. There would also remain the risk that, even where it is otherwise practicable, the Manager would sometimes fail to insert the required contractual term out of carelessness or opportunism, and the Manager's performance in this regard would be very difficult for either the Transferor or the Recipient to police.⁶⁹

the Manager is not considered as receiving the full title of ownership (which remains in the Transferor), but only a limited right to dispose of the property within the limits set by the fiduciary contract and recognized by the legal system. Consequently, this scheme falls short of a full trust-like relationship. See Jaeger, *supra* note 29, at 26.

There are also a variety of more particular exceptions to the general rule. Under German law, for example, the Manager's creditors cannot attach debts owed by a third party to the Manager when the Manager is a commission agent acting for his principal, see § 392 Para. 2 HGB, nor attach funds deposited in bank accounts opened by professionals who openly act as fiduciaries for their clients. And, while French law in this area is elusive, it is at least clear that a French principal is preferred to the creditors of his *commissionnaire* (commission agent) and may personally enforce the rights acquired through him by a special action in rivendication which is allowed by Law No. 85-98 of Jan. 25, 1985, J.O., Jan. 26, 1985, sem. jur., éd. gén., Feb. 13, 1985, 56711. Moreover, in the field of financial services, European Community directives now enhance the protection of investors who entrust their savings to financial intermediaries. See, e.g., Council Directive 93/22/EEC of May 10, 1993, on Investment Services in the Securities Field, 1993 O.J. (L 141) 27 (introducing strict requirements of financial adequacy for intermediaries licensed in one member state who wish to operate in another).

⁶⁸ Note, however, that in some civil law countries this possibility is ruled out by the law. In Italy, for example, article 2740 of the Civil Code would seem to negate the efficacy of contractual provisions of the type described here in the text. See C.c. art. 2740. According to this general provision, a debtor cannot—beyond the cases strictly specified by written law—limit by contract his creditors' ability to reach all his present and future assets. See *id.*

⁶⁹ In the absence of trust law, one might try to shield the Managed Property from the Manager's creditors by giving title in the Managed Property to the Recipient, with authority in the Manager to manage those assets and, where appropriate, to sell the assets and replace them with others to which the Recipient is also to be given title. But this solution creates other problems that are avoided by trust law. One of these is that it may be difficult to signal clearly to third parties that the agent has the requisite authority to sell and buy the beneficiary's property. Another is that it may be difficult for the Transferor to limit the Recipient's authority to deal in the Managed Property himself. A third is that the

Not surprisingly, then, the common response in the civil law countries to the lack of a trust-law-like default rule to govern the Manager's insolvency is not to try to create the same result through contracting, but rather to employ as Managers only large and stable institutions, such as banks, that are unlikely to go bankrupt.⁷⁰ This is in conspicuous contrast to the common law countries, where individuals commonly serve as trustees, with the advantage that the role of Manager can be performed by individuals who have special familiarity with the Transferor's wishes and the Recipient's needs and who have personal ties with the Transferor and Recipient that help assure performance of their managerial commitments.⁷¹

As a further indication of the important advantages offered by the trust regime concerning the Manager's insolvency, in civil law countries, special legislation now shields Managed Property from claims against the Manager with regard to certain kinds of property and certain transactions—including, in particular, securities held by professional investment managers, which today represent the largest and most important class of trust-like arrangements. By now, for example, every European country has enacted legislation to this effect for mutual funds⁷²

Recipient is likely to face personal liability for obligations incurred in the Manager's dealings with the Managed Property.

Yet another approach would be to leave title to the Managed Property with the Manager, but seek to give the Recipient a security interest in the Managed Property that would give the Recipient priority over the Manager's other creditors in case of the Manager's bankruptcy. We shall not explore here in detail the extent to which, in the absence of trust law, this approach would be feasible. As our discussion of asset securitization trusts in Part III.A.3 below indicates, however, the entity-like attributes of the trust make it a superior substitute for simple security interests in important categories of transactions.

⁷⁰ See generally Gambaro, *supra* note 2.

⁷¹ Today, resort to institutions as trustees is also becoming routine in the common law countries. In those countries, however, an individual is often made a cotrustee with the institution, in order to have the advantage of both the institution's financial sophistication and the individual's familiarity with the desires of the settlor and the needs of the beneficiary. In such a situation, absent the law of trusts, the trust assets would remain vulnerable to the individual trustee's insolvency.

⁷² Examples include French Law No. 88-1201 of Dec. 23, 1988, J.O., Dec. 31, 1988, *Recueil Dalloz, Législation*, 1989, at 40; the Italian *Leggi sui fondi comuni di investimento: L. 23 marzo 1983 n. 77, Istituzione e disciplina dei fondi comuni di investimento mobiliare*, Gazz. Uff., Mar. 28, 1983, No. 85, Lex, LXIX, 1983, parte I, p. 610; and the German *Gesetz ueber Kapitalanlagegesellschaften*, v. 14.1.1970 (BGBI. I S.127). The minimum requirements posed by the European Community intervention in this field are contained in Council Directive 85/611/EEC of 20 Dec. 1985 on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities, 1985 O.J. (L 375) 3 (with subsequent modifications). For a comparative analysis, see Michele Graziadei, *Fondi comuni di investimento in diritto comparato*, 6 *Digesto della Discipline Privatistiche* 237 (4th ed. 1991).

and for investment firms that operate as portfolio managers.⁷³

Unlike the other trust doctrines we have discussed so far, the rule governing claims to the Managed Property in case of the Manager's insolvency is, therefore, an important contribution of the law of trusts, permitting parties to enter into useful contractual relationships that can be replicated using just the basic tools of contract and agency law only at substantial cost, if at all.

C. Relationship with Creditors of the Managed Property

Finally, we turn to the treatment of claims by creditors that arise out of transactions that involve the Managed Property itself, but that cannot be satisfied by the Managed Property.⁷⁴

1. Liability of the Manager

Under trust law, the trustee is presumed to be personally liable to third persons on all contractual and other obligations she incurs in the course of administering the trust.⁷⁵ The trustee can avoid such per-

⁷³ Examples include the French Law No. 89-531 of Aug. 2, 1989, J.O., Aug. 4, 1989, Recueil Dalloz, Législation, 1989, at 264, and the Italian Leggi sulle società di intermediazione mobiliare: L. 2 gennaio 1991 n. 1, disciplina dell'attività di intermediazione mobiliare e disposizioni sull'organizzazione dei mercati mobiliari, Gazz. Uff., Jan. 4, 1991, No. 3, Lex, LXXVII, 1991, parte I, p. 27. The Italian law has been recently amended by new statutory rules: decreto legislativo 23 luglio 1996, n. 415, recepimento della direttiva 93/22/CEE del 10 maggio 1993 relativa ai servizi di investimento nel settore dei valori mobiliari e della direttiva 93/6/CEE relativa alla adeguatezza patrimoniale delle imprese di investimento e degli enti creditizi, Gazz. Uff., Aug. 9, 1996, No. 186, Lex, LXXXII, 1996, parte I, p. 3078. The relevant European Community legislation is Council Directive 93/22/EEC, *supra* note 67.

⁷⁴ Here, as in the discussion of personal creditors of the trust participants, we focus principally on voluntary rather than involuntary creditors. This is because we are primarily interested in the degree to which trust law expands the range of transactions that parties can (*willingly*) engage in. Tort liability, in principle, should generally not be a matter for choice among the participants to a relationship such as a trust, since it concerns the interests of unwilling third parties.

The principal contours of liability for torts committed in the course of managing a trust are that, as a general matter, (a) the trustee is personally liable for torts committed by him or by agents retained to manage the trust; (b) a tort plaintiff, or a trustee from whom a tort plaintiff has obtained personal recovery, may sometimes receive compensation out of the trust funds themselves; and (c) the beneficiary has no personal liability. See generally Bogert & Bogert, *supra* note 57, §§ 731-35. Rule (a) makes rule (c) less troublesome from an efficiency point of view. Nevertheless, with or without rule (a), there may be many contexts in which rule (c) is of doubtful efficiency, for reasons analogous to those explored in an earlier article. See generally Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 Yale L.J. 1879 (1991) (arguing that limited liability in tort cannot be rationalized for corporations on strength of conventional arguments offered on its behalf). As we observe *infra* note 121, modern business trust law appears to be abandoning rule (a).

⁷⁵ See Restatement (Second) of Trusts §§ 261-62 (1959).

sonal liability on contracts, however, if she makes clear when signing a contract that she is signing strictly as trustee for the trust and not in her personal capacity.⁷⁶ Moreover, noncontractual liability imposed on the trustee as title holder is limited to the extent she can obtain indemnity from the trust.⁷⁷

This seems the sensible approach. In most cases, so long as third party creditors are aware that they are dealing with Managed Property, it is probably inefficient to make the Manager personally liable for obligations entered into for the benefit of the Recipient in the course of administering the Managed Property. The reduced cost of credit for the trust resulting from such a rule would, in general, be more than offset by the increase in the cost of credit for the Manager in her personal (and other business) transactions owing to the increased complexity in monitoring credit that the rule would impose on all of the creditors involved. Moreover, the incentive effects of such a rule for the Manager also appear unattractive, since the rule would tend to induce severe conservatism by giving the Manager a personal stake in the losses, but not the gains, resulting from her administration of the Managed Property. Thus, the efficient rule would seem to be no personal liability to third parties for a non-negligent Manager acting within the scope of her authority.

If limited liability for the Manager were the unconditional default rule, however, there would arise the possibility that creditors might be misled into believing that they are dealing with the Manager in her personal capacity rather than just in her capacity as Manager, and consequently would extend credit on more generous terms than they would have if they had realized that they could not rely upon the Manager's personal assets for security. By requiring that the Manager give creditors clear notice before she can avoid personal liability, the prevailing trust rule assures both limited liability for the Manager and clear signaling to creditors of the assets on which they can rely. And here, as elsewhere, the existence of the trust as a standard form makes it easy for the Manager to send this signal because, in signing a contract, she need simply use the phrase "as trustee for X and not individually" to convey the situation to creditors.⁷⁸ Absent trust law, the Manager would need to insert explicit language in each of her contracts insulating her personal assets from creditors' claims—a costly burden that would presumably be impractical in many circumstances.

⁷⁶ See id. § 263.

⁷⁷ See id. § 265.

⁷⁸ See id. § 265 cmt. a.

In short, trust law establishes here a “penalty default”—that is, a default rule of liability for the Manager that is generally inefficient, but that gives the Manager an incentive to reverse the rule by revealing clearly to third parties that she is, in fact, just a Manager and that the third parties may turn only to designated Managed Property for their security.⁷⁹

2. *Liability of the Transferor*

Under trust law, the settlor as such is not personally subject to liabilities incurred in the administration of the trust.⁸⁰ Where the Transferor is not also a Recipient, this rule is easy to understand. The Transferor typically has little or no control over the ongoing administration of the Managed Property; indeed, the default rule in trust law is that the settlor has no right to enforce the trustee’s duties.⁸¹ Further, total monitoring costs for the creditors of the Managed Property and the personal creditors of the Transferor will likely be minimized if the former creditors need only monitor the Managed Property and the latter creditors need only monitor the personal finances of the Transferor. Finally, by creating strong incentives for a Manager to indicate that she is acting “as trustee for X and not individually,” the law of trusts helps assure that creditors are on notice that the Transferor’s personal assets are not pledged as security for liabilities incurred by the Manager on behalf of the Managed Property. (We will address in the following Part the case in which the Transferor is also a Recipient.)

In the absence of trust law, and with only contract and agency law with which to work, creation of a trust-like relationship in which the Transferor is free of personal liability would be difficult. In particular, if (as seems the natural alternative) the Manager were made the agent of the Transferor, contracts entered into by the Manager would generally be presumed to bind the Transferor as principal. The latter result could be avoided by putting a specific waiver of the Transferor’s liability into all contracts entered into by the Manager in connection with the Managed Property, but for the reasons noted earlier this individ-

⁷⁹ On penalty defaults in general, see Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L.J. 87, 95-107 (1989).

⁸⁰ See *Pottorff v. Dean*, 77 F.2d 893, 895 (1st Cir. 1935) (holding trustor who transferred stock in good faith to trustees not personally liable for assessment on stock). The principal exception is the case in which the settlor—particularly in the role of combined settlor/beneficiary—retains sufficient control over the conduct of the trustee as to make the trustee the settlor’s agent. See *infra* Part II.C.3 for a discussion of beneficiary liability.

⁸¹ See Restatement (Second) of Trusts § 200 cmt. b (1959).

ual contracting approach would likely be both unreliable for the Transferor and costly or impractical for the Manager.

3. *Liability of the Recipient*

Trust law also provides that the beneficiary is not personally subject to contractual commitments and other liabilities incurred in the administration of the trust.⁸² In the absence of trust law, this result might be difficult to obtain even where the Recipient is not the Transferor: An effort to establish a trust-like relationship could well lead to the Manager being characterized under the law as the Recipient's agent, with the consequence that contracts entered into by the Manager for the Recipient's benefit would bind the Recipient as well, whether or not the third parties knew that the Manager was acting for the Recipient.⁸³ Indeed, absent the law of trusts, it would be difficult to establish a trust-like relationship without the Manager being characterized as the agent of either the Transferor, the Recipient, or both, with the result that at least one of these two parties would be personally liable for obligations of the Managed Property. Thus, where the Recipient is also the Transferor, characterization of the Manager as the agent of the Transferor/Recipient, and consequent personal liability for the latter, would seem unavoidable. Further, as just noted in connection with personal liability for the Transferor absent trust law, efforts to avoid personal liability by contractual waivers from individual creditors would be a very inferior substitute for trust law. Indeed, the risk that a careless or unfaithful Manager would fail to insist on waivers would presumably be greatest precisely where unlimited liability for the Recipient is least appropriate, namely where the Recipient lacks not only the competence to manage the Managed Assets by himself, but also the ability to monitor the Manager.

At least so far as voluntary creditors are concerned, trust law's reversal of the agency law rule seems efficient. First, although the beneficiary receives the benefit—the residual returns—from the trust property, in common uses of the trust he typically exercises little direct control over it. Consequently, the beneficial incentive effects of personal liability for the Recipient would generally be modest at best.⁸⁴

⁸² See id. §§ 274-77.

⁸³ See Restatement (Second) of Agency §§ 140, 144, 186 (1958).

⁸⁴ Moreover, in the traditional three-party trust (as opposed to two-party trusts in which an individual simply delegates management of property to an expert for the individual's own benefit), the original decisions to create the trust, to contribute assets to it, and to select the Manager are all made not by the Recipient, but by the Transferor, so that

Second, and perhaps more important, since title to the trust property is in the trustee's rather than the beneficiary's name, persons who are contemplating extending credit to the trust are unlikely to be misled into believing that they will be able to rely on the beneficiary's personal assets for satisfaction of their claims, and can make appropriate adjustments in the terms on which they extend credit. The ability of creditors to make those adjustments is enhanced, moreover, by the fact that private trusts are most commonly employed where the Managed Property consists of a discrete pool of assets that are segregated from other assets owned by the Recipient, and whose management is unrelated to that of the Recipient's other assets. Additionally, the Manager (if she wishes to avoid personal liability herself) will signal to third parties that they are dealing with a trust, which will put those third parties on clear notice that the liability of the Recipient is limited to the trust assets.

Third, as with limited liability for the Transferor, limited liability for the Recipient (or the Recipient/Transferor) is likely to minimize the total costs of monitoring for the creditors of the Managed Property and the Recipient combined, and hence minimize the total costs of credit. Or at least this appears true for the purposes for which trusts are commonly used, such as asset management. Where it is not true, it is open to the Transferor/Recipient to assume personal liability for trust debts explicitly or to adopt a different organizational form, such as a partnership with the Manager, that automatically brings personal liability and hence pledges his personal assets as security for transactions with the Managed Property.

D. Relationships with Purchasers and Donees of the Managed Property

Another class of third parties whose contractual relationships are affected by trust law are persons to whom the Manager sells or donates Managed Property. Under the law of trusts, if the trustee transfers trust property to someone in breach of the terms of the trust, the beneficiary can recover the property and any income derived from it if the transferee is anyone other than a good faith purchaser who gives something of value in exchange for the property (i.e., is not a donee) and has no notice of the trust. The beneficiary's claims, moreover, are supported by an equitable lien on the property and its proceeds.⁸⁵ It is easy to rationalize, on efficiency grounds, a rule at least this protec-

personal liability for the Recipient would also have no useful incentives with respect to creation of the trust.

⁸⁵ See Restatement (Second) of Trusts §§ 287-95 (1959).

tive of the Recipient: In the circumstances in which the rule operates, the third party transferee is almost by definition a lower-cost monitor of the Manager's breach of duty than is the Recipient.

If the default rule were different—if, for example, a purchaser from the trustee always took good title—it would be virtually impossible for the Transferor, the Manager, and the Recipient to establish by contractual means the regime that is now the trust law default rule. This rule, then, is a significant contribution that the law makes to the creation of trust-like relationships. The extent to which it is a contribution of trust law, however, is subject to debate. The remedies that the common law of agency gives to principals when their agents make unauthorized transfers of property are of similar character.⁸⁶ On the other hand, European civil law remedies available when a Manager transfers property in breach of her contractual obligations to the Recipient are often somewhat weaker than those provided by the common law of trusts,⁸⁷ so that importation of trust law could have a meaningful impact in this regard. Perhaps more important than the default rule remedies, moreover, is the way in which trust law facilitates signaling to third parties the existence of the trust-like relationship, and hence helps put them on notice that the Manager lacks authority to make the transfer.

E. Successive and Shifting Recipients

So far we have implicitly assumed a single Recipient. Subject to the rule against perpetuities, the common law permits the beneficial interest in a trust to shift among individuals over time, and these shifts may be conditional upon a wide variety of contingencies. Thus, a father might create a trust for his daughter in which he stipulates that the beneficial interest in the trust will transfer from his daughter to his son if and when the latter reaches twenty-one years of age, and that, if the son should fail to complete law school by age twenty-seven, the beneficial interest in the trust will then shift to the settlor's oldest surviving nephew. In general, such shifting beneficial interests are not permitted under civil law. In the situation just mentioned, for example, the father might, at most, establish a usufruct interest in his daughter which lasts for her lifetime, with the remainder to shift to somebody else after her death. It is not possible, however, to create a

⁸⁶ One cannot say, however, precisely what rules agency law would provide in the absence of trust law, since agency law explicitly incorporates the trust law rules when an agent holds title for the benefit of the principal. See Restatement (Second) of Agency § 201A (1958). But cf. id. §§ 200-01 (concerning extent to which principal is bound when agent makes unauthorized transfer of chattel whose possession has been entrusted to him).

⁸⁷ See supra note 29 and accompanying text.

succession of two usufruct interests, with a third beneficiary to receive the remainder (e.g., usufruct to A for her life, then usufruct to B for his life, with remainder to C after the death of both A and B).⁸⁸

Whether the narrower civil law restrictions on multiple contingent interests are more or less efficient than the more liberal common law approach depends upon whether such arrangements have substantial utility. Whatever the answer to that question may be,⁸⁹ the difference between common law and civil law approaches in this regard is not a consequence of the failure to recognize the trust, but rather of a broader difference in the structure of property rights. The possibility afforded by the common law for creating a trust in which the beneficial interest shifts over time is a feature of the common law of property in general, and not of trust law in particular. That is, the common law rules that permit property interests to be made conditional and shifting have simply been extended to the particular form of property constituted by the beneficial interest in a trust. One could retain the

⁸⁸ Moreover, shifting interests are further discouraged in European law because usufruct transactions are relatively costly to set up. Arguably, before the abolition of *fideicomissa* (following the French Revolution), considerable flexibility was also available in the civil law. See, e.g., Michel Petitjean, *Essai sur l'histoire des substitutions du IX au XV Siècle dans la pratique et la doctrine, spécialement en France Méridionale* (1975).

⁸⁹ In contemporary society there is relatively little utility in multiple contingent interests. Moreover, any utility that arises is generally confined to the settlor, who wishes to impose his preferences on the behavior and fortunes of succeeding generations. Yet, since the settlor is dead for at least the latter portion of the life of the testamentary trust, it is impossible to recontract with the settlor should conditions change to thwart his original intent. That is, Coasean bargains to rearrange property rights when their current allocation becomes inefficient are impossible if the Transferor is dead and hence powerless to consent to a change. Yet, the law continues to respect the preferences he expressed while living. Moreover, even if the living parties with interests in the trust property have the power to consent collectively to changes in the terms of the trust, if those parties are numerous and all have different types of interests in the trust property, agreement among them is likely to be very costly or impossible. For this reason, decisionmaking mechanisms in modern trust-like arrangements—such as the corporation—in which property is managed by fiduciaries for a large number of individuals, are generally nonunanimous and permit substantial discretion on the part of the fiduciaries (and also generally have structures that provide for substantial homogeneity of interest among those who have the beneficial interests).

In the common law, the rule against perpetuities and other doctrines that undo dead hand restrictions are designed precisely to avoid complex fragmented property rights created by persons not among the continuing rights holders who cannot consent to changes. See generally Robert C. Ellickson, *Adverse Possession and Perpetuities Law: Two Dents in the Libertarian Model of Property Rights*, 64 Wash. U. L.Q. 723 (1986); Richard A. Epstein, *Past and Future: The Temporal Dimension in the Law of Property*, 64 Wash. U. L.Q. 667 (1986); Adam J. Hirsch & William K.S. Wang, *A Qualitative Theory of the Dead Hand*, 68 Ind. L.J. 1 (1992). Nevertheless, it is clear that the rule against perpetuities is too blunt an instrument to cure the problems that may arise during the life of the trust. Not surprisingly, courts in some jurisdictions may sanction variations of trusts even against the will of the settlor.

common law of trusts without the possibility of conditional or shifting interests in a trust, and one could retain the common law rules that permit interests in certain forms of property to be made conditional or shifting without maintaining the common law of trusts. Thus, the utility of the trust as a legal form is independent of the utility of successive and shifting interests.

On the other hand, if there are to be successive Recipients of the Managed Assets, trust law provides a convenient means for accomplishing the shift from one Recipient to another—a point we shall return to below.

III TRUST LAW'S IMPORTANT CONTRIBUTION

In sum, it appears that the important contribution of trust law lies not in its ordering, via default rules of contract, of the relationships among the three principal parties to a trust-like relationship—the Transferor, the Manager, and the Recipient—but rather in its ordering of the relationships between those persons and third parties with whom they deal. It is the latter relationships that, owing to high transaction costs, cannot be rearranged easily by contractual means.

The most significant of the contractual default rules that trust law establishes with respect to third parties are those governing creditors' rights. Those rules provide a convenient means by which the three principal parties can partition off a discrete set of assets—the Managed Property—not only for separate delegated management, but also for purposes of pledging those assets, taken together, to a distinct group of creditors as security.

A. Commercial Trusts

The modern commercial uses of the trust form, which are now by far the dominant uses, illustrate quite clearly the crucial role that creditors' rights play in trust law.

I. Pension Funds

Consider, first, the pension fund. In the United States, the typical pension fund is a pool of assets that is accumulated as a reserve with which to pay the pensions of employees at a given firm, and that is both funded and managed by the corporation whose employees are covered by the fund.

The Employee Retirement Income Security Act of 1974⁹⁰ (ERISA) requires that pension fund assets be held in trust form.⁹¹ A critically important consequence of this requirement—and presumably the principal motivation for it—is to assure that the fund's assets will be immune from claims of the corporation's creditors. If it were otherwise—if, for example, a pension fund were just an investment account maintained by the corporation within its corporate shell—the employees' pensions would always be subject to the risk of the corporation's insolvency. Thus, bankruptcy of the corporation could deprive the employees not only of their jobs, but of their retirement savings as well. Worse, if pension assets were available to the corporation's creditors, corporate shareholders and managers would have both the incentive and the ability to have the corporation take on inefficiently risky investments, knowing that if the investments succeed the shareholders will get the gains, while losses will be borne in substantial part by the employees.

At the same time, ERISA's insistence on use of the trust form does *not* serve as a means of imposing on the managers of pension funds the standard form fiduciary duties that trust law imposes on trustees. Instead, ERISA spells out those fiduciary duties on its own and thus imposes them directly without relying on trust law.⁹² One reason for this is to impose on the managers of pension funds a number of detailed obligations appropriate to such funds.⁹³ Another, presumably, is to limit the flexibility that trust law might otherwise afford to deviate from important elements of the standard form duties.

2. Mutual Funds

Immunity from the creditors of the fund's manager is also a critical reason for use of the trust form for mutual funds. If a fund's manager were simply the agent of the fund's investors, the fund's portfolio would always be at risk of the fund manager's insolvency—a risk that the investors would have great difficulty monitoring or controlling. For this reason, mutual funds that are not formed as trusts are typically formed as business corporations, which similarly immunizes the fund's portfolio from the insolvency of its managers.

⁹⁰ Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended in scattered sections of 26 U.S.C. and at 29 U.S.C. §§ 1001-1461 (1994)).

⁹¹ See ERISA § 403, 29 U.S.C. § 1103 (1994). There are limited exceptions, including principally assets of a pension plan that consist of insurance contracts or policies. See *id.*

⁹² See ERISA §§ 404-12, 29 U.S.C. §§ 1104-12 (1994).

⁹³ See Bogert & Bogert, *supra* note 57, § 255 (describing uniqueness of benefit plan funds and special fiduciary rules associated with them).

As with pension funds, the trust form clearly is not being used for mutual funds to take advantage of the particular fiduciary duties that are the default rule in trust law. The fact that nearly half of all mutual funds are formed as corporations, which have somewhat less rigorous standard form fiduciary duties (roughly those of agency law), is one indication of this. Another is that the Investment Company Act of 1940,⁹⁴ which governs mutual funds, imposes its own fiduciary duties on the managers of investment companies.⁹⁵

3. Asset Securitization

In a typical asset securitization transaction, a business corporation forms a private trust and transfers to that trust title to some subset of the corporation's assets—say, its accounts receivable—that yields an income stream. The trust in turn issues bonds that are backed by those assets and pays the proceeds of the bond sale to the corporation. Thus, the trust is used as an intermediary in a transaction in which a corporation, in effect, pledges some of its assets as security to back an issue of marketable bonds.

Why use the trust, rather than just have the corporation issue the bonds itself, pledging its accounts receivable as security? The answer is that the trust permits a very clear partitioning of the corporation's assets into different subsets that can be offered separately as security to different groups of creditors. The result is to reduce the total costs of monitoring for the corporation's creditors and hence reduce the corporation's cost of credit.⁹⁶ For this purpose, an essential feature of the trust is that it is (in the language of the securitization literature) "bankruptcy remote"—that is, it will be unaffected by the bankruptcy of the corporation and in particular will maintain secure title to the assets it holds (the corporation's accounts receivable, in our example) free of the potential delays or compromise that can result from the bankruptcy process.⁹⁷ Thus, the accounts receivable can be pledged more effectively as security for the bonds than would be the case if the corporation itself were to issue the bonds. By this means, corpora-

⁹⁴ 15 U.S.C. §§ 80a-1 to 80b-21 (1994).

⁹⁵ See Investment Company Act § 17, 15 U.S.C. § 80a-17 (1994), which sets out rules on conflicts of interest and establishes minimum standards of care for the directors or trustees of investment companies. Nearly all the terms of the Act, however, are designed to protect the investors who are the beneficial owners of the assets of investment companies.

⁹⁶ See Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 Wash. U. L.Q. 1061, 1090-94 (1996) (discussing information and monitoring costs related to firm's receivables and associated cost of credit).

⁹⁷ See Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan. J.L. Bus. & Fin. 133, 135 (1994) (discussing bankruptcy remoteness of firm's receivables that are transferred and held in trust, special purpose corporation, or other "special purpose vehicle").

tions that, taken as a whole, present a relatively high level of risk to their creditors are able to secure financing through the issuance of high-grade bonds.⁹⁸ Once again, it is the immunity of the Managed Property (the accounts receivable) from the bankruptcy of the Transferor (the corporation) and the Manager (which would be the corporation in the absence of the trust) that is the crucial contribution of the trust form to this transaction. The particular fiduciary duties imposed by trust law, on the other hand, are of little importance, since they are largely displaced by the highly detailed provisions of the trust agreement.⁹⁹

B. *Trust as Contract Versus Trust as Property*

In an important article, John Langbein recently has taken up the old debate—in which Frederick W. Maitland and Austin W. Scott represented, historically, the polar views—as to whether the law of trusts is properly considered a branch of contract law or of property law.¹⁰⁰ He notes that the property view advocated by Scott largely prevailed and that today “[w]e are accustomed to think of the trust as a branch of property law”¹⁰¹—a view that, Langbein observes, is affirmed in the Restatement (Second) of Trusts of 1959, which (like the first Restatement of 1935) declares that “[t]he creation of a trust is conceived of as a conveyance of the beneficial interest in the trust property rather than as a contract.”¹⁰² Langbein argues that this view is mistaken and that, in contrast, we should view trust law as a branch of contract law: “[T]he deal between settlor and trustee is functionally indistinguishable from the modern third-party-beneficiary contract. Trusts are contracts.”¹⁰³ In support of that assertion, he offers principally the fact that, as we have observed above, most of the powers and duties that trust law specifies for trustees are effectively just standard form default terms in a contract between the trustee and the settlor of the trust.

The analysis we offer here, in contrast, argues that it is precisely the property-like aspects of the trust that are the principal contribution of trust law. When we say that assets are someone’s property, we generally mean (among other things) that those assets are presumed available to satisfy claims of that person’s creditors. More particu-

⁹⁸ See Hill, *supra* note 96, at 1073 (discussing separation of receivables, with their relatively high creditworthiness, from firm’s overall, usually relatively lower, creditworthiness).

⁹⁹ See *id.* at 1098 n.163 (discussing detail found in such agreements).

¹⁰⁰ See Langbein, *supra* note 2.

¹⁰¹ *Id.* at 627.

¹⁰² *Id.* at 628 (quoting Restatement (Second) of Trusts § 197 cmt. b (1959)).

¹⁰³ *Id.* at 627.

larly, we mean that that person can pledge those assets as security for his contractual commitments, and indeed will generally be presumed to have done so unless he specifies otherwise (that is, the law effectively imposes a default term in all of that person's contracts providing that, if he defaults, the other party to the contract can levy on the assets in question). Trust law has important consequences in this regard and thus appropriately can be said to involve property law.¹⁰⁴

In effect, trust law provides for the creation of an entity—the trust—that is separate from the three principal parties. Under trust law, the Managed Assets are the property (in the sense just discussed) of the trust, not of the three parties associated with it, and particularly not of the Manager, despite her legal title to the assets. And the trust, in turn, is the property of the Recipient (at least to the extent of the Recipient's interest in it), and not of the Manager or the Transferor. The power of trust law is that, by invoking it, the principal parties to the trust—the settlor, the trustee, and the beneficiary—can easily (re)organize their contractual relationships with a large number of parties other than themselves, which would otherwise be extremely difficult to do. (Among these reorganizations facilitated by trust law, of course, are transfers of property rights in the entire pool of Managed Assets from one Recipient to another, as with the successive or shifting interests commonly seen in intrafamily uses of the trust, or in the tradable securities issued by mutual funds and asset securitization trusts.)

We agree with Langbein that, so far as the relationships between the settlor, the trustee, and the beneficiary are concerned, trust law adds very little to contract law. Aside from the pattern of creditors' rights that it establishes, trust law is little more than just agency law warmed over. But this simply underlines why that pattern of creditors' rights—the property-like aspect of trust law—is trust law's crucial contribution. If trust law were just a special purpose subset of agency law, easily replicated by inserting a few terms in the contract between the Transferor and the Manager, it would be difficult to understand why "Maitland was surely right to speak of the trust as perhaps 'the most distinctive achievement' of the Anglo-American legal tradition,"¹⁰⁵ and it would be equally difficult to understand why civil

¹⁰⁴ Langbein does acknowledge briefly that the insulation of trust assets from the trustee's creditors is a property-like attribute of the trust. See *id.* at 667-69. He is at pains, however, to minimize this aspect of trust law and suggests that it, too, might be replicated by ingenious contracting. Rather, he asserts, "What is special about the trust is the deal that subjects [the trust] property to the trust management regime." *Id.* at 671.

¹⁰⁵ *Id.* at 671 (quoting Frederic W. Maitland, *Equity: A Course of Lectures* 23 (John Brunyante ed., 2d ed. 1936) (A.H. Chaytor & W.J. Whittaker eds., 1st ed. 1909)).

law jurisdictions would have any particular interest in adopting the trust as a legal form, or would feel that adopting the trust is fundamentally inconsistent with the civil law's unitary theory of property rights.

Why, then, does Langbein argue so strongly for viewing trust law as part of contract law? It is because he has a normative purpose. He feels that the law of trusts is presently too rigid in some of its aspects and that this rigidity frustrates settlors' efforts to use trust law to achieve their objectives.¹⁰⁶ In particular, he feels that the law resists too strongly settlors' sometimes reasonable efforts to use as trustees persons who have, at least in a formal sense, conflicting interests in trust transactions.¹⁰⁷ He also feels that the law inappropriately refuses to permit settlors to enforce a trust when they are not among the trust's nominal beneficiaries.¹⁰⁸ He argues—quite convincingly—that courts and commentators should be more flexible in these respects in order to make trust law serve the purposes for which it should naturally be principally employed, which is to effectuate the shared intent of the principal participants in the trust.¹⁰⁹ For this purpose, it is quite appropriate to emphasize that the trust has an important contractual aspect. In pursuing this line of argument, however, Langbein has engaged in a bit of rhetorical exaggeration, overemphasizing the contractual aspects of trust law and minimizing what is in fact the most critical contribution of the law of trusts, which is its property-like aspect. Indeed, for Langbein's central—and sensible—normative purpose, it seems quite unnecessary to resurrect the hoary old debate as to whether trust law is a branch of contract law or of property law, much less to take a side. The arrangement of creditors' rights that the law of trusts effects is perfectly consistent with the reforms Langbein offers.

Indeed, we can go further. Once one recognizes that the fundamental contribution of trust law is in its arrangement of creditors' rights, and not in the fiduciary duties it provides, one should be more comfortable in accepting the contractual freedom in altering those duties for which Langbein argues.

Langbein is emphasizing, correctly, that a trust is principally a voluntary organization of rights and responsibilities among the Transferor, the Manager, and the Recipient—that is, it is a contractual arrangement. We are emphasizing that, while creating this pattern of rights and responsibilities among those three parties is the primary

¹⁰⁶ See *id.* at 663-67.

¹⁰⁷ See *id.* at 665-67.

¹⁰⁸ See *id.* at 664.

¹⁰⁹ See *id.* at 663-67.

reason for establishing a trust, and while the law of trusts is unquestionably a convenience in establishing that pattern, the law of trusts is not necessary for that purpose: In the absence of trust law, the law of contracts and agency would suffice, without enormous inconvenience. Rather, the essential purpose served by trust law—as opposed to the principal purpose served by the trust itself—is to facilitate an accompanying reorganization of rights and responsibilities between the three principal parties and third parties, such as creditors, with whom the principal parties deal. That reorganization of the rights of third parties—which is the property-like aspect of the trust relationship—is difficult to accomplish without the law of trusts.

The drafters of the Hague Convention on recognition of trusts in nontrust countries had to face these issues to determine what it was that had to be recognized. To this end, the Convention specifies that recognition implies, at a minimum, legal personality (the trustee may sue and be sued in his capacity as trustee) and a separate fund (including, in particular, the isolation of trust assets from the creditors of the trustee).¹¹⁰ In short, the Convention emphasizes what we have emphasized here: the trust as entity.

IV THE TRUST VERSUS THE CORPORATION

The trust as entity bears an obvious resemblance to the corporation. It has effective legal personality, and the assets it holds are subject to a pattern of creditors' rights essentially the same as those that characterize the corporation—in particular, freedom of the entity's assets from the managers' creditors and limited liability for those who hold the beneficial interests in the entity. This means that the corporation—particularly in its modern flexible forms that facilitate closely held firms—often serves as a good substitute for the trust. Evidently the corporation is not, however, a perfect substitute, as illustrated by the rapidly expanding role played by commercial trusts.

Consequently, having explored what the law of trusts adds to the law of contract and agency, it is necessary to ask next what the law of trusts adds to corporation law. The most general answer to this question is: flexibility. Trusts are free of many of the restrictions that are placed upon corporations by even the more liberal business corporation statutes. For example, trusts need not adopt the internal governance structures that are generally imposed on business corporations, such as the requirement that the entity be managed by a board of

¹¹⁰ See 2 Hague Conference on Private International Law, Proceedings of Fifteenth Session: Trusts—Applicable Law and Recognition 361, 363-64 (1985).

directors, elected annually by shareholders at a meeting held for that purpose. Moreover, while business corporation statutes generally require special shareholder authorization to increase the number of shares that the corporation is authorized to issue, there is no similar requirement imposed on trusts—an obvious advantage for investment pools such as mutual funds, which generally must be prepared for large and rapid increases in the number of beneficial owners they have and the size of the beneficial interests those owners hold.¹¹¹ While the practical significance of these forms of flexibility should perhaps not be exaggerated, neither are they obviously trivial.

Moreover, business corporation law is structured on the premise that at least one class of the holders of residual claims on the organization will be given the power to choose and remove the firm's directors and to participate as well in major decisions involving the firm. Trust law, in contrast, easily permits the creation of an entity managed by persons who are not subject to direct control by the residual claimholders (the Recipients). This is an advantage not only when the Recipients are incompetent, but as well when there are multiple Recipients with potentially conflicting interests, and the Manager must necessarily be given some discretion in balancing among those competing interests. In such situations, giving one class of Recipients the right to appoint and remove the Managers would threaten exploitation of the other Recipients, while having the Recipients share such authority would bring the added threats of wasteful maneuvering and deadlock. Making the Manager a pure fiduciary, not subject to control by any of the Recipients, helps avoid these risks, albeit at the potential price of reduced incentives for efficiency in management (i.e., larger managerial agency costs).

These observations suggest that the question we are asking should be turned around: Given the existence of the trust, why does one need the corporate form? This question has been placed in sharp relief by recent developments in the law of business trusts. The business trust first came to prominence in Massachusetts in the nineteenth century as a common law variant on the private trust.¹¹² In effect, the business trust simply involves the use of the trust form for the conduct of business on behalf of investors of capital, who become the beneficiaries of the trust. The investors' interests in the trust are commonly

¹¹¹ See Mary Ann Tynan, *Form of Investment Company Organization: Corporation vs. Massachusetts Business Trust*, in *Investment Companies* 1986, at 55, 55-64 (PLI Corporate Law & Practice Course Handbook Series No. B4-6746, 1986).

¹¹² See Sheldon A. Jones et al., *The Massachusetts Business Trust and Registered Investment Companies*, 13 Del. J. Corp. L. 421, 424-28 (1988) (discussing origin of business trust in Massachusetts).

tradable, just like shares in a business corporation, and the investors may also have the power to elect the trustees of the trust, just as corporate shareholders elect corporate directors. The initial attraction of the business trust in Massachusetts was that it avoided arbitrary restrictions in that state's corporation laws.¹¹³ The business trust has remained popular, however—particularly as a vehicle for asset management—even with the liberalization of business corporation statutes, and in the twentieth century it has become a fixture in the law of a number of states other than Massachusetts.¹¹⁴ Most conspicuously in the latter regard, Delaware in 1988 adopted a new statute governing business trusts that seeks to remove the remaining uncertainties that have inhibited the use of the form for business organizations.¹¹⁵

The greatest of these uncertainties was whether business trusts could assure limited liability for their beneficiaries. The common law rule is that if the beneficiary of a trust has substantial control over the conduct of the trustee, the trustee will be considered the agent of the beneficiary,¹¹⁶ with the result that the beneficiary is personally liable for obligations incurred by the trustee in the administration of the trust. In effect, this is a veil piercing rule for trusts that—because the requisite degree of control is not well settled in the law—has uncertain scope. Following the logic of this rule, courts have sometimes held that even if the beneficial owners of a business trust simply have the authority to elect the trustees, they control the trust sufficiently for the entity to be classified as a partnership, with the result that the beneficiaries become personally liable for the obligations of the trust.¹¹⁷ The Massachusetts courts rejected this rule for Massachusetts business trusts by 1947, but not all other states have followed suit, and there has remained the possibility that courts in other states might apply the rule even to business trusts formed under Massachusetts law. And, whatever the status of this rule, the exercise by beneficiaries of other forms of control might still expose the beneficiaries to

¹¹³ See *id.* at 426.

¹¹⁴ For a general survey, see Bogert & Bogert, *supra* note 57, § 247.

¹¹⁵ See Delaware Business Trust Act, 67 Del. Laws ch. 297, § 8 (1990) (codified as amended at Del. Code Ann. tit. 12, §§ 3801-20 (1996)).

¹¹⁶ See Restatement (Second) of Agency § 14B (1958).

¹¹⁷ See, e.g., *Goldwater v. Oltman*, 292 P. 624, 628-29 (Cal. 1930) (stating that "it is generally held that the power to elect trustees and fill any vacancies in the board gives the certificate holders such ultimate control over the trustees that the organization will be treated as a partnership and not a true trust"); *National City Bank v. First Nat'l Bank*, 19 S.E.2d 19, 26-27 (Ga. 1942) (holding that beneficiaries, by virtue of power to remove their representatives and fill vacancies, and power to remove trustee through their representatives, were virtually in complete command of trust and thus liable as principals).

personal liability.¹¹⁸ The recent Delaware business trust statute seeks to lay this matter to rest completely, providing explicitly that "the beneficial owners shall be entitled to the same limitation of personal liability extended to stockholders of private corporations for profit organized under the general corporation law of the State"¹¹⁹ and seeking to assure that, whenever a Delaware business trust is involved, Delaware law in this regard will be recognized by other jurisdictions as well.¹²⁰

The result is that the Delaware business trust statute is effectively a generic corporation statute. It provides for an entity with those basic attributes of a business corporation that cannot be established at reasonable cost simply by private contracting—namely, (1) legal personality and (2) the pattern of creditors' rights that characterizes both the business corporation and the common law trust, including, in particular, limited liability for both managers¹²¹ and beneficial owners.¹²² Beyond that, it is simply a facilitating statute, permitting the entity to be shaped as its organizers wish. The statute specifically grants freedom to arrange both control and distribution of earnings in any fashion that the governing instrument specifies.¹²³ Clearly it is possible, under the statute, to organize an entity with all the attributes of a standard business corporation—including tradable shares with all the rights to earnings and control typical of common stock—simply by providing in the trust's governing instrument that the entity is to have those attributes. In fact, trusts with such attributes are now commonplace, at least in the mutual fund industry. Indeed, it would also seem possible to organize a business trust with all the basic attributes of a

¹¹⁸ See Bogert & Bogert, *supra* note 57, § 247; Jones et al., *supra* note 112, at 439-43.

¹¹⁹ Del. Code Ann. tit. 12, § 3803(a) (1996).

¹²⁰ See *id.* § 3809 (providing for application of Delaware trust law unless otherwise specified in trust's governing instrument); *id.* § 3807(a) (requiring that at least one trustee reside in Delaware or be business with its principal place of business in Delaware).

¹²¹ The statute provides full limited liability in contract for managers simply as a consequence of registering the entity, rather than requiring, as the common law of trusts does, that the trustee indicate in each contract that she is acting as trustee. See *id.* § 3803(b)-(c). The Delaware statute also seeks to free managers from tort liability, which the common law of trusts does not. See *id.*

¹²² Insulation of trust assets from the personal creditors of the trustees is not specifically provided for in the statute, although it seems effectively guaranteed by the statutory provisions to the effect that the Delaware law of trusts shall apply, see *id.* § 3809, and by the provisions that give the business trust an even stronger character as a discrete entity than the traditional common law trust (for example by the statement that the trust is a legal entity, see *id.* § 3801(a), and that the trust itself can sue and be sued, see *id.* § 3804(a)).

¹²³ See *id.* § 3805(a).

cooperative corporation, limited liability company or, arguably, even a nonprofit corporation.¹²⁴

Why, then, is there any need for separate statutes providing for business corporations—or, for that matter, cooperative corporations, nonprofit corporations, or limited liability companies? In effect, these latter statutes just provide standard forms for enterprise organization that offer more detailed structure than does the business trust—a point that is emphasized by the increasing tendency (in the United States) to permit corporations, and particularly business corporations, to deviate from the standard forms through particular provisions in their charters.¹²⁵ There are a number of reasons why these more specific standard forms might serve a useful purpose. These include: reducing the burden of drafting; reducing information costs for various actors—lawyers, judges, and businesspeople—by inducing them to use the same form; making it easier for actors to bond themselves credibly to certain structures or forms of conduct; and facilitating an accretion of clarifying legal precedent.¹²⁶ It is quite possible, however, that all of these functions might be performed satisfactorily by standard forms that are privately supplied rather than supplied by the state, so long as the law offers a generic limited liability entity, such as the business trust, that provides the essential not-easily-contractible elements on which these specific standard forms must be built. Whether law has an important advantage over private contracting in supplying more than these basic elements is a difficult question.

To date, experience with the trust form has not provided us with a clear answer to this question. Although business trusts with the basic attributes of publicly traded business corporations are now commonplace, they are found principally in the mutual fund industry. This means that, like other business trusts, their activities are confined largely to management of a pool of relatively liquid financial assets. The business trust form, with or without the addition (via governing instrument) of the standard attributes of business corporations, apparently is not used at present to organize “operating” firms—that is,

¹²⁴ See, e.g., id. § 3801(a) (“whether or not conducted for profit”); id. § 3805(a) (providing that beneficial owner shall have proportional share in profits of trust “[e]xcept to the extent otherwise provided”).

¹²⁵ See, e.g., Bernard S. Black, Is Corporate Law Trivial?: A Political and Economic Analysis, 84 Nw. U. L. Rev. 542, 555-59 (1990) (noting that many apparently mandatory rules can be avoided through proper planning).

¹²⁶ For some thoughtful observations on the role of statutory standard organizational forms in a related context, see Larry E. Ribstein, Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs, 73 Wash. U. L.Q. 369, 374-84 (1995).

firms engaged in manufacturing or other industries that involve the production or distribution of complex goods and services.¹²⁷

There are, of course, important reasons why investors of equity capital in operating firms would find the protections offered by the governance mechanisms characteristic of the business corporation more important than would investors who are simply turning their funds over to portfolio managers. The performance of portfolio managers is relatively easy to ascertain and to compare with that of similar firms, and the most costly forms of abuse by portfolio managers can generally be avoided by means of specific regulation of self-dealing transactions, such as that imposed by the Investment Company Act of 1940.¹²⁸ In contrast, such constraints are largely ineffective in limiting some important forms of poor management in operating firms, such as investment in poor projects for purposes of empire building, or weak efforts to control costs. Moreover, in contrast to most manufacturing and service firms, firms providing portfolio management can be, and frequently are, organized as open-end funds that investors can quickly exit—and effectively force into partial dissolution—by redeeming their shares. Consequently, it is understandable that operating firms are commonly organized with the attributes of business corporations.

What we do not learn from current practice is whether an operating firm formed under a business corporation statute has any necessary advantage over a similar firm formed as a business trust in which the attributes of a standard business corporation have been added via privately drafted standard-form clauses in the firm's governing instrument. It may be that operating firms continue to be organized overwhelmingly under business corporation statutes simply through a mild form of inertia, and that if those statutes were repealed there would be a switch to the trust form with relatively little cost. Or it could be that the advantages of having a legally provided standard form, as opposed to one that is contractually provided, are quite important here, and that a generic limited liability form such as the business trust

¹²⁷ The situation was different in the late nineteenth century, when business trusts were used as the holding companies through which industrial oligopolies and monopolies were assembled—hence giving us the Sherman “Antitrust” Act of 1890. But the use of the trust form for this purpose was then dictated by the fact that business corporations were prohibited from holding shares in other corporations. When the latter restriction was eliminated—beginning with revision of the New Jersey statute in 1889—the corporation supplanted the trust form in this role. See Alfred D. Chandler, Jr., *The Visible Hand: The Managerial Revolution in American Business* 319-20 (1977) (noting that such legal consolidations “provided the first essential step in the transformation of such federations into modern industrial enterprises by means of administrative consolidation and centralization”).

¹²⁸ See Investment Company Act § 17, 15 U.S.C. § 80a-17 (1994).

could never substitute adequately for more specialized forms such as the business corporation.

We shall not try to resolve that issue here. We simply note that both law and practice concerning private trusts, and particularly business trusts, have evolved to the point where they have begun to pose this question quite directly. The reason for this is not that the business trust represents a transformation of the trust form in some fundamental way. Rather, the modern business trust just clarifies the features of the trust that, as we have argued here, have long constituted the most important contribution of trust law—namely, the partitioning off of a pool of assets into a separate fund subject to a distinctive pattern of creditors' rights. And those features happen to be features that the private trust has in common with the corporation.

V

TAXATION AND REGULATION

In this Article we have focused on the organizational attributes of the trust—that is, on the ways in which the legal form of the trust reduces the costs of organizing transactions. Yet, it is a familiar fact that, apart from its transaction-cost reducing advantages, the trust form is often used as a means of avoiding taxes, such as the separate income tax levied on firms organized as corporations. We shall not discuss these tax matters here because they are in principle separable from the organizational issues that are integral to the trust as a legal form: It is possible to tax trusts in any way desired, and in fact under current United States federal income tax law, they are taxed sometimes as trusts (under special tax rules established for that form¹²⁹), sometimes as corporations,¹³⁰ sometimes as partnerships,¹³¹ and sometimes they are simply ignored,¹³² depending on their particular attributes. Nevertheless, the availability of the trust as an organizational form requires the government to adopt tax rules adequate to prevent use of the trust form to avoid the government's desired pattern of taxation and—owing to the necessary incompleteness of any such set of rules—necessarily gives private parties more control over the tax treatment of their transactions than would be available without the trust.

Any jurisdiction that contemplates adopting the trust form therefore must be prepared to confront its tendency to facilitate avoidance

¹²⁹ See I.R.C. §§ 641-68 (1994).

¹³⁰ See Treas. Reg. § 301.7701-4(a) to -4(b) (as amended in 1996).

¹³¹ See *id.*

¹³² As in the case of grantor trusts. See I.R.C. §§ 671-79 (1994).

of taxation—and, as well, of other forms of fiscal and regulatory law. Indeed, the protean nature of the trust makes it particularly well suited to efforts at fiscal and regulatory avoidance, and this has been among the reasons that the European civil law countries have been reluctant to adopt the form.¹³³

CONCLUSION

Private trusts serve a variety of useful transactional purposes. The most important contribution of trust law to the accomplishment of these purposes is that it facilitates a particular partitioning of assets for purposes of pledging those assets to creditors. Unlike other aspects of the trust as an institution—including, in particular, the fiduciary duties that trust law imposes—this asset partitioning would be difficult or impossible to arrange if the law of trusts did not exist and parties were forced to rely upon just the ordinary tools of contract and agency law.

Much the same, however, is true of corporation law, which establishes essentially the same partitioning of assets. We are left, then, with the question whether the differences between these two forms are in any way fundamental, or whether the roles now served by these two forms could both be served as well by a single legal form that by itself imposes little beyond the asset partitioning that is their lowest common denominator, leaving other aspects of the assignment of earnings and control to contracting among the parties directly involved. This question is pressed upon us by the convergence in these two forms that has recently been taking place in American law through, on the one hand, the formalization and clarification of the trust form via business trust statutes and, on the other hand, the increasing contractualization of the business corporation through the elimination of mandatory rules.

¹³³ For example, concerns about tax avoidance played a role in France's recent rejection of legislation establishing the trust. See Decheix, *supra* note 31.