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The Private Creation of Private Trusts

Jonathan R. Macey
Yale Law School

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PRIVATE TRUSTS FOR THE PROVISION OF PRIVATE GOODS

by
Jonathan R. Macey*

I. INTRODUCTION

Usually the benefits and burdens of property ownership belong to the same person. In a trust, however, the two are separate. All the benefits belong to one party (the beneficiary) and all the burdens belong to another party (the trustee). Under modern law, three legal entities — a settlor, a beneficiary, and a trustee — are necessary in order to create a trust. To

* Professor of Law, Cornell University School of Law. I am indebted to my colleague Greg Alexander for extremely constructive comments and suggestions. An earlier version of this paper was presented at a conference on trust relationships jointly sponsored by the Liberty Fund and the Political Economy Research Center. The comments of Terry Anderson, Peter Aranson, Stephen Cornell, Dean Leuck, Roger Meiners, Laura Nelson, Kim Ohnemus, Richard Stroup, and Stephen Williams are also much appreciated.

1 Keplinger v. Keplinger, 185 Ind. 81, 113 N.E. 292 (1916) (a trust is defined as a property right held by one party for the use or benefit of another).

Modern trusts are traceable to the feudal concerns of medieval England. Under the feudal system, someone in possession of land held it as a grant from his lord. The lord granted his land away to obtain certain benefits, called duties, that the possessor, or tenant, of the land would owe to him. The most costly of these duties fell due at the tenant’s death when the land would pass to his heir.

The landholders developed a system to keep their land in their families, but avoid the duties that fell due at inheritance. They deeded their land to two or more other persons, but in the deed reserved the use of the land for themselves. When one of the persons the land was deeded to died, he would be replaced by someone else. Thus the land never passed to an heir and the feudal incidents never became due.

In time, most of the land in England came to be held this way. This system had many side benefits for the tenants; their creditors could not reach the land, since the legal title was in other people, and the medieval law requiring forfeiture of land upon a criminal act was avoided. Also, in early medieval times, land could not be sold or willed away; it had to pass to the tenant’s legal heir. However, the use of the land, which is all the tenant retained, could be willed to whomever he wished.

This dividing up of the ownership of land into legal title and use greatly weakened the power of the overlords, especially the king. As a result, in 1535, Henry VIII forced the Statute of Uses through an unwilling Parliament. The statute was intended to turn the legal title in land over to those who had the use of the land, and to do away with dual ownership.

The statute, however, had many loopholes, which were exploited by the land holders and embraced by the courts. The most significant of those loopholes were that only realty was included under the statute, not personality, and only those trusts which imposed no duty on the legal owner to actively use the property for the benefit of the use holder were included. Modern trusts sprang from these exceptions. See G. Keeton & L. Sheridan, The Law of Trusts 18-32 (10th ed. 1974); A. Scott & W. Fratcher, Scott on Trusts: The Law of Trusts §§ 1.2-1.7 (1987).

2 The creation of a trust vests legal title to property in the trustee and equitable (or beneficial)
create a trust, the settlor transfers his title in the trust property to the trustee who holds the property for the benefit of the beneficiary.

This Article employs an economic perspective to evaluate the creation of private trusts by private individuals. At first blush, private trusts appear to be simply another means by which private property owners may make use of their assets. As such, the private creation of private trusts seems to be a rather uninteresting topic for the application of economic analysis. In fact, however, the common law, which is generally considered to move towards efficient resolution of legal disputes, places significant constraints on the ability of property owners to alienate their property by means of the trust relation.

It is the thesis of this Article that the byzantine array of common law trust doctrines, which purport to modify trusts to conform to changing circumstances in ways the courts believe the settlor would have done if he possessed the requisite information to make an informed choice, do not promote efficiency and increase societal wealth. In this regard, the Article is at odds with the conventional wisdom in the law and economics literature, particularly as articulated by Judge Richard Posner, which holds that the common law in general and the law of trusts in particular tend toward efficiency.\(^3\)

This Article departs from the conventional wisdom in two respects. First, it posits that the harmony between efficiency concerns and outcomes

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generated by courts applying the common law of trusts is generally overstated. Second, and by way of explanation, it argues that particular aspects of the trust relation cause the common law system to depart from the conventional efficiency model in ways that previously have gone unrecognized.

The first part of this Article explores the nature of the economic problems that lead the legal system to impose constraints on the ability to create trust relationships. The following sections examine particular aspects of the law of trusts against the analytic framework devised in Section II. From an economic perspective, the failure of the legal system to regulate certain aspects of the trust relation (particularly the charitable foundation) is as interesting as its insistence on regulating certain other aspects of that relation. The final section of the Article offers an analysis of the private trust from the perspective of the modern theory of the firm.

II. AN ECONOMIC FRAMEWORK FOR ANALYZING THE LAW CONCERNING THE PRIVATE CREATION OF PRIVATE TRUSTS

From the standpoint of economic efficiency, the legal right to create private trusts that permit dead hand control of wealth appears to cause a dilemma. On the one hand, the legal right to dictate through a trust how wealth is to be used after death may lead to economic inefficiency because conditions inevitably will change in ways unforeseeable to the settlor. On the other hand, regulating how a settlor can dispose of his wealth may lead to inefficiencies because such interference would decrease the incentive to accumulate wealth, since influencing events and individuals after one's death may provide a primary motivation for accumulating wealth during one's life.

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4 The dead hand control of wealth refers to those legal rights that permit property owners to dictate through a trust how wealth is to be used after their death.

5 This appears fairly obvious when one stops to consider the fact that most people of means die without consuming all of their wealth during their lifetimes. If people derived no utility from the prospect of influencing events after their death, then it is improbable that they would die while still in possession of significant economic resources.

And, as Judge Posner has observed, the argument that the reason people die leaving significant resources cannot persuasively be answered by the argument that people do not know when they are going to die. The ability to purchase financial instruments such as annuities means that property holders can, if they so choose, be assured of dying without leaving a significant estate at death. See R. Posner, supra note 3, at 479-80.
Judge Posner, after noting the existence of this apparent conflict, dismisses it as a false dilemma. He argues that, in many cases, rigid adherence to the settlor's terms actually would frustrate his intentions, under the assumption that the settlor did not intend to make a useless gift. While this assumption appears uncontroversial, indeed banal, it begs the more important theoretical questions associated with the private creation of private trusts.

Perhaps the most obvious question is whether the initial premise, that conditions often change in ways unforeseeable by the settlor, is necessarily correct. Put another way, the question becomes whether the transaction costs of writing a trust instrument that specifies all conceivable future contingencies are truly infinite. Even if the answer to the question is yes, it is interesting to wonder: at what point does it become inefficient to plan for the unexpected? This Article argues that this must depend on how the settlor expects the unexpected to be handled.

The next question is the extent to which the possibility of a settlor's error creates an additional justification for regulating the ways that a settlor can dispose of his wealth. That issue is related to the previous issue in the following way: even if a settlor can increase the probability of achieving his wishes by specifying such wishes in great detail, he will refrain from doing so if the gain is offset by the losses that come in the form of increased error costs.

The final question, and perhaps the most complicated issue embedded in an analysis of how to create the optimal system for the creation of private trusts, is how to monitor and control those people involved in the disposition of the trust after it is created. This issue is closely analogous to the problems in corporate finance associated with the separation of ownership and management of the large, public corporation. The problem, however, appears to be significantly more acute in the context of the trust relation — and in the context of the charitable foundation in particular — as the market forces that constrain the scope of authority of corporate officials do not appear to constrain similarly the trustees and employees of

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7 See generally Goetz & Scott, The Limits of Expanded Choice: An Analysis of the Interaction Between Express and Implied Contract Terms, 73 Cal. L. Rev. 261, 265-73 (1985) (discussing the various sorts of errors that can occur in formulating contracts, including administrative error, ambiguity, incompleteness, inconsistency, and misinterpretation).
The questions described above can be summarized as follows: (1) what is the nature of the transaction costs associated with the creation of private trusts; (2) what are the error costs associated with the private creation of private trusts; and (3) what are the agency costs associated with the private creation of private trusts?

A simple example demonstrates that the analysis concerns broader issues about economic efficiency and overall societal welfare. Suppose a testator with $40,000,000 has decided that he will derive 100 units of utility from organizing a charitable trust that will establish a fund to sponsor conferences on the general subject of liberty in society. Our testator also has decided that he would derive 95 units of utility from declining to establish a trust and instead making an outright gift of his money to the Indianapolis Symphony Orchestra. The testator will not automatically choose to give his money to the charitable trust. Rather, his decision about how to allocate his money will depend on the probability that the fund ultimately will in fact sponsor conferences on the general subject of liberty in society. If there is a one-hundred percent probability that the gift to the Symphony will be used as the benefactor prefers, and a probability of any sum less than 95% that the bequest, for any of the reasons described above, will be used to sponsor seminars that deal with the subject of liberty, then the benefactor will prefer that his money go to the Symphony.

Thus, overall societal welfare can be improved by erecting a legal system that lowers the error, transaction, and agency costs associated with creating private trusts. Such a legal system would provide maximum incentives to create wealth, and facilitate the creation of private trusts which provide for the creation of significant public goods. The remainder of this Article reviews the major legal rules that concern the private creation of private trusts and analyzes them on the basis of whether they serve to reduce the costs associated with the creation of trusts in ways suggested by the model described above.

* See generally Bernheim, Shleifer & Summers, The Strategic Bequest Motive, 93 J. POL. ECON. 1045 (1985) (an analysis of the use of bequests by testators to influence the behavior of potential beneficiaries).
III. THE COMMON LAW OF TRUSTS

A. The Cy Pres Doctrine

Perhaps the most notorious intersection of the law of trusts and the analytic constructs developed above comes in the form of the cy pres doctrine. The doctrine holds that when the goals of a charitable trust become unattainable, inexpedient, or impracticable, a judge may substitute another charitable object which he believes closely approaches the original purpose of the trust. At the outset, it is interesting to note that the common law gives far more latitude for courts to apply cy pres to charitable trusts than to purely private trusts.

For example, while courts will invoke the cy pres doctrine to change the beneficiary of a charitable trust a court will never invoke this doctrine to change the beneficiary of a private trust. On the other hand, courts will permit alterations in private trusts on account of unforeseen circumstances. The first part of this section examines the cy pres doctrine in the context of purely private trusts. The second part examines the doctrine in the context of charitable trusts.

1. Private Trusts Lacking a Charitable Purpose

The case of Donnelly v. National Bank of Washington provides an example of a court applying common law doctrine to interfere with the language used by a settlor in the creation of a trust document. In this case, a trust was created to provide for annual payments for Donnelly, the beneficiary, to attend college and law school. The trust specified that no payments were to be made after December 31, 1945. In 1942, after having completed one year of law school, Donnelly was drafted, and was not discharged until 1946. The court ordered the trustee to resume payments, despite the fact that such payments were being made after the 1945 deadline set by the settlor. The court opined that the settlor's clear intention was to allow the beneficiary to complete law school, and that the settlor did not foresee that Donnelly's education would be interrupted by military service.

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10 27 Wash. 2d 622, 179 P.2d 333 (1947).
By no means does the result in this case clearly effectuate the settlor's intentions. The settlor, had he so intended, easily could have specified that payments would not be made after 1945, unless events beyond the control of the beneficiary delayed the completion of law school. Thus, the court's ruling cannot be justified on the rationale that it economizes on testators' transaction costs. Similarly, as indicated, there are plausible reasons why the settlor might not have wanted to subsidize Donnelly's education after a certain date. Thus, the court's decision does not seem to result in an economy of error costs to the settlor. As this case does not involve a conflict of interest between the beneficiary and the settlor or the settlor and the trustee, the agency cost rationale is inapplicable.

Another case that makes provision for the payment of money for the education of the beneficiary seems similarly misguided. *In re Estate of Kerber*12 involved the creation of a private trust to provide for the college education of the settlor's yet unborn grandchildren. One of the settlor's grandchildren was born with brain damage sufficiently severe to make the child's chances of attending college slight, particularly if the child did not receive special education early in life. The court directed the trustee to pay the trust principal to the child's parents for them to use to provide special education for the child. The court held that this payment effectuated the settlor's intentions since it increased the chances that the child ultimately would attend college.13

Once again, despite the sympathetic facts, it is by no means clear that the result reached by the court is the one that the settlor would have reached if he had been around to make the decision for himself. Here the error costs justification described above comes into play. The court presumes that the settlor erred in that he did not foresee that he might have a grandchild who would be unfit to attend college without the benefit of costly special education. On the other hand, the settlor did not make any provision for providing payments for the college preparation of any of his other grandchildren.

Is it reasonable to infer from this that the settlor only wanted to pay for

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11 *Id.* at 628, 179 P.2d at 336.
12 71 Misc. 2d 489, 336 N.Y.S.2d 400 (1972).
13 *Id.* at 490-91, 336 N.Y.S.2d at 402.
the education of his grandchildren if they could gain entrance to college without preparation? Of course not. The settlor realized that his grandchildren, like all children, would need college preparation, which presumably they would receive from their parents. Normally, the parents, in the absence of a trust arrangement such as this, would participate in the payment of the college education of their children. Seen in this light, the settlor's creation of this trust is not only a gift to the settlor's grandchildren but to the settlor's children as well. Specifically, the trust relieved the settlor's children of the financial burden of providing for the college education of their children. But this benefit was not to be enjoyed by the parents without cost. Rather, the parents would still be expected to incur the cost of college preparation as an implied condition of receiving the benefit of a college education for their children free of charge.

Thus, the court's opinion may have destroyed a *quid pro quo*, intended by the settlor, in which the settlor agreed to provide for the college education of his grandchildren if and only if the parents of the grandchildren provided for the college preparation of the grandchildren. Here, at least, it is arguable that the court's decision raises rather than lowers the transaction costs associated with establishing private trusts because it requires settlors to specify in great detail the circumstances under which trust funds can be used for purposes other than those described in the trust instrument. It seems impossible to know whether the court was right or wrong in permitting the trust's funds to be used for a purpose other than the college education of the settlor's grandchildren. Suppose, however, that so much money was spent on this child's special education needs that insufficient funds were available to satisfy the educational needs of the other grandchildren. If this were the case, the opinion would seem indefensible as it would promote the interests of one grandchild (and perhaps one set of parents) over the others in the absence of any reasoned basis for doing this.

The point here is not to prove that the court was wrong in these two cases, only to demonstrate that the evidence does not show that these decisions were right: the courts, by invoking the *cy pres* doctrine in these cases, were just as likely to have thwarted the settlor's intentions as to further them. The point becomes even clearer when we see that the law

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14 Some states give courts power to amend trusts by statutes, in some instances in very limited
has created an entirely artificial distinction between the situation in which a settlor has established an inter vivos trust and the situation in which the settlor has established an identical trust by writing a will. Courts will, even after the settlor's death, revise an inter vivos trust in the ways described above, but will decline to revise a will under identical circumstances. Both legal doctrines cannot be efficient in the way Judge Posner describes.

2. The Charitable Trust

The even greater malleability of the charitable trust is shown by the famous case of Evans v. Abney. Augustus Bacon, a United States Senator from Georgia, died leaving a will drafted during the segregationist period of the late 1800s. In this will, Senator Bacon donated a park to the city of Macon, Georgia but stipulated that the park was to be used only by white women and children. The City of Macon filed suit to charge that enforcement of the racial condition violated the equal protection clause of the fourteenth amendment to the Constitution. In Evans v. Newton, the
United States Supreme Court agreed, holding the condition void.\textsuperscript{18}

Following the 1965 Supreme Court decision, the heirs of Senator Bacon sued to have the gift declared void under the theory that the city could no longer legally run the park in a manner consistent with the testator's wishes. The heirs won this suit.\textsuperscript{19} As a result, the property that comprised the park reverted by operation of law to the heirs\textsuperscript{20} under the residuary clause\textsuperscript{21} of the will.

This decision has been criticized by Judge Posner as inconsistent with the likely intentions of the settlor:

It appears that Senator Bacon may have inserted the racial condition primarily to assure that the city would agree to administer the park. There was no indication that the dominant purpose of the gift was to foster racial segregation rather than to provide a recreational facility for the people of Macon. It seems likely that if Senator Bacon could be consulted on the matter, he would prefer that the park remain a park, albeit open to nonwhites, rather than that his distant heirs subdivide the property for residential or commercial use.\textsuperscript{22}

But Judge Posner's analysis is subject to considerable doubt because it ignores the fact that Senator Bacon's decision to bequeath the land for a park instead of for some alternative use was a marginal decision. That is, a range of alternatives were open to Bacon, and the park decision may only have prevailed by a narrow increment. Thus, even if the segregation provision was not "the dominant purpose of the gift," it may have been enough to cause this particular allocation to edge out the alternative of bequeathing the land to his heirs.\textsuperscript{23}

\textsuperscript{18} Id. at 302.
\textsuperscript{19} Evans, 396 U.S. at 448.
\textsuperscript{20} Id. at 439.
\textsuperscript{21} A standard clause which provides for disposition of the testator's property in the event the conditions of the will turn out to be illegal or impossible to attain.
\textsuperscript{22} R. Posner, supra note 3, at 482.
\textsuperscript{23} Contrary to Judge Posner's assertions, the Court carefully analyzed the nature of the testator's preferences and concluded that the racial restrictions in the will "were solely the product of the testator's own full-blown social philosophy." 396 U.S. at 435. Posner's analysis becomes particularly doubtful when we look at the actual language used by Senator Bacon in his will:

I take occasion to say that in limiting the use and enjoyment of this property to white people, I am not influenced by any unkindness of feeling or want of consideration for the Negroes, or colored people. . . . I am, however, without hesitation in the opinion that in
Thus, it is by no means clear that the Court reached the wrong result in *Evans*. But the question is not, as Judge Posner and the Court put it, whether maintaining racist restrictions in the park was the testator's primary intention. Rather, the question is whether the testator would have preferred the land to be used as a desegregated park more or less than the alternative available to the Court: allowing the land to revert to Bacon's existing heirs. At the time of the Court's decision, the Bacon family contained no representatives known to Bacon. In addition, the family had grown so that dividing the property into a sufficient number of increments to provide everybody with a share would result in dividing the property into parcels so small as to be of extremely limited commercial utility.

The only plausible conclusion in light of the available evidence is that neither of the alternatives available to Senator Bacon would have been attractive to him. In all likelihood, it would have been a matter of indifference to him whether the land was to be used for an integrated park or distributed to a bevy of distant relatives. It simply is impossible to know, in this case, the fact that Bacon declined to specify how his trust should be used in case the bequest failed seemed to support permitting the City of Macon to retain the park and run it on a nondiscriminatory basis.24

The more common type of amendment made by the courts is purely ministerial. For example, when circumstances dictate, courts will change the directions the trust instrument gives to the trustee regarding how the trust principal is to be invested, when the original directions become impracticable because of changed conditions. Courts deviate from the trust instrument by conferring additional authority on the trustees.

In *Union Commercial Bank v. Kusse*,25 the trust instrument directed the trustee to retain securities, but the court authorized their sale after it had become imprudent to retain them.26 Such changes are usually allowed, however, only when necessary to keep the purpose of the trust from being defeated, not merely to benefit the trust. This use of the *cy

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396 U.S. at 442. The Senator's own words thus cast considerable doubt on Posner's supposition that Senator Bacon would prefer to keep the park open to nonwhites to letting the park revert to his heirs.


26 *Id.* at 223, 251 N.E.2d at 889.
The cy pres doctrine unambiguously serves the interests of economic efficiency by reconciling the goals of settlors with unanticipated future events seems doubtful when examined closely. An alternative rule which stipulates that the settlor’s assets always revert back to his heirs whenever any significant aspect of the settlor’s intentions are thwarted, unless the settlor provides for a contrary result, would serve the interests of efficiency at least as well. Such a rule would provide a better guide to courts on the value to the settlor of his second choice asset allocation.

B. The Rule Against Perpetuities

Every trust must conform to the Rule Against Perpetuities. The rule prevents settlors from establishing trusts that contain contingent interests that vest too remotely in time. A contingent interest such as a contingent remainder, an executory interest, or a vested remainder subject to open, is an interest that is either conditional on the occurrence of some specified event or one where the beneficiaries are unascertainable (for example, a bequest to all of the children of Joe is contingent if Joe is alive since he might have more children).

The rule requires that all contingent interests vest, if at all, within twenty-one years after some life (called the measuring life) that is in being at the time of the creation of the trust. Trusts that violate the rule are void at their creation. So for example, a trust to begin making payments to Jon
Macey's grandchildren when an orchestra is established in Bozeman, Montana would be void from the outset because it was not certain that the condition would occur, if at all within twenty-one years after a life in being. Even if an orchestra were established in Bozeman within twenty-one years after some life in being at the time of the creation of the trust, it would not matter because the common law does not permit us to wait and see whether the contingent interests vest within twenty-one years of a life in being at the time of the creation of the trust. On the other hand, a trust to begin payments to Donna Aranson if an orchestra is established within twenty-one years after Ronald Reagan's death would be valid, because the trust must vest, if at all, within the time specified by the rule.

The rule contains certain pitfalls relevant to trusts. Perhaps the most famous of these is the conclusive presumption of lifetime fertility (the "fertile octogenarian" rule). In determining whether an interest will vest within twenty-one years after some life in being at the time of the creation of the trust, the law conclusively assumes that anyone alive is capable of having children. Even if someone creates a trust for the benefit of the grandchildren of an eighty-year old woman to vest at the death of the last surviving child of the eighty-year old woman, the trust is void because the woman might have another child after the interest is created, in which case the interest is not certain to vest within twenty-one years of a life in being at the time of the creation of the interest.

The Rule Against Perpetuities has been praised as efficient because it limits the ability of people to control assets into the distant future. Such restrictions on a person's property rights, in turn, are praised as means to reduce the error costs associated with the creation of a private trust because, it is argued, "arrangements for the distant future are likely to result in an inefficient use of resources brought about by unforeseen contingencies."27 This seems to be a peculiar form of paternalism. People forming trusts clearly will take the possibility of unforeseen contingencies into account when creating the trust. If the utility to them from making this allocation of resources is still higher than the next most attractive alternative, after the possibility of error has been factored into the individual's utility calculation, then a basic respect for property rights would require that settlors be able to establish trusts as they see fit.

27 R. Posner, supra note 3, at 486.
Another traditional justification for the Rule Against Perpetuities is that it increases the possibility of alienation of an interest since it reduces the amount of time future owners of the interest will be unknown. This justification does not seem to apply to trusts since the trust principal is fully alienable by the trustee unless the trust instrument specifies otherwise.

In fact, in modern times, a strong motivation for making gifts to remote descendants appears to have been a desire to avoid tax consequences of a bequest to immediate heirs. Specifically, it long has been a principle of the law of estate and gift tax that such taxes apply only to transfers of property. A life estate that expires on the holder’s death, therefore, causes no additional tax burden on the holder’s estate since the property passes to the next owner without a transfer by the decedent. Thus, a gift of property in trust with income to Joe for life and the remainder to Joe’s children at his death, historically would have allowed Joe to enjoy the property without paying taxes on it at his death (the property would be taxed as a gratuitous transfer to the grantor).28 In 1977 with passage of the 1976 Reform Act entitled “Tax on Certain Generation-Skipping Transfers,” a tax is imposed on certain generation-skipping transfers upon the distribution of property to a generation-skipping heir (Joe’s children in the above example) or upon the termination of an intervening interest in the trust (such as Joe’s life income).29 More recent tax law changes have complicated the rules immensely, and it now appears that, while the possibilities to achieve tax avoidance through generation-skipping transfers have been reduced, they have not been eliminated.

Even the most hearty defender of the tax revenue collection process cannot defend the Rule Against Perpetuities on the grounds that it protects the fisc. If there is a tax avoidance problem associated with a particular transfer, the efficient (and the tax revenue maximizing) solution is to amend the tax laws to close the loophole rather than to decline to permit the transfer altogether. Such a solution should be preferred by both the taxing authority and the property owner.

Despite the fact that the Rule Against Perpetuities is difficult to justify

on efficiency grounds, common law courts have done little to mitigate the effects of the rule on property holders so as to relieve transferors of the consequences of technical violations. Indeed, most of the significant liberalizations of the effects of the rule have come in the form of statutory enactments.\textsuperscript{30}

If the common law is efficient, it is hard to imagine why the law has not amended the rule to include a “wait and see” provision in order to avoid the technical pitfalls of the common law version of the rule. The “wait and see” rule is a statutory device used to alter the Rule Against Perpetuities to increase the chances that the settlor’s intentions will be carried out. When a “wait and see” rule is in place, the validity of a contingent interest is determined on the date the contingency becomes vested rather than on the date of the creation of the trust. If a trust that might not vest within some life in being plus twenty-one years winds up vesting within that period, then the interest is good. So, for example, under the common law, if an eighty-year old woman establishes a trust for all of her children, and stipulates that upon the death of the last child the corpus of the trust is to go to the surviving grandchildren, the interest would violate the Rule Against Perpetuities because the eighty-year old woman might have another child after the trust is established. In a juris-

\textsuperscript{30} In addition to the states that have adopted a “wait and see” provision, five other states — Connecticut, CONN. GEN. STAT. ANN. § 45-95 (West 1981); Florida, FLA. STAT. ANN. § 689.22(2)(a) (West 1969); Maine, ME. REV. STAT. ANN. tit. 33, § 101 (1978); Maryland, MD. EST. & TRUSTS CODE ANN. § 11-103(a) (1979); and Massachusetts, MASS. GEN. LAWS ANN. ch. 184A, § 1 (West 1987) — determine the validity of a contingent interest upon the expiration of all the life estates of persons in being when the trust began.

Nine states allow courts by statute to use cy pres powers to amend interests which would be invalid under the rule: California, CAL. CIV. CODE § 715.5 (West 1982); Idaho, IDAHO CODE § 55-111 (1948); Kentucky, KY. REV. STAT. ANN. § 381.216 (Michie/Bobbs-Merrill 1972); Missouri, MO. ANN. STAT. § 442.555(2) (Vernon 1986); Ohio, OHIO REV. CODE ANN. § 2131.08(c) (Anderson 1976); Oklahoma, OKLA. STAT. ANN. tit. 60, § 75-78 (West Supp. 1988); Pennsylvania, 20 PA. CONS. STAT. § 6105 (1986); Vermont, VT. STAT. ANN. tit. 27, § 501 (1975); Washington, WASH. REV. CODE ANN. § 11.98.150 (1987). The Hawaii courts gave themselves this power. \textit{See In re Estate of Chun Qun Yee Hop}, 52 Haw. 40, 469 P.2d 183 (1970).

An additional seven states allow the courts to reform only to the extent of reducing the age at which an interest will vest, to bring it within the 21 year limit: Connecticut, CONN. GEN. STAT. ANN. § 45-96 (West 1981); Florida, FLA. STAT. ANN. § 689.22(4) (West 1969); Illinois, ILL. REV. STAT. ch. 30, § 194(c) (1986); Maine, ME. REV. STAT. ANN. tit. 33, § 102 (1978); Maryland, MD. EST. & TRUSTS CODE ANN. § 11-103(b) (1974); Massachusetts, MASS. GEN. LAWS ANN., ch. 184A, § 1 (West 1987); and New York, N.Y. EST. POWERS & TRUSTS LAW § 9-1.2 (McKinney 1981).

In some states, the right of entry and possibility of reverter terminate after a period of years; Kentucky has abolished those interests completely.
diction with a "wait and see" provision a court would not declare the trust invalid, but would wait and see if the woman had any more children, and if she did not, declare the interest valid.

Those who argue that the common law is efficient might argue that as long as we have the Rule Against Perpetuities, strict enforcement best serves the interests of efficiency because it provides certainty and predictability of title. But such an argument does not account for the fact that the common law does not permit settlors to contract around the strictures of the rule by, for example, allowing a property owner to specify that courts construing the trust document should adopt a wait and see posture towards a particular bequest.

C. Limits on Accumulations

The additional, and perhaps even less understandable, limitations on the ability of property owners to dispose of their property as they see fit are the statutory and common law restrictions on the amount of time that the income generated by a trust may be used to purchase new assets or increase the value of existing assets rather than be paid out to the beneficiary. While judicial opinions on the subject are scarce, the apparent majority of opinions holds that accumulations are limited to the time allowed under the Rule Against Perpetuities. The Kansas Supreme Court has held that a trust that directed the trustees to add six-twentieths of the surplus income to the corpus of the trust each year violates the common law Rule Against Accumulations, and courts in Delaware and Connecticut have reached similar results. In most jurisdictions, if an accumulation extends for an invalid period of time, the trust assets go to the estate which would have taken them at the end of the directed accumulation.

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33 Equitable Trust Co. v. Ward, 48 A.2d 519 (Del. Ch. 1946).

34 Gaess v. Gaess, 132 Conn. 96, 42 A.2d 796 (1945).

35 This is called the "next eventual estate." See G.G. Bogert & G.T. Bogert, The Law of Trusts § 215 (2d ed. 1985); G.G. Bogert & G.T. Bogert, Handbook of the Law of Trusts 140 (5th ed. 1973). In many states, statutes void only the excessive period of accumulation, which is
The arguments in favor of a rule limiting accumulations are not persuasive. The reasoning seems to be that accumulations are not to be allowed because they allow wealth to be concentrated in the hands of a few and that the current generation is deprived of the benefits of wealth. It must be emphasized that these arguments do not support a rule barring accumulations even if one accepts the dubious premise that these goals are worth attaining.

Under a modern trust, the beneficiary is not the only one who derives a benefit. The trustees are required by law to invest the money that comprises the corpus of a trust in prudent investments of some kind. As such, the current generation is in no way deprived of the benefits of the wealth contained in the trust. Instead, whichever members of the current generation are the subjects of the investments of the trustees gain the use of the wealth. In other words, the fact that trust assets are alienable and that they are invested means that the current generation is not deprived of their use.

Similarly, unless trustees systematically are able to invest trust accumulations so as to outperform all other investments, there is no reason that permitting such accumulations will allow wealth to become more concentrated. If societal wealth increases at, say, five percent per year, and trust accumulations on average increase at the same rate per year, then the beneficiaries of trust accumulations will not control increasingly large shares of society's wealth.

D. Miscellaneous Other Provisions

Other common law restrictions on the ability of people to dispose of their property through the creation of a trust relationship abound. One restriction, except where it has been abolished by statute, is the ancient Rule in Shelley's Case which restricts settlors from granting a life estate to one person, and giving the remainder to that person's heirs. Under the Rule in Shelley's Case, when a transferor attempted such a transfer (such as O to X for life then to X's heirs and their heirs), the heirs took nothing and the life tenant took the remainder, despite what courts have rightly described as the "remarkably clear" intention of the settlor.36

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36 Sutton v. Milburn, 289 Ark. 421, 711 S.W.2d 808, 812 (1986) (the court refused to apply the generally defined as the perpetuities period.
A similar common law restriction on alienability is contained in the Doctrine of Worthier Title. Under this doctrine, if a property owner creates a life estate, either in himself or someone else, with a remainder in his own heirs, the grantor receives a reversion and the heirs receive nothing. Since reversions are inheritable, the effect of the rule is that heirs get the property by descent (inheriting the land or the reversion) rather than devise (the instrument that gave them the remainder), and title by descent is considered "worthier" than title by devise. Of course, where the settlor makes a subsequent transfer of the property during his life or dies leaving a will with no provision for his heirs, the Doctrine of Worthier Title frustrates the settlor's intentions.

Strange as it may seem, as the following example indicates, an argument can be made that this rule often serves to effectuate the intention of testators. Suppose that a property owner, Mr. Anderson, creates a trust with himself as beneficiary of a life estate and with the principal in remainder to his heirs alive at his death. Without the Doctrine of Worthier Title, if Mr. Anderson wanted to end the trust during his life, he would need the consent of all his beneficiaries, making it impossible for him to get at the principal. The Doctrine of Worthier Title remedies this problem by finding that Mr. Anderson actually intended to create a trust with a reversion in himself rather than a remainder in his heirs.

On the other hand, to the extent that the initial arrangement made by the settlor is a form of self-bonding in which the settlor decides to deprive himself of the opportunity to make future alterations to a gratuitous property transfer, the Doctrine of Worthier Title frustrates the settlor's intentions. In general, courts have begun to apply the Doctrine of Worthier Title as a rule of construction, with the goal of giving effect to the settlor's intention. The doctrine has been abolished by statute in some states and abolished as a principal of law in others; clear cut applications of the rule rule to a case involving personal property but noted an inclination to apply the rule in cases involving real property).

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Reaching the principal would be impossible because Mr. Anderson could not obtain the consent of his unborn heirs.

For example, in Warren Boynton State Bank v. Wallbaum, 143 Ill. App. 3d 628, 493 N.E.2d 21 (1986), the court refused to apply the doctrine because it found that the seller did not use the word "heirs" in its technical sense, but used it to signify his children. In Doctor v. Hughes, 225 N.Y. 305, 122 N.E. 221 (1919), the court similarly refused to apply the doctrine when doing so appeared to frustrate the settlor's intentions.
are exceedingly rare.

IV. THE LAW OF TRUSTS AND COMMON LAW EFFICIENCY

The efficiency theory of the common law is that "the common law is best (not perfectly) explained as a system for maximizing the wealth of society."\textsuperscript{40} The common law tends toward efficiency, it is argued, because an inefficient rule imposes larger costs upon society than an efficient rule, so there is a greater incentive to litigate such rules than to litigate efficient rules.\textsuperscript{41}

This Article is not intended to critique the general theory of the common law's efficiency. Rather, its purpose is to demonstrate that trust relationships have special characteristics which distinguish the law of trusts from other facets of the common law. Thus, arguments suggesting that the common law is generally efficient apply with less force to the law of trusts than to other facets of the common law.

First, and most obviously, the argument that the common law is efficient presumes that those affected by a particular legal outcome will litigate. This clearly is not the case in a trust relationship. The real party in interest, the settlor, generally is dead when problems arise, so he is unable to bring suit directly. While his trustee theoretically champions the settlor's interests, the existence of a trustee does not solve the initial problem of ascertaining the interests of the settlor. As discussed below, a trustee has no direct economic interest in seeing that the settlor's trust be used in one way over another. The trustee's real economic goal is to avoid legal liability for breaching his fiduciary duty to the beneficiary. This may lead the trustee to favor the parties most likely to prevail in a suit against the trustee for breach of his fiduciary duty rather than to favor the party whom the trustee believes the settlor would have favored.

In addition, settlors are able to observe inefficient legal rules as well as


efficient ones, and can craft their trusts so as to avoid potential problems. As such, the only trusts that become the subject of litigation are those that have been artlessly crafted by lawyers. Rather than tending towards efficiency, then, common law judges inevitably seem destined to be faced with a set of alternatives, none of which seem clearly to further the settlor’s intentions. In other words, over time courts reexamine rules relating to trusts because they are unartfully created, not because they are inefficient.

The final reason why the common law of trusts does not appear to tend towards efficiency stems from the basic observation that preferences vary. A judicial decision in one case to uphold a trust may accord with the preferences of the settlor in that case, while the same decision in an identical case would not be in accord with the preferences of another settlor. Rules such as those described above that tinker with settlors’ intentions are likely to thwart the wishes of at least some testators.

Thus, the argument that Judge Posner makes in support of the *cy pres* doctrine seems very weak. Settlors have no way to avoid the risk that courts might invoke their *cy pres* power to alter their expectations, and consequently the possibility always exists that their intentions will be thwarted. But if there were no such doctrine, then settlors would know that if conditions change so as to make their trust impracticable, then the trust would fail. This would encourage settlors to specify how they wish their funds to be allocated in case it becomes impossible to fulfill their initial request.

From a public choice perspective, it is interesting to note that the *cy pres* doctrine applies only to charitable trusts. Courts do not rewrite trusts that are not for charitable purposes. Thus, the *cy pres* power appears to be a device for permitting judges, through a finding that the settlor had a “general charitable purpose” when he created the trust, to keep private funds in the public domain, even when the settlor’s intent might have been to have the assets revert back to the settlor’s estate. The special interest beneficiaries of the trust have a clear incentive to press for alterations in the trust that would allow them to retain control over the trust’s assets, even after the settlor’s original intentions have been frustrated. Repeated litigation, particularly in the absence of opponents with any natural allies on the bench, would lead not to an efficient outcome, but to the *cy pres*
doctrine, which seems highly inefficient.42

V. PRIVATE TRUSTS AND THE THEORY OF THE FIRM

Trusts, particularly charitable trusts, often exhibit characteristics identical to the separation of ownership and management that characterizes the modern, publicly held corporation. In a public corporation, principals (the shareholders) purchase an ownership interest in a firm that they fully expect to be managed by their agents (the officers and directors). As in any agency relationship, problems arise due to the inherent conflict of interest between the agents and the principals. Agents have incentives to shirk and to divert the resources of the firm toward their own ends, while the principals, due to collective action and free rider problems, often find it costly to curtail such conduct. The costs to the firm of diversion by managers from the interests of shareholders, together with the costs of avoiding such conduct are called agency costs. The subject of corporate finance is largely made up of a study of the contractual devices and market mechanisms that serve to align the interests of managers and shareholders in order to reduce the costs to firms of the agency relationship.

Seen in this way, the agency cost problem facing the charitable trust appears to be much greater than the agency cost problem facing the public corporation. Competition in capital markets, product markets, and the market for corporate control all induce managers and directors of public corporations to act in ways consonant with shareholder welfare. By contrast, none of these incentive systems serve to prompt foundation trustees to serve the welfare of beneficiaries. Along these lines, Terry Anderson has argued that monitoring a trust relation is more difficult than monitoring a public corporation because the objectives of the trust are not as clearly specified as those of the corporation.43 Specifically, the public corporation clearly exists as a contractually created legal entity whose pur-

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42 See generally Rubin, Common Law and Statute Law, 11 J. LEG. STUD. 205, 211 (1982) (observing that if the determining factor in the outcome of litigation is the interest group involved, litigation will only result in efficiency if each party to the litigation represents the entire range of social interests involved in the dispute).

43 T. Anderson, The Economics of Trusts 3 (December 1987) (unpublished manuscript) ("[M]easurement and monitoring costs are often higher with the trust relationship because it is more difficult to specify what the objective function is. In the absence of profits as the ultimate measure of performance, measurement and monitoring costs rise thus affording the trustee with more potential for opportunistic behavior.").
pose is to maximize profits. But, as noted above, the objectives of the trust vary with the individual preferences of the settlor. As a consequence, it appears to be more difficult to develop standardized, default legal rules to lower transactions and error costs for trusts than it is for the general corporation.

These problems have led to an enormous degree of skepticism about the efficacy of the trust relationship. Judge Posner, for example, argues in favor of a rule requiring charitable foundations to distribute every gift received — original endowment and accrued interest — within a specified number of years in order to force the foundation to seek new gifts from time to time in order to continue its existence. His argument is that, "[s]ince donors are unlikely to give money to an enterprise known to be slack, the necessity for returning periodically to the market for charitable donations would give trustees and managers of charitable foundations an incentive they now lack to conduct a tight operation."

Of course, such a rule is per se inefficient. Since donors are at present completely free to specify a fixed term for the life of their trust if they choose to do so, this rule invariably would violate the intentions of the donors. Presumably, donors are aware of the possibilities for shirking by trustees when they establish the trust relation in the first place. Rational settlors will discount the expected benefits to them from the establishment of the trust by the probability that shirking by the trustees will reduce or completely thwart their intentions.

The literature on the economics of the trust relationship recognizes only two sources of constraint on agency misbehavior (which might also be described as trustee opportunism). The first is the legal standard of fiduciary duties facing trustees. The second is the reputational capital of "repeat player" trustees such as bank trust departments, which provides such entities with incentives to maximize trust value in order to attract new business based on prior performance.

It seems that the comparisons between publicly held corporations and trusts significantly exaggerate the problems inherent in the private trust relationship. There are three reasons for this. First, the comparisons fail to recognize that the objective function of the modern trust is in fact far

44 R. Posner, supra note 3, at 484.
simpler than the objective function for the publicly held firm. As a consequence, there is less need for market discipline of ordinary trustee business decisions than for market discipline of ordinary officer/director business decisions. Second, the residual claimants of a private trust often are a small group of easily identified people who have strong economic incentives to monitor the activities of the trustee. Finally, because the optimal strategy for attaining the objectives of a private trust are frequently defined with reference to universally understood terms, the sense of individual responsibility of the trustee is much more clearly defined, and community based public monitoring is likely to be effective for a private trust where it is not for the public corporation.

A. The Simplicity of the Objective Function

As demonstrated above, purely private trusts often are established to provide a particular person with a fixed source of income, an education, a house, or some other easily indentified object. It is significantly easier to discern whether a trustee has reached these sorts of objectives than it is to determine whether the officers and directors of a publicly held corporation are doing everything within their power to maximize firm profits.

Where the needs of a trust’s beneficiaries are clearly identified, the only difficulty associated with the trustee’s duties involves investing the trust’s assets so as to ensure a stream of income sufficient to meet these needs. As Langbein and Posner have pointed out, the trustee’s investment decision involves two steps: evaluating specific assets and combining these assets to form a portfolio.  

Modern portfolio theory has reduced these investment decisions to a science. For instance, the Capital Asset Pricing Model posits a linear relationship between the risk and return of an investment portfolio. The market, in other words, induces investors to assume higher degrees of risk only by offering them higher rates of return. Simply put, investors are compensated for bearing increasing levels of risk. But not all investor risk is compensated. Rivalrous competition among investors eliminates any compensation to investors for any risk associated with a particular stock that the investors can avoid at low cost through diversification. And be-

cause it is possible to construct an investment portfolio whose components are negatively correlated (as well as uncorrelated), it is possible to construct a portfolio that virtually eliminates the risks associated with any particular firm whose stock is represented in the portfolio. In a portfolio that is diversified in this manner, if a particular stock does poorly another stock in the portfolio can be expected to perform well, thereby offsetting the poor performance of the first stock.

These insights about different sorts of risk have led to the classification of risk into two categories — systematic risk and unsystematic risk. The unsystematic (or firm specific) risk associated with a particular security can be eliminated by mixing the security with other securities in a diversified portfolio. Systematic risk (or risk associated with general market fluctuations) cannot be eliminated by diversification. Investors are only compensated for this latter type of risk.46

Thus, it can be noted that financial economics enable us to specify with some degree of completeness a trustee's objective function over a fund of money left to his stewardship.47 His duty is simply to obtain the market rate of return on the investment, which is done by: (1) creating a diversified portfolio of financial assets that eliminates non-systematic risk; and (2) selecting a portfolio with the appropriate risk/return tradeoff to ensure that the beneficiary will be provided for. It is not difficult to determine whether the trustee is fulfilling this duty.

In fact, the requirements of the law are even less demanding than described above. While there is a general duty to make trust assets "productive,"48 as well as a requirement that trustees make investments with the same degree of care as would a "prudent person in the care of his or her own assets,"49 courts and legislatures have been slow to adopt the Langbein and Posner suggestion of imposing a general duty to diversify, although the trend appears to be in that direction. Some jurisdictions rec-

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49 Harvard College v. Amory, 26 Mass. (9 Pick.) 446, 461 (1830) (the duty of a trustee is to "observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested").
ognize the duty to diversify as a separate, distinct duty of the trustee; and others recognize it as a factor in determining whether the trustee has complied with the prudent person rule, although the definition such courts give to the term "diversification" is not yet particularly rigorous. But it remains that the chore of specifying the details of an objective function for the trustees of purely private trusts seems significantly easier than the chore of specifying such details for the officers and directors of public corporations.

B. The Nature of Private Trust Beneficiaries

Often the trustee of a purely private trust has a duty of "preserving real or personal property in its present form and delivering title or possession upon the happening of some event, e.g. attaining age twenty-one or the payment of a debt."151 In such cases, not only is the objective function of the trustee exceedingly easy to discover, there is a clear residual claimant with strong incentives to monitor the trustee's performance. Problems arise only when the object of the trust is not clearly identified. For example, trusts established to fund "scientific research" or to "reduce poverty in Appalachia" are more difficult to monitor and to evaluate than a trust to provide for the college education of a specified individual. But, as explained in the following section, in the latter class of cases, the individual trustee is likely to feel a heightened sense of individual responsibility that provides an additional incentive to faithfully administer the provisions of the trust.

Moreover, there is no danger due to lack of monitoring in the realm of purely private trusts due to the well-established requirement that such trusts cannot have "indefinite beneficiaries." This requirement, which does not apply to charitable trusts, ensures that there always will be a well-defined beneficiary to monitor the behavior of the trustees.

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60 See Langbein & Posner, supra note 45, at 3-6 (describing the slow evolution of the law defining trustees' duties).
61 MENNELL, supra note 48, at 298.
C. Public Expectations

Individuals develop reputational capital not only as experts in particular specialties (such as economists and lawyers), but also for general personal qualities such as honesty and scrupulousness. The value of a reputation for honesty cannot be overestimated. In addition, where a trust specifies that it is to be used for some general purpose such as the funding of scientific research or the elimination of poverty, there is in place a community of scientists and social workers with very clearly defined ideas and expectations regarding the appropriate bounds of proper conduct. Thus while there may be no clearly defined or identifiable set of beneficiaries for trusts of this kind, there is an (admittedly loose) set of standards for judging the performance of the trustees of such trusts.

This set of standards, which might be called community standards, is bolstered by the fact that trustees who stray markedly from adherence to such standards are likely to face precipitous drops in the value of their own reputations within the relevant communities. This fear of loss of reputational capital is particularly acute where, as generally occurs, the trustees are drawn from the communities directly affected by the trust. Thus by choosing trustees whose personal reputation is at stake, beneficiaries can obtain some assurance that the trusts they create for the provision of public goods will be administered faithfully.

Note that, while this argument seems valid with respect to private trusts with private trustees, it does not apply to governmental trusts administered by bureaucrats responding to vastly different institutional pressures than those described above. Such officials, whose goal it is to advance within the government bureaucracy, are likely to be far less sensitive to community pressures, and are unlikely to have amassed significant reputational capital within the relevant community in the first place.

VI. Conclusion

This Article has made three distinct points. First, it has examined the restrictions that the legal system places on settlors’ use of their property. The goals of the legal system should be to establish rules that reduce the incidence of transaction costs, error costs, and agency costs associated with the creation of a trust. In reality, the legal restrictions do not appear to reduce such costs and thus seem inconsistent with existing arguments re-
regarding the general efficiency of the common law.

Second, this Article has argued that individual investors who establish private trusts make rational dispositions of their property, and these dispositions do not result in systematic inefficiencies. It is exceedingly rare for settlors to restrict the way in which their investments are allocated, and where the trustees can invest freely, there is no distortion of the market processes that cause assets to flow to their highest valued users. Thus, there appears to be no basis for the argument that there is a conflict between respect for the rights of the settlor to enter into contracts for the disposition of his property and the goal of assuring that property rights are allocated efficiently.

Finally, the Article has looked at the private trust from the perspective of the modern theory of the firm. It has been observed that, while the constraints facing officers and directors of public corporations differ from the constraints facing the trustees of private trusts, the differences can be explained with reference to the differences between private trusts and public corporations. For one thing, the absence of profits as the ultimate measure of performance is not an insurmountable burden. Modern portfolio theory, the reputational capital of trustees, and the simplicity of most settlors' wishes ensures that trust assets generally are allocated in ways consistent with the intentions of their creators.

Thus the oft-made argument that, from an efficiency standpoint, private trusts are nothing but a retarded variety of public corporations due to the lack of market constraints on trustee misbehavior, appears unfounded. Where, as in the case of Judge Posner, the complaint is coupled with a plea for increased regulation of the trust relation, the charge is particularly dangerous. As in other areas, the public interest is best served by a legal system that respects the integrity of individual choice and privately arranged contractual obligation.