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The Limitations of an Economic Agency Cost Theory of Trust Law

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THE LIMITATIONS OF AN ECONOMIC AGENCY COST THEORY OF TRUST LAW

Lee-ford Tritt*

ABSTRACT

Should the donor’s specific interests or potentially conflicting theoretical economic principles control the creation and administration of trusts? In a highly influential article advancing an agency cost framework for trust law, Harvard Law Professor Robert Sitkoff suggests retooling trust law to focus on wealth maximization and to minimize costs stemming from an assumed misalignment of the interests between deemed “principals” and “agents” within the trust setting. An agency cost theory of trust law, however, reduces the complex, highly idiosyncratic, and emotionally charged nature of trust law into a simple business relationship. Given the special nature of trust law and practice—where interests remain difficult to quantify, interpersonal preferences remain incommensurable, and normative principles trump other preferences—slavish attention to economic analysis resembles the youthful mistake of forcing square pegs into round holes.

This Article demonstrates that applying a rigid agency cost analysis to trust law not only produces a positively inaccurate account of modern trusts but also a normatively incoherent philosophy to guide the evolution of trust law. Quite frankly, trust law is not damaged, let alone so broken that it needs to be infused with a new overarching jurisprudential principle. Therefore, this Article urges a return to first principles of trusts that focus on the processes for achieving the settlor’s goals and a methodology for fostering integrity in the trustee’s stewardship of trust property. For centuries, trust law existed as a

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2579
vehicle for transferring wealth coupled with some preference regarding the conditions for distribution. While estate planning undoubtedly will become even more sophisticated in the decades to come, the complexity of the questions posed does not require ignoring relatively simple solutions. Ultimately, trusts should be viewed as a means to fulfill donative freedom.

**TABLE OF CONTENTS**

Introduction............................................................................................................. 2581
I. Agency Cost Theory and Trusts......................................................................... 2586
   A. An Elementary Understanding of Private Trusts ...................... 2587
   B. An Elucidation of Some Basic Tenets of Law and Economics ............. 2588
      1. Rational Choice ............................................................ 2590
      2. Wealth Maximization ..................................................... 2591
      3. Agency Cost Theory ........................................................ 2592
   C. An Agency Cost Model of Trusts.......................................... 2593
II. The Limitations of an Agency Cost Theory of Trust Law...................... 2597
   A. The Special Nature of Trusts............................................... 2598
   B. A Critique of the Theoretical Assumptions of an Agency Cost Theory of Trusts ......................................................... 2601
      1. An Ill-fitting Principal-Agent Analogy......................... 2602
      2. Settlors Are More Than Wealth Maximizers................... 2606
      3. Unsubstantiated Party Preferences............................... 2608
      4. Disproportionate Reliance on the Managerial Aspect of Trusts ................................................................. 2610
      5. An Idiosyncratic Decision Making Process...................... 2613
      6. Beneficiaries Are Not (Conceptual) Parties to the Bargain........ 2614
      7. Risk Aversion .................................................................. 2615
   C. A Critique of the Agency Cost Formula of Trusts ......................... 2616
      1. All Costs Are Not Agency Costs ........................................ 2616
      2. An Incomplete Calculation of Agency Costs ...................... 2619
      3. An Ex Post Solution to an Ex Ante Problem ...................... 2620
      4. An Overstatement of Agency Costs .................................... 2623
   D. Unintended Consequences of Agency Cost Theory of Trusts .................. 2623
      1. Evolving Preferences .................................................. 2624
      2. Settlor’s Standing .......................................................... 2625
      3. Settlors vs. Beneficiaries .............................................. 2627
      4. Litigation ...................................................................... 2633
      5. Coasean Corollaries: The Settlor’s Dilemma .................... 2635
III. A Return to First Principles......................................................................... 2638
     Conclusion......................................................................................... 2640
INTRODUCTION

Should the donor’s specific interests or potentially conflicting theoretical economic principles control the creation and administration of trusts? Two brief examples help shed some light on the growing importance of this question. First, consider In re Estate of Max Feinberg,¹ in which the Illinois Supreme Court addressed the validity of a conditional trust provision regarding religious affiliation. Mr. Feinberg created a trust in which he declared that any descendant of his children who married outside the Jewish faith or whose non-Jewish spouse did not convert to Judaism within one year of marriage would be disinherited. One might surmise that Mr. Feinberg’s purpose in creating the clause was the desire to preserve his 4000 year old religious heritage and accordingly conclude that the court should effectuate his clear intent. An economic agency cost analysis, however, could invalidate that clause under the guise that a rational person views marriage as promoting love or procreation regardless of religious views.² Second, suppose that an extremely ardent environmentalist creates a trust for her descendants with a specific direction that the trustee must engage only in Socially Responsible Investing (SRI),³ fully understanding that such an investment strategy might result in lower returns and higher risks than a fully diversified investment portfolio. An economic agency cost theory would not indulge such a moral interest in environmentalism or other social goals over maximizing the wealth of the trust.⁴ These two examples might make it seem that the cold mechanics of an economic agency cost theory is quite ill-suited to the individualistic and highly personal realm of trust law, yet agency cost theory is becoming

¹ 919 N.E.2d 888 (Ill. 2009).
² As will be discussed later in this Article, trust conditions that do not maximize the welfare of the beneficiary may be deemed inefficient and invalid under an agency cost analysis. Query, though, whether an individual that does not satisfy the prerequisite of a conditional gift could even be deemed a beneficiary in order to have standing to make this argument in the first place.
³ SRI is an investment strategy that complies with an individual’s moral, ethical, or environmental preferences, such as engaging in fair-trade policies with suppliers, or avoiding disfavored activities, such as deforestation. See Michael R. Siebecker, Trust & Transparency: Promoting Efficient Corporate Disclosure Through Fiduciary-Based Disclosure, 87 WASH. U. L. REV. 115, 123 (2009). For an interesting discussion of the use of SRI in trust law, see Joel C. Dobris, SRI—Shibboleth or Canard (Socially Responsible Investing, That Is), 42 REAL PROP. PROB. & TR. J. 755 (2008).
⁴ In fact, the official comment to the Uniform Prudent Investor Act Section 5 states that “[n]o form of so-called ‘social investing’ is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries—for example, by accepting below-market returns—in favor of the interests of the persons supposedly benefited by pursuing the particular social cause.” UNIF. PRUDENT INVESTOR ACT § 5 & cmt. (2006).
increasingly influential in trust law analysis. This Article demonstrates, however, that an agency cost theory of trust law is fundamentally and fatally flawed if rigidly applied.

In the seminal article articulating an agency cost framework for trust law, Professor Robert Sitkoff (preeminent and influential trust scholar at Harvard Law School) articulates a theoretical legal platform to analyze trusts under an essentially corporate organizational model. By so doing, Professor Sitkoff invigorated the jurisprudential debate in the academy concerning fiduciary trust law in general and proffered insightful and fresh analysis of the interplay and potential conflicts that arise between the various parties of a trust. Although this Article describes Professor Stikoff's articulated model of an agency cost theory of trust in particular, it also endeavors to address agency costs analysis of trust law from a broader perspective than that defined by Professor Sitkoff.

In general, the application of a rigid or "thick" agency cost theory of trust law would reduce the complex, highly idiosyncratic, and emotionally charged nature of trust law into a simple business

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5 Recent prominent scholarship advances agency cost theory as the most meaningful guide for understanding and developing basic trust law. As observed in one of the foremost trusts and estates casebook's teacher's manual, the application of an agency cost framework in analyzing trust law has become ubiquitous. See JESSE DUKEMINIER ET AL., WILLS, TRUSTS, AND ESTATES: TEACHER'S MANUAL § 10-3 (8th ed. 2009) ("This Note makes explicit what is now a common analogy between the beneficiary/trustee relationship and the shareholder/manager relationship, fitting both within the principal/agent economic model . . .").


7 Professor Sitkoff is a member of the Uniform Law Commission, the group responsible for drafting the Uniform Probate Code and the Uniform Trust Code, and is also a member of the American Law Institute, which is responsible for drafting the new Restatements (Third) of Property, Wills, and Other Donative Transfers.
relationship. Given the special nature of trust law and practice—where interests remain difficult to quantify, interpersonal preferences remain incommensurable, and normative principles trump other preferences—slavish attention to economic analysis resembles the youthful mistake of forcing square pegs into round holes.

Although neoclassical law and economics and agency cost theory represent important approaches to legal scholarship and provide useful insights into rule making in certain areas of the law, such as contracts and corporate law, the normative value of economic theory declines as it gets stretched too tenuously to less profit-oriented legal disciplines. Expanding legal theories developed in one area to entirely new contexts may cause unintended and unforeseen consequences. The logic of the transferred legal concept may have a momentum of its own that distorts the principles and practices within the new context. Quite simply, the marginal utility of agency cost theory declines precipitously as the analysis is forced into contexts such as trust law, for which it is ill-suited. Accordingly, applying an agency cost analysis to trust law produces not only a positively inaccurate account of modern trusts but a normatively incoherent philosophy to guide the evolution of trust law.

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8 See, e.g., Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, 3 J. FIN. ECON. 305, 308 (1976) (a seminal article in the field describing firms as a “nexus of contracts” and highlighting the importance of agency relationships in analyzing firms).

9 Perhaps the most forceful description of the waning applicability and relevance of law and economics comes from Ugo Mattei:

[Law and economics discourse] keep[s] restating the usual, cynical ideological platitudes, and, as a result, they are unattractive and banal to inquisitive and critical minds. ... There exists a tiny clique of insiders, usually repeating more or less the same stuff in dozens of papers, constantly cited, in what is little more than an exercise of cut and paste. ... As to the nonpositivism, universalism, and adaptability of law and economics to different contests, we can only observe here a dramatic involution into technicality and parochialism. ... After its early grand promises (for which it was worth fighting), law and economics has evolved locally into a parochial tool of propaganda of an established anti-intellectual mainstream turning everything, even culture, into technological skills. When law is turned into an expensive technology, it abandons being a product of culture.


11 The purpose of this Article is not to suggest that law and economics theory should play no role in understanding and shaping trust law. Instead, the purpose is to cut back on the claims that some scholars make about the degree of prominence an agency cost theory analysis should enjoy in guiding trust law. Reducing costs in the creation and administration of trusts is a perfectly laudable, albeit subservient, goal as long as costs are viewed from all of the parties’ perspectives. Using agency cost theory as the guiding principle of trust law, however, is inapposite to traditional goals of trust law doctrine and estate planning.
“Agency costs” are defined as the costs that stem from an assumed misalignment of the interests of a principal and an agent. These costs arise because of the impossibility of complete contracting, the assumption that agents will act on their own behalf to the detriment of the principal (so called “shirking”), and the difficulty for the principal to observe whether the contract is being fulfilled.

As a positive analytical tool within the realm of trust law, agency cost is of limited value because of unverified foundational assumptions about human nature generally and real-life settlors in particular; its inattention to the fundamental principles animating the historical evolution of trust law; and the failure to adequately understand modern estate planning techniques as well as the incentives that trust law provides to the various individual and institutional actors subject to the proposed agency cost analysis. Agency cost theory may help in a limited way by explaining some of the economic internal dynamics of trusts (like the potential friction between a trustee and beneficiary), but it is not sufficient to explain the existence, nature, and function of trusts. Descriptively, agency cost theory seems to provide little more than a sort of lexicological shorthand to describe an ancient observation (i.e., that there are inherent risks when an individual trusts another to control and manage an asset). Using agency cost descriptively is wrought with risks because the term carries some amount of “baggage” in terms of varying definitions, assumptions, theories, and consequences. In fact, the mere use of agency cost rhetoric, in and of itself, over time may weaken the traditional normative principles of trust law.12 Moreover, descriptively, agency cost analysis of trust law brings no additional substance to the ongoing debate regarding trusts than the traditional concepts of fiduciary relationships and other proffered theories.

As a normative model, utilizing an agency cost analysis could likely provide somewhat misguided answers to open trust law questions. Discounting the special nature of trusts while underestimating the incongruent aspects of the principles of agency cost theory and trust law renders the integrity of the approach suspect and application of a thick agency cost analysis troublesome. In fact, three flaws exist that cast doubt on the ultimate utility of an agency cost theory of trusts.

First, analytical shortcomings of an agency cost theory of trust law arise because its theoretical assumptions are applied to trust law without first scrutinizing whether they are readily transferable to the concepts of trust law. For example, agency cost theory relies on a rather stilted

12 “Terminology matters.” Leslie, Trusting Trustees, supra note 6, at 116 (positing that the mere change in trust terminology may leave traditional trust doctrine vulnerable to attack, in that it allows scholars and law makers to ignore trust law’s unique features and traditional normative jurisprudence). For a discussion about the dangers of using transplanted terminology, see infra note 83 and accompanying text.
view of humans as selfish individuals primarily focused on wealth maximization. The application of microeconomic principles to legal questions loses value, however, if the questions cannot be easily recast as purely monetary interests. But within the realm of trusts, interests of settlors may go far beyond their own wealth maximization or the wealth maximization of their beneficiaries, like the concerns of Mr. Feinberg and the nameless environmentalist introduced in our introductory examples. In a legal discipline like property succession law, where individuals become entrenched with idiosyncratic preconceptions about death, property rights, personal legacies, paternalism, altruism, or other affective interests, preferences are not easily reduced to monetary metrics. In addition, the identity of the parties in the principal-agent relationship itself remains wholly unclear in the context of trusts. Unlike the corporate context where managers clearly act as agents to the residual shareholder owners, it remains uncertain in the trust context whether trustees remain agents of settlors who create the trusts (and gratuitously transfer property into trust), the trust beneficiaries (who equitably enjoy the benefits of the gifts), or the trust itself. By not attending to actual preferences and practices associated with the creation of trusts and the awkward fit of the principal-agent analogy, agency cost theory does not seem fully capable of forging a path that respects the market preferences at the core of an economic model.

Second, an agency cost model of trusts is not completely articulated or easily workable. For example, an agency cost theory of trusts overstates agency costs in that it portrays all costs associated with trusts as “bad.” In addition, the model focuses solely on the costs to the beneficiary that might arise from the actions of just one actor (the trustee), while ignoring costs associated with the actions of a settlor or beneficiary that might cause agency costs to the trustee, or the actions of a beneficiary that might create agency costs to other beneficiaries (for example, a current beneficiary affecting a co-beneficiary, remainder beneficiary, or contingent beneficiary). The model also removes any concept of trust or social norms from the analysis, which leads to an overinflated view of agency costs. Finally, agency costs seem to be only identified ex post, while the decisions must be made ex ante.

Third, an application of an agency cost model of trust law could result in a cascade of undesirable consequences. For example, if the application of an agency cost theory of trusts could prevent a settlor’s instructions from being effectuated, future settlors might avoid the trust framework to implement their wishes. In addition, an agency cost theory of trusts may cause beneficiaries to believe that they have a greater stake in the trust, therefore becoming more litigious regarding the administration of the trust then they otherwise would have been. Changing the rules of the game could change the player’s preferences
and behavior, which could lead to increased costs to certain parties, frivolous lawsuits, and the diminishing use of trusts.

So what should guide the evolution of trust law if not agency cost theory? Quite frankly, trust law is not damaged, let alone so broken that it needs to be infused with a new overarching jurisprudential principle. Therefore, this Article urges a return to first principles of trusts that focus on the processes for achieving the settlor's goals and a methodology for fostering a healthy level of trust in the trustee's stewardship of trust property. For centuries, trust law existed as a vehicle for transferring wealth coupled with some preference regarding the conditions for distribution. While the practice of estate and trust law undoubtedly will become even more sophisticated in the decades to come, the complexity of the questions posed does not require ignoring relatively simple solutions. Ultimately, trusts should be viewed as a means to fulfill donative freedom. This historical impetus for trusts is now, and should remain, the guiding light for the normative analysis of trust law.

In arriving at this conclusion, Part I provides an overview of the important and conflicting doctrinal issues involved in this debate, including an elementary understanding of private trusts, an elucidation of the basic tenets of law and economics, and a discussion of Professor Sitkoff's application of an agency cost theory to trust law. Part II demonstrates that the application of agency cost theory produces not only a potentially descriptively inaccurate account of modern trusts but a normatively disjointed philosophy to guide the evolution of trust law. Part III advocates a return to using settlor's intent as the framework for understanding trust law. Finally, this Article concludes that because the underlying assumptions of agency cost theory cannot be verified and because agency cost theory causes distortions of trust law theory and practice, a return to first principles of trust law is in order.

I. AGENCY COST THEORY AND TRUSTS

Exploring the potential dangers of applying agency cost theory to trust law requires an understanding of the prevailing agency cost analysis of trusts advanced by Professor Sitkoff. Before offering a description of Professor Sitkoff's particular application of agency cost theory to trust law, it is necessary to discuss (1) elementary aspects of trust law in general, and (2) some basic tenets of law and economics, including agency cost theory. With that grounding, it becomes possible to offer a cogent criticism of an agency cost theory of trusts.
A. An Elementary Understanding of Private Trusts

A substantive analysis of the limitations of an agency cost theory of trusts must begin with an elementary overview of the basic principles of trusts. An appreciation of these principles is necessary to understand how agency cost theory can potentially thwart traditional trust law doctrine and modern estate planning practices.

In essence, trusts provide a means for individuals to make gifts. Although most gifts involve a donor simply giving a gift outright to the donee, a gift through trusts conceptually splits the gift between a trustee and beneficiary. In creating a trust, the settlor gives property to a trustee to hold for the benefit of a beneficiary upon terms and conditions that the settlor has imposed. A gift to a trust separates its legal ownership from its equitable enjoyment in that the trustee acquires legal title to the trust property, while equitable title of trust property rests with the beneficiaries.

Trust law historically has aimed to effectuate the settlor's intent. In this regard, the settlor faces few restraints when formulating the details of the trust instrument. Therefore, trust law consists overwhelmingly of default rules that the settlor can alter or reject.

In administering the trust, the trustee is held to a robust and rich concept of fiduciary duties. In fact, the concept of fiduciary duties may

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13 The primary focus of Professor Sitkoff's article and, therefore, the primary focus of this Article, is on private trusts that are created gratuitously for the benefit of individual beneficiaries. Although business trusts carry noteworthy transactional and capital-market importance, and charitable trusts play their own significant role in American society, the Article's application of agency cost theory extends solely to private trusts. See generally John H. Langbein, The Secret Life of the Trust: The Trust as an Instrument of Commerce, 107 YALE L.J. 165 (1997) (discussing the importance of trusts in commercial transactions).

14 The settlor is the original property owner who transfers the property to establish the trust. The settlor may also be referred to as the “grantor,” “testator,” or “decedent.”

15 As Scott's treatise contemplates, “[t]he duties of the trustee are such as the creator of the trust may choose to impose; the interests of the beneficiaries are such as he may choose to confer upon them.” 1 AUSTIN S. WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS § 1 (4th ed. 1987) [hereinafter SCOTT ON TRUSTS].

16 Effectuating the settlor's intent has been characterized as “the dominant substantive principle of the law of gratuitous transfers.” Langbein, Mandatory Rules, supra note 6, at 1109. Courts have “repeatedly reaffirm[ed] the traditional primacy of a settlor's intent.” Jeffrey A. Cooper, Empty Promises: Settlor's Intent, the Uniform Trust Code, and the Future of Trust Investment Law, 88 B.U. L. REV. 1165, 1172 (2008).

17 Generally, settlor's intent will be overridden only in those rare instances where it violates public policy, for example, by encouraging illegal activity, fostering immorality, or requiring the destruction of property, or where the trust advocates “capricious purposes.” For a discussion of the rule against capricious purposes, see Langbein, Mandatory Rules, supra note 6, at 1107-08.

18 Id. at 1105.
be one of the defining aspects of trusts. These duties function both as legal rules and social or moral norms.

Finally, the basic use and structure of trusts continue to evolve. Four important developments are worth noting: First, trusts, once relatively rare, have become increasingly more accessible, and the use of trusts by the non-affluent has become rather common. Second, trusts have taken on an elevated managerial function—property owners are increasingly relying upon trusts for ongoing and intergenerational professional wealth management. Third, trusts often employ asset protection mechanisms, with some trusts designed specifically to shield assets from creditors. Finally, some states have abolished or severely curtailed the rules against perpetual trusts. An agency cost theory of trust law that ignores any of these developments will be limited in its usefulness.

B. An Elucidation of Some Basic Tenets of Law and Economics

The law and economics pillar upon which the prevailing agency cost theory of trusts was built raises doubts about its ultimate viability in trust law. Fully comprehending the limitations of an agency cost theory of trusts, therefore, requires an elucidation of the basic law and economics’ tenets upon which that approach is based, including agency cost theory. Although detailing the history, principles, and applications

19 See Leslie, Trusting Trustees, supra note 6 (discussing the importance of the social and moral norms underlying fiduciary duties).
20 Id. at 70.
21 The recent rise in trust accessibility and use has been labeled the “massification” or “pedestrianization” of trusts. See Dobris, supra note 3.
24 To date, nineteen states (Alaska, Arizona, Delaware, Florida, Idaho, Illinois, Maine, Maryland, Missouri, Nebraska, New Hampshire, New Jersey, Ohio, South Dakota, Rhode Island, Utah, Virginia, Wisconsin, and Wyoming) and the District of Columbia have terminated restrictions on the duration of private trusts by abolishing the rule against perpetuities or severely curtailing its effect. See Joshua C. Tate, Perpetual Trusts and the Settlor’s Intent, 53 KANSAS L. REV. 595, 603 (2005).
of law and economics theory lies outside the scope of this Article, the summary account that follows provides a sufficiently strong platform to understand why an agency cost theory of the firm remains untenable.

By focusing on efficiency-based legal standards, law and economics essentially is about decision-making.25 As applied to trust law, an economic analysis would focus on the decision-making processes of the parties involved in the creation of a trust. At the most basic level, economic analysis seeks to determine the efficiency of those decisions and the distribution of their effects26—basically providing a method of explaining and predicting human behavior associated with the creation and the administration of trusts. The predicted human behavior can then be compared to the outcome sought by lawmakers (or scholars) to determine the "efficiency" of trust law.27

In order to determine an "efficient" solution, however, a comparative evaluation between different rules must be undertaken. Proponents of law and economics have methodological differences concerning the criteria for carrying out such comparative analysis (cost benefit analysis, collective action theory, decision-making under uncertainty, and risk aversion, to name a few). These differences concern how social preferences should be evaluated and what precise value should be maximized to achieve an optimal legal system. It should be noted, however, that in order to determine efficiency one must face intractable difficulties in interpersonal comparisons of utility, welfare, and aggregation.28


26 ROBERT COOTER & THOMAS ULEN, LAW & ECONOMICS 4 (3d ed. 2000). There are two basic categories of efficiency: static and dynamic. Static efficiency is achieved if there is no further possibility of mutually beneficial exchanges of current assets. Static efficiency is about what we have rather than about production of what we may have to allocate. Russell Hardin, The Morality of Law and Economics, 11 L. & PHIL. 331, 336 (1992). Dynamic efficiency is achieved through protecting individual interest to give individuals reason to think their productive efforts will bear fruit for them and by enabling them to be productive. Id.; see also RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 30-31 (3d ed. 1986).

27 There are several additional types of efficiency used by economists in varying situations: production efficiency, Pareto efficiency, and Kaldor-Hicks efficiency. Production efficiency exists when either it is impossible to produce the same amount of something using fewer resources, or it is impossible to produce more of something using the same amount of resources. Efficiency in the satisfaction of individual preferences, Pareto efficiency, is achieved if it is impossible to change the situation to benefit one actor without harming another. Kaldor-Hicks efficiency is realized if the individuals that are made better off by a particular change would have to be made sufficiently better off that they could (at least conceptually, if not actually) compensate those who are made worse off because of the same change. Kaldor-Hicks efficiency is now intricately associated with the wealth maximization principle (the focus of the modern law and economics movement), a model that measures well-being by focusing on "wealth"—in effect, "wealth" is a surrogate of utility. See COOTER & ULEN, supra note 26, at 44.

28 Hardin, supra note 26, at 335.
In determining efficiency, law and economics’ agency cost theory applies the cost-benefit methodology and accepts two of law and economics’ fundamental assumptions: (1) people are rational actors; and (2) people seek to maximize their own utility—assumptions that seem to have to be taken on faith. Professor Sitkoff’s agency cost theory of trusts uses “wealth” as a measurement for well-being or utility.

1. Rational Choice

Law and economics theory’s rational choice assumption has long been criticized, but its relevance is even more suspect in the emotionally charged and highly idiosyncratic realm of trust law. Rational choice posits that an autonomous person makes decisions that maximize individual utility. A “rational” choice is one in which an actor engages in a cost-benefit analysis to make a choice consistent with her system of beliefs and preferences. Rationality would require that individuals not engage in acts that seem to be inconsistent. The assumption that human beings, when faced with any choice, are “ruthless optimizers of their utility,” who perform instantaneous cost-benefit analyses which lead them to choose the option that maximizes their satisfaction, or utility, seems dubious on its face. This assumption is presented a priori and finds little support in either human experience or academic literature. Of course, decision-makers are “bound” by

30 Sitkoff, Agency Costs, supra note 6.
31 See, e.g., Cynthia A. Williams, A Tale of Two Trajectories, 75 FORDHAM L. REV. 1629, 1657 (2006) (stating that “‘primitive’ law and economics... has taken the neoclassical economist’s stylized picture of the person, homo economicus, as a self-interested, utility maximizer, and has assumed that this real person occupies the real world, subjecting every aspect of life to cost-benefit analysis, including decisions about law compliance”).
32 See Korobkin & Ulen, supra note 29, at 106.
33 See id.
34 Id. at 1059.
both the limitations in what the decision-maker knows\textsuperscript{36} and by subjective cognitive shortcuts that each of us employs subconsciously all the time—so-called heuristics.\textsuperscript{37} One need only remember Mr. Feinberg and the Jewish clause to see the limitations of rational choice in trust law and how it could undermine sound estate planning.

2. Wealth Maximization

The second half of law and economics' core assumptions, wealth maximization, is equally subject to the criticism that its relevance is diminished significantly in trust law. Wealth maximization seeks to increase social wealth, as measured by the dollar equivalents of everything in society.\textsuperscript{38} In essence, this principle posits that each actor selfishly seeks to maximize wealth.\textsuperscript{39} Wealth maximization analysis, however, allows for an ex post analysis of behavior by assuming that individuals are selfish wealth maximizers, but, when presented with the myriad of motivating and competing behavioral factors in the real world, the assumption is powerless to portend precisely which behavioral factor or factors motivated the decision making process.\textsuperscript{40}

\textsuperscript{36} Bounded rationality is a modification of the rational choice theory that recognizes that human beings, when making decisions, can only base that decision on the information they actually have, which is not always going to be all available information.

\textsuperscript{37} Heuristics, or decision biases, encompass different types of cognitive processes by which humans shorten the complexity of decision-making, for better or worse. For example, a "representative heuristic" is "the tendency of actors to ignore base rates and overestimate the correlation between what something appears to be and what something actually is." See Korobkin \& Ulen, supra note 29, at 1086. The "availability heuristic" occurs "[w]hen actors overestimate the relevance of salient or memorable incidents at the expense of base rates." See id. at 1087. Additional decision biases include the overconfidence bias, id. at 1091-93; self-serving bias, id. at 1093-95; and hindsight bias, id. at 1095-1100. All of these serve to further undermine the simplistic assumption upon which rational choice theory—and therefore law and economics—is founded.

\textsuperscript{38} Korobkin \& Ulen, supra note 29.

\textsuperscript{39} See, e.g., id. at 1066 (describing the wealth-maximization version of rational choice theory as the "thickest conception," which "provide[s] . . . specific predictions about the ends of the decision makers").

\textsuperscript{40} To solve this problem, economists resort to "revealed preference theory" which suggests that to determine actor preferences, economists need only observe the market choices made by those actors. See Harrison, supra note 29, at 1317 (citing the work of Paul Samuelson). As Professor Harrison notes, the theory is lacking because it still requires the observer to divine the relationship between the observed preference and the methodology of actor's choice. Id. In addition, the theory proves unworkable in the realm of trust law, in part, because there is simply a lack of data, empirical or otherwise, on actor choices due to the inherently private nature of trust law.
Recall the example at the outset of the Article involving the environmentalist who requires investing the trust assets to promote corporate social responsibility. How could a sensible monetary value be placed on the settlor’s preference for socially responsible environmental behavior? Thus, its uncertainty makes it a poor tool for prediction in the real world, especially in the realm trust law where individual preferences remain hard to monetize.

3. Agency Cost Theory

An agency cost theory of trusts is based functionally upon an analogy between trusts and business firms. The results of its application in trust law becomes suspect by overemphasizing the similarities of the bifurcation of ownership from control found in both firms and trusts while downplaying fundamental differences between the two.

Agency cost theory is used in the organizational law and economics literature as a theoretical framework for structuring and managing contract relationships and to explain the behaviors of principals and agents. The structure of firms create certain costs, some of which arise as a consequence of dividing the beneficial ownership of the firm from the control of firm. Agency cost analysis posits that the nature of firm itself creates inefficiencies by assuming that agents and principals have inherently divergent interests.

As a term of art, “agency costs” explain the costs that stem from an assumed misalignment of the interests of principal and agent. These costs arise because of the impossibility of complete contracting, the assumption that agents will act on their own behalf to the detriment of the principal (so called “shirking”) and the difficulty of the principal to observe whether the contract is being fulfilled. The principal, then,

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41 See Korobkin & Ulen, supra note 29, at 1067 (noting that “[p]olicymakers need to predict future behavior under various legal scenarios, not merely understand past actions in hindsight”).

42 Agency cost theory is but one methodology in an ever evolving effort by economists to produce an accurate theoretical model of the firm. Four theories of the firm have gained prevalence: the agency cost theory, the transaction costs theory, the property rights theory and the contractarian theory. For a useful and informative survey of this field, see Oliver Hart, An Economist’s Perspective on the Theory of the Firm, 89 COLUM. L. REV. 1757 (1989); see also Bengt R. Holmstrom & Jean Tirole, The Theory of the Firm, in 1 HANDBOOK OF INDUSTRIAL ORGANIZATION 63 (Richard Schmalensee & Robert Willing eds., 1989); Paul Milgrom & John Roberts, Economic Theories of the Firm: Past, Present, and Future, 21 CAN. J. ECON. 444 (1988); Oliver E. Williamson, The Logic of Economic Organization, 4 J.L. ECON. & ORG. 65 (1988). This Article focuses on agency cost theory.

43 Jensen & Meckling, supra note 8.

44 Id. at 5 (“If both parties to the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal.”).

45 Shirking includes any action by a member of the production team that diverges from the interests of the team as a whole. Id.
must either continuously monitor its agents’ actions to ensure that they
do not diverge from the principal’s interests, or compensate the agents
sufficiently to ensure that the agents abide by the principal’s wishes.46
Quite clearly, neither can be done without some cost.47 Accordingly,
agency-cost theory attempts to both identify the costs which are
inherent in dividing ownership and control of a corporation, and to
minimize them through more efficient incentive schemes.48 “Agency
costs” are defined as “the sum of: [1.] the monitoring expenditures by
the principal, [2.] the bonding expenditures by the agent, [and 3.] the
residual loss.”49 Simply, agency cost theory posits that principals will
enter into principal-agent relationships when the agency costs are
outweighed by the net economic gains made possible by the
relationship.50

C. An Agency Cost Model of Trusts

In An Agency Costs Theory of Trust Law, Professor Sitkoff creates
a theoretical legal platform in which he equates the role and rights of the
beneficiary in trust law to the role and rights of the shareholder in
corporate law.51 Professor Sitkoff uses agency cost modeling both
positively and normatively52 in his analysis of trusts. He posits that:

46 These expenses are referred to as “monitoring costs” and “bonding costs,” respectively.
47 Jensen & Meckling, supra note 8, at 308 (“[I]t is generally impossible for the principal or
the agent at zero cost to ensure that the agent will make optimal decisions from the principal’s
viewpoint . . .”).
48 See Hart, supra note 42, at 1758-60. For a more detailed treatment of the agency cost
approach in the law, see Eric A. Posner, Agency Models in Law and Economics, in CHICAGO
49 Jensen & Meckling, supra note 8, at 308. Monitoring expenditures are thought of broadly;
they include measuring and observing behavior, efforts at control, auditing, and even “efforts on
the part of the principal to ‘control’ the behavior of the agent.” Id. Bonding expenditures are
costs that the principal undertakes in order to encourage the agent to act in the principal’s best
interest. Eric W. Orts, Shirking and Sharking: A Legal Theory of the Firm, 16 YALE L. & POL’Y
Residual loss is defined as the cost that results from any divergence between hypothetical
decisions which would maximize principal’s welfare and the actual decisions made by the agent.
Jensen & Meckling, supra note 8, at 308.
50 Orts, supra note 49, at 276.
51 Sitkoff, Agency Costs, supra note 6, at 624.
52 It is important to note that Professor Sitkoff uses agency cost theory both positively and
 normatively. Positive analysis describes the current state of the law and asks whether the law is
efficient. Normative analysis suggests the direction which the law ought to take in order to
become more efficient. A normative law and economics’ claim is that society should make
decisions that maximize social wealth. COOTER & ULEN, supra note 26. When that law is
already in existence, the tools of economic analysis are at their strongest. Armed with the benefit
of hindsight, they can often explain and model the interactions between human behavior and the
law. In contrast, when a law is merely proposed, economic analysis is at its weakest. Id.
Without actual data, economic analysis becomes little more than conjecture.
(1) positively, traditional trust law already conforms to agency cost theory;\(^5\) and (2) normatively, the law of trusts should minimize agency costs, but only to the extent that doing so is consistent with the \textit{ex ante} instructions of the settlor.\(^4\)

Relying on law and economics’ assumptions without taking into account trust law’s unique characteristics weakens two fundamental, and highly questionable, principles upon which an agency cost theory of trust is built. First, the reliance on rational choice and wealth maximization could lead an agency cost advocate to conclude that the settlor’s ultimate goal in creating a trust is to maximize the wealth of the beneficiaries.\(^5\) However, describing this goal as the primary purpose (or, as one of the primary purposes) of trusts is unsubstantiated and seems, in part, to be inconsistent with everyday estate planning experiences. Second, notwithstanding Professor Sitkoff’s uncontroversial claim of deferring to settlor’s intent when it conflicts with agency cost modeling, a rigid agency cost analysis and the real world implications of agency cost theory applied to modern trust practice elucidates why his normative claim should be reinterpreted to mean that agency cost theory should be applied whenever it is deemed that the settlor’s instructions are irrational or they hinder the wealth maximization of a beneficiary’s interest in trust.\(^5\) As Professor Sitkoff notes, some of the suggested agency cost reducing mechanisms that give beneficiaries greater ability to keep trustees in check might be counter to a specific intent of the settlor.\(^5\) Agency cost analysis does not offer a coherent theory to explain this paradigm nor does it provide proper criteria to explain the selective application of discounting a settlor’s intent or specific instructions.

Tracing the fiduciary foundational ancestry of corporate law to the private express trust fiduciary law, Professor Sitkoff inversely reasons that economic agency cost analysis should be equally applicable to the structure of trust law\(^5\) as it is to the structure of the firm. Advancing an argument that trust law should be treated as an outgrowth of organizational law, Professor Sitkoff first attempts to situate his analysis of economic principles as a natural part of basic trust law theory.\(^5\)

\(^5\) Id.
\(^4\) Id. at 621.
\(^5\) Sitkoff, \textit{Agency Costs}, supra note 6.
\(^6\) I am not implying that Professor Sitkoff is being intellectually dishonest with the reader or being mischievous in his articulation of an agency cost model to trust law. I believe that Professor Sitkoff and I are both strong believers that trust law should primarily effectuate the settlor’s intent. A thicker application of agency cost theory, though, might undermine settlor’s intent. As this Article will demonstrate, though, the assumptions, model, and predicted results of an agency cost theory of trusts are, at the very least, suspect.
\(^5\) Sitkoff, \textit{Agency Costs}, supra note 6, at 663-65.
\(^8\) Id. at 627-34.
\(^9\) Id.
Conceding that the clear majority position is that trust law is a form of property law, Sitkoff nevertheless argues that this understanding of trust law obscures elements with respect to the trust's *in personam*, contractual relations. In support of his position, Professor Sitkoff integrates portions of Professor John Langbein's contractarian theory of trust law which presents, *inter alia*, a predominance of the nexus of contracts between the settlor and trustee as a functional basis of trust law. Advancing Professor Langbein's theory which asserts that "the deal between settlor and trustee is functionally indistinguishable from the modern third-party beneficiary contract," Professor Sitkoff extrapolates that the basis for the rights and remedies of the beneficiary against the trustee must accordingly be the contract between the settlor and trustee. Therefore, Professor Sitkoff adduces that trust law's role is to minimize transaction costs between the settlor and the trustee. Based on these theories, Professor Sitkoff argues that default trust law should reflect terms for which the parties would have negotiated for under low negotiation costs and full information and courts should interpret any open questions accordingly—in other words, he applies cost benefit analysis to determine trust law efficiency.

Next, Professor Sitkoff introduces Professors Henry Hansmann and Ugo Mattei's organizational law theory of trust law, which argues that the important contribution of trust law is its ability to "facilitate an accompanying reorganization of rights and responsibilities between the three principal parties [settlor, trustee and beneficiary] and third parties, such as creditors, with whom the principal parties deal." Specifically, Professor Sitkoff stresses Professors Hansmann and Mattei's description of trust law's "asset partitioning" function which allows the trustee to deal separately with creditors of his own property and those of trust property. Expertly blending the work of Professor Langbein with that of Professors Hansmann and Mattei, Professor Sitkoff reasons that since the law of trusts demonstrates a mingling of *in rem* and *in personam* qualities similar to organizational law, then trusts should be categorized essentially as organizations and, accordingly,
agency cost analysis should be equally applicable to private trusts as it would be to other organizations.  

Finally, Professor Sitkoff advances the notion that the evolution of the use of trusts from a medieval instrument to convey land ownership into sophisticated wealth management vehicles supports treating trust law as organization law.  

For example, noting that the default rules now require total return investment consistent with modern portfolio theory (which Professor Sitkoff argues reflect an agency cost evolution of trust law and results in the reduction of agency costs), Sitkoff goes on to assert that the modern donative trust has evolved primarily into a means of bringing together "portfolio management skills with investment capital." Based on these assumptions and others, Professor Sitkoff concludes that the study of trust law should be treated the same as the study of organization law.

Professor Sitkoff uses his agency cost model to examine issues pertaining to the deemed information asymmetry between the trust parties, trustee shirking and monitoring costs, and how an agency cost theory could shape the evolution of trust law. Although the implications of agency cost theory are far broader, Professor Sitkoff specifically addresses the following areas of trust doctrine in his article: (i) trust investments, (ii) trust modification and termination, (iii) trustee removal, (iv) settlor standing, (vi) the role of special "trust protectors," (vii) equitable tracing, (viii) spendthrift trusts, and (ix) fiduciary litigation.

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68 Id. at 633 ("The empirical observation that the modern use of the private trust increasingly resembles the use of other organizational forms provides further support for treating trust law as organization law.").

69 Id.

70 Id. at 634.

71 Id. at 633. Though Professor Sitkoff acknowledges that "context-specific rationales" for trust creation are still relevant, he seems to minimize their prominence in relation to the portfolio management function.

72 Id. at 634.

73 Id. at 634-83. As discussed in greater detail infra, a "thick" application of agency cost theory to each of these topics demonstrates that there are numerous unintended and unforeseen consequences from agency cost theory's application to trust law.

74 Id. at 652-57 (advocating that the application of modern portfolio theory's total return investment strategy and broadening beneficiaries' ability to influence investment could reduce agency costs).

75 Id. at 658-63 (opining that the liberalization of the beneficiaries' ability to modify or terminate trusts, including the ability to modify dispositive trust provisions, could reduce agency costs).

76 Id. at 663-66 (explaining how the strengthening the ability of the beneficiaries to remove trustees could reduce agency costs).

77 Id. at 666-69 (discussing how the recognition of settlor standing to enforce the terms of the trust could reduce agency costs).

78 Id. at 670-71 (opining that the evolution of trust protectors demonstrates an agency cost theory framework).
Although Professor Sitkoff's article offers interesting insights into one of many issues concerning trusts (the friction between a trustee and beneficiary), agency cost theory does not consistently offer a wholly complete, justifiable, or viable theory to guide the evolution of trust law. Accordingly, applying an agency cost analysis to trust law produces not only a positively inaccurate account of modern trusts but a normatively incoherent philosophy to guide the evolution of trust law.

II. THE LIMITATIONS OF AN AGENCY COST THEORY OF TRUST LAW

The application of agency cost theory produces not only a descriptively inaccurate account of modern trusts but a normatively disjointed philosophy to guide the evolution of trust law.

Agency cost analysis as a descriptive tool for trust law is of limited value because of its unverified foundational assumptions about human nature generally and real settlors in particular. Agency costs may help in a limited way by explaining some of the economic internal dynamics of trusts (like the potential friction between a trustee and beneficiary), but the theory is not sufficient to explain the existence, nature, and function of trusts. Although a "thin" application of agency cost theory creates new vocabulary for an ancient observation (i.e., that there are inherent risks when an individual trusts another to control and manage an asset), it brings no more substance to the ongoing debate regarding trusts than traditional concepts of fiduciary relationships.

From a normative perspective, utilizing an agency cost analysis could provide misguided, if not incoherent, answers to open trust law

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79 Id. at 672-74 (describing how agency cost theory explains the trust doctrine of equitable tracing).
80 Id. at 674-77 (explaining that spendthrift provisions create agency costs from an economic sense by eliminating market options for beneficiaries, but that agency costs, nevertheless, still illuminate the evolution of spendthrift trusts in that settlors would have to look outside of trusts to create such limitations on beneficiary alienation).
81 Id. at 677-82 (advocating the increase of trustee liability and potential litigation as the best mechanism to reduce agency costs).
82 In this sense, "thin" might be described as "selective."
83 There is inherent danger in selectively using transplanted legal terminology merely because it provides convenient shorthand. The conclusion that trust administration has inherent risks associated with the bifurcation of trust assets between legal and equitable ownership is unoriginal, notwithstanding the novel terminology agency cost theory adopts in describing that risk. The problems with using agency cost terminology in trust dialogue is that it dilutes the existing debate on fiduciary law which addresses the same core issues while perpetuating a misapplication of agency cost theory. The very use of the transplanted terminology can be damaging insofar as it is inexorably accompanied by the implications associated with the original theory. This effect is separate and aside from the substantive effect of the theory. Such an effect may be wholly unintended by an author using the transplanted term, but it is nevertheless an inexorable consequence of using ideologically loaded language.
questions. Discounting the special nature of trusts while underestimating the incongruent aspects of the principles of agency cost theory and trust law renders the integrity of the approach suspect and application of agency cost analysis troublesome. In fact, three flaws cast doubt on the applicability of an agency cost theory of trust. First, analytical shortcomings of an agency cost theory of trust law arise because its theoretical assumptions are applied to trust law without first scrutinizing whether they are readily transmutable to the concepts of trusts. Second, an agency cost model is not fully articulated or easily workable. Finally, a "thick" application of an agency cost model of trust law becomes conceptually unwieldy and produces inaccurate results and unintended consequences. Therefore, an exploration of the special nature of trusts and an examination of these three fundamental flaws is in order.

A. The Special Nature of Trusts

An appreciation of the special nature of trusts helps elucidate why agency cost theory remains so ill-suited to trust law. Only by ignoring the unique characteristics of trusts does an agency cost theory of trust law seem viable. But, because trusts differ so fundamentally from corporate firms, an agency cost theory of trusts remains fundamentally flawed.

First, trusts are not created to minimize agency costs, but are utilized by individuals to implement their donative wishes. Agency costs are the inevitable consequences of the very essence of trusts. Any theory of trusts that might inadvertantly undervalue the primary utility of trusts or that could result in relegating (intentionally or not) the principle of donative freedom to a secondary goal could channel potential settlors away from creating trusts and lead them to explore other arrangements.85

Second, the ever increasing number of reasons people create trusts illuminates why the reliance on the single wealth-maximization model could create unsubstantiated results. Private trusts are used within the

84 "Thick" can be described as "thorough," as opposed to a selective application of particular tenets that foster a claim while ignoring others tenets. A thick application of agency cost would include all of its extensive intellectual baggage.

85 In fact, Professor Sitkoff recognizes that the mere removal from trust law of options that restrict beneficiary alienation of trust assets could "channel[] [individuals] toward informal arrangements, such as outright transfers to trusted kin or friends with a wink and a nod that the transferee will take care of the would-be beneficiary. The potential agency costs to the beneficiaries and to the settlor ... are manifest." Sitkoff, Agency Costs, supra note 6, at 677. If denying spendthrift options to settlors would cause a diminishment in the use of the trust, surely undermining other intent effectuating aspects of trusts would have similar, if not larger, results.
estate planning context to achieve a number of objectives and the emotionally charged decision making processes are entrenched with idiosyncratic and personal preconceptions about death, property rights, personal legacies, paternalism, altruism, or other affective interests. Potential goals include, among many others, protecting assets from creditors, minimizing potential taxes or achieving tax deferral, providing familial support and maintenance, caring for minors or incompetents, preserving future post-mortem control, permitting flexibility, teaching wealth management, instilling values, promoting ethics, and encouraging or discouraging particular lifestyles. Settlors may be motivated by one goal or multiple goals. Moreover, these goals may be difficult to rank in some sort of lexical ordering. Even if settlors’ preferences were easily calculable, nothing ensures the values attached to one individual’s interests remain coherently commensurable with any settlor or other actor. The difficulty of ascertaining actual preferences and analyzing the decision making process of settlors undermines the capability of forging a path that respects market preferences, which is the core of an economic project in the first place.

Third, downplaying the various forms and structures in which people are choosing to form trusts leads to a skewed agency cost model for trusts. Trusts vary from simple to complex. Trusts can be created during the settlor’s life (inter vivos trusts) or upon her death in her will (testamentary trusts); can have short-term, long-term, and even perpetual in duration in some states; and, notably, contemplate both inexperienced individuals and experienced corporations86 serving as trustees. Trusts are no longer only for the wealthy, although, inter vivos and/or the long-term (or perpetual) dynasty type of trusts are probably primarily used by the very affluent.87 Accordingly, agency cost theory

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86 Today settlors are using professional trustees with greater frequency than in the past. See Gregory S. Alexander, A Cognitive Theory of Fiduciary Relationships, 85 CORNELL L. REV. 767, 775 (2000) (“Today, the vast majority of trusts are administered by large financial institutions, such as trust companies and trust developments of commercial banks.”); Langbein, Contractarian Basis, supra note 22, at 638 (“Private trustees still abound, but the prototypical modern trustee is the fee-paid professional, whose business is to enter into and carry out trust agreements.”). Although I agree that the use of corporate trustees has dramatically increased, I am skeptical of the assumption that the vast majority of trusts are administered solely by corporate trustees. For long-term, very wealthy trusts, the role of corporate trustees predominates, but in my experience, there are usually individual co-trustees as well. One might argue that it is the corporate co-trustee that does the bulk of the administration; nevertheless, the individual co-trustee is bound by the same rules and accountable to the same liability penalties as the corporate co-trustee. Short-term trusts of more modest means probably use individual trustees rather than corporate trustees.

87 To be able to transfer assets irrevocably during one’s lifetime seems to imply that the transferor has other wealth upon which to live. More relevantly, two important reasons for creating an irrevocable inter vivos trust are tax reasons and asset protection, both of which seem to imply a wealthy transferor. Otherwise, the property owner could just maintain control of the assets until her death.
could provide inaccurate if not incoherent answers to open trust law questions by slighting the substantial differences between trusts used by the very wealthy and trusts used by those of more modest means, and downplaying the critical distinctions between individual trustees and corporate trustees.

Fourth, an agency cost model could render useless one of the unique aspects of trust law: the asset partitioning/protection features of a trust. Although academics dispute whether the concept of a trust is grounded primarily in property law, in contract law, or in organizational law, it seems generally accepted that there are very special and unique property law aspects of trusts that cannot be duplicated through contractual drafting or an organizational lens, such as the asset partitioning/protection features of a trust. Conceptually, a trust may be perceived as a separate entity from that of any of the trust parties. With respect to the trustee, trust law splits the trustee into two distinct legal persons—an individual acting on his own behalf and a trustee acting on behalf of the trust, thereby insulating the trustee from creditors of the trust and protecting trust assets from creditors of the trustee. By creating a spendthrift trust or a discretionary trust, the trust property is insulated from the beneficiaries’ creditors. Finally, the settlor’s creditors generally cannot reach the trust assets (as long as the settlor is not also a beneficiary). The creditor protection aspects of trusts are very important in modern estate planning. Increasing the rights or interests of the settlor or beneficiary, however, could invalidate the creditor protection function of a trust. If there is indeed a unique property aspect to trust law that separates it from other legal disciplines, then it is this functional aspect that warrants protection and review.

Without taking into account the special nature of trusts, the assumptions and data upon which agency cost theory was developed may not be pertinent to trust law. By expanding the reach of agency

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88 Hansmann & Mattei, supra note 66, at 438 (noting that the property law aspect of shielding trustee’s assets from creditors is one of the most important contributions of trust law); see also Sitkoff, Agency Costs, supra note 6, at 638 (observing that trusts are more than contracts because of the unique in rem asset partitioning aspect of trusts).


cost theory from business firms to trusts without adequate and reliable data underpinning the foundational assumptions, the theory could produce indeterminate outcomes.

B. A Critique of the Theoretical Assumptions of an Agency Cost Theory of Trusts

Novel application of theoretical concepts of one legal discipline to another is not without risk, even though it may produce valuable insights. When a legal concept is taken from one context and incorporated into a fundamentally different setting without reevaluating the underlying assumptions upon which the original legal concept was developed and tested, the “legal transplant” may carry with it unintended and unforeseen consequences and influences.91 Simply, the logic of the transferred legal concept may have a momentum of its own.92 This seems to be the case in the application of agency cost theory to trust law.

In the discipline of economics, theories can be tested against readily ascertainable statistical data and can therefore be more fairly scrutinized, commented on, and built upon. While this approach can be readily duplicated with respect to some areas of the law,93 the inherent lack of data in other areas of the law94 makes application of this approach somewhat less desirable.

At first blush, trusts may seem similar to corporate firms in that trusts bifurcate the legal title of an asset from the equitable title of the asset (basically, a division between management and enjoyment).95 Thus, agency cost scholars may take an intellectual shortcut by focusing on the analogous aspects of trusts and firms. But the assumptions, hard-data, and empirical evidence that have already been accumulated for an

91 See generally WATSON, supra note 10 (discussing in greater detail the perils of “legal transplants”); Rock & Wachter, supra note 10.
92 See, e.g., Alex Y. Seita, Common Myths in the Economic Analysis of Law, 1989 BYU L. REV. 993, 997 (observing how the pure aura of law and economics theory has a momentum of its own).
93 Corporate law is an excellent example of the straightforward applicability of economic principles of agency. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991).
94 The private, and often even secretive, realm of trust law is a good example of discipline in which it would be exceedingly difficult, if not impossible, to measure the effectiveness (or ineffectiveness) of the application of an economic principle to the law. See generally Rock & Wachter, supra note 10.
95 There is not only a debate whether a trust is an “entity” or an “organization” (i.e., a firm), but also, within the law and economics organizational camp, there is an internal debate of whether trusts are more similar to a market relationship or a firm relationship. For an argument that trust relationships are, at their core, market relationships and not firms, see Rock & Wachter, supra note 10, at 664.
agency cost theory of the firm were compiled through the lens of the business firm. Inevitably, difficulties arise by failing to reconfigure these assumptions and data to correspond with the unique nature of trusts. In moving agency cost theory unselfconsciously across the boundaries between business firms and trusts, some of the incongruent aspects of the legal disciplines were downplayed or ignored altogether.96

1. An Ill-Fitting Principal-Agent Analogy

The principal-agent analogy is an awkward attempt upon which to base a new fundamental principle of trust law. It should stand to reason that if there is no principal-agent relationship in trust law, the usefulness of agency cost analysis is greatly weakened. 

Agency cost theory of the firm was developed as an analytical tool to shed important light on organization law and the nature of the firm by identifying the friction that is deemed to be inherent in principal-agent relationships. Unlike the corporate context where managers more clearly act as agents to the residual shareholder owners, the identity of the parties in the agency relationship itself remains wholly unclear in the context of trusts because there are two central relationships in the law of trusts: settlor to trustee, and trustee to beneficiary.97 Focusing, at least initially, on the trusts’ two central relationships provides an excellent starting point for analysis. This paradigm evinces a question antecedent to the application of agency principles: Is there even a principal-agent relationship in trust law?

Applying a principal-agent analogy to trust law presents an immediately perceptible problem—who is the principal whom the agent must serve?98 The principal could be the settlor who creates the trust and gratuitously transfers her property to the trust. The principal could also be the beneficiary who equitably enjoys the benefits of the gift. Professor Sitkoff, in applying an agency cost model to trust law,

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96 See supra note 7 and accompanying text.
97 See Sitkoff, Agency Costs, supra note 6, at 640 (describing these as two of the “dominant” relationships). There are other significant relationships in trust law such as those between the principle parties and creditors, and between the principle parties and trust protectors. See id. at 639-40 (presenting a non-exclusive list of ten “constituent relationships”).
98 Under traditional American trust law, the settlor may impose a variety of ex ante obligations, benefits and restrictions on and to the trustee and beneficiaries, but those obligations, benefits and restrictions are enforceable only by the trustee and/or beneficiaries, as the case may be.
recognizes a principal-agent relationship between both the settlor and trustee and between the beneficiary and trustee.99

To meaningfully discuss this analogy, a principal-agent relationship in general must be defined. Agency, at its core, describes and defines the relationship between two people—the principal and the agent. Its principles and implications differ, however, under a legal concept of agency from under an economic concept of agency.

As it pertains to the law, agency is a term of art with precise requirements and resultant consequences. Legal agency is defined as "the fiduciary relationship that arises when one person (a ‘principal’) manifests assent to another person (an ‘agent’) that the agent shall act on the principal’s behalf and subject to the principal’s control, and the agent manifests assent or otherwise consents to so act." 100 The essential element of control is augmented only by the requirement that the relationship is consensual—there is no inadvertent agency under the common law.101

Economists have also defined agency, albeit somewhat less exactlying. The foremost definition of agency from an economic perspective is "a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent."102 The economic concept of agency is more descriptive than it is binding. The term is used to describe a large body of relationships, some of which would be legal agency relationships,103 others of which would likely fall short for one reason or another.104

Generally, economic agency differs from legal agency in two important ways. First, economic agency is a broader definition with less vigorous requirements.105 Second, it imposes no consequences on

100 RESTATEMENT (THIRD) OF AGENCY § 1.01 & cmts. (2003) (defining agency). Numerous legal consequences flow from the creation of an agency relationship, including scope of authority, duties and liabilities. RESTATEMENT (THIRD) OF AGENCY §§ 2, 7, 8. These consequences are essential to the purpose of agency law, “enabl[ing] individuals to create relationships of authority and power among themselves.” Orts, supra note 49, at 271.
101 See RESTATEMENT (THIRD) OF AGENCY § 1.02. Note that the requisite consent refers to the existence and nature of the relationship itself and does not import a requirement that the parties subjectively believe that they are in an agency relationship. Id.
102 Jensen & Meckling, supra note 8, at 308.
103 The classic example of employer/employee can be found in Jensen & Meckling, supra note 8.
104 For example, economists would likely include an independent contractor in their definition of “agent” for the purposes of calculating agency costs. However, independent contractors may or may not be agents under agency law, depending upon specific circumstances. See RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. c.
105 For example, it does not require a showing of control. Id.
any of the parties—it is merely an analytical tool. This is not to suggest, though, that the two fields never overlap—quite the opposite is true.

Professor Sitkoff uses agency in its economic sense, concluding that there is a principal-agent relationship between both the settlor and trustee and the beneficiary and trustee. In addition, he also seems to use agency in a legal sense, which might contradict his ostensibly economic use of agency. Because of this uncertainty in determining whether a principal-agent relationship exists in the trust context, this paper examines the fundamental relationships from both the economic and legal perspectives.

a. Settlor-Trustee Relationship

From a legal perspective, one of the implications of applying agency cost theory to trust law is that the determination of a "principal" may depend on the type of trust being analyzed. For instance, in revocable trusts or self-settled asset protection trusts, a settlor seems akin to a principal. However, in testamentary trusts (where the settlor is dead), for facially obvious reasons, the settlor and trustee relationship cannot reasonably be described as a principal-agent relationship. Finally, in inter vivos trusts, the principal-agent model is an awkward and forced fit. Typically, when a settlor creates an inter vivos trust (of which she is not a beneficiary), the settlor relinquishes dominion and
control over the transferred assets and retains no beneficial interests.\(^\text{111}\) Accordingly, the trustee does not act on behalf of the settlor or represent the settlor, nor does the trustee act for the settlor's benefit. In addition, the settlor lacks standing to enforce the trust. Can there be a principal-agent relationship when the principal lacks standing to sue the agent to enforce the arrangement?

Likewise, the settlor-trustee relationship evades classification as an agency relationship in the economic sense. Although the settlor might be thought to engage the trustee to perform a service, such a service is not, as noted above, done on behalf of the settlor.\(^\text{112}\) The trustee is required to act for the benefit of the beneficiaries within the confines of the trust itself.\(^\text{113}\) In fact, any mention of the settlor is conspicuously absent from the trustee's duties. In addition, making the trustee too accountable to the settlor could trigger undesirable tax consequences, undermine estate planning techniques, and diminish creditor protection.\(^\text{114}\)

b. Beneficiary-Trustee Relationship

The characterization of the beneficiary-trustee relationship is less cut-and-dry. As in the settlor-trustee relationship, the beneficiary lacks true control over the trustee,\(^\text{115}\) and thus, there can be no legal agency.

In an economic sense, however, the character of the relationship is somewhat less clear. Under trust law, the trustee holds legal title to the trust property while the beneficiary holds equitable title, and the trustee is bound to exercise her powers in the interest of the beneficiary.\(^\text{116}\) However, the beneficiary's interest is effectively defined by the terms of the trust as provided by the settlor.\(^\text{117}\) Generally, trustee powers and duties almost are exclusively derived from the settlor. The trustee interprets and enforces the settlors' directives and intent. Although beneficiaries have standing to enforce the settlor's directives and their equitable interest, beneficiaries do not control trustees. And,

\(^\text{111}\) If the settlor retains any direct or indirect interest in trust funds, those funds will be included in the settlor's taxable estate for estate tax purposes. I.R.C. §§ 2036, 2038 (2006). The main reasons to create inter vivos revocable trusts are the minimization of taxes and creditor protection. These provisions provide a strong incentive to relinquish dominion and control over the assets.

\(^\text{112}\) In any event, the trustee is engaged and paid, if at all, by the trust itself, not by the settlor.

\(^\text{113}\) Restatement (Third) of Trusts § 70 (2007).

\(^\text{114}\) For a more detailed discussion of these implications, see infra Part II.D.2.

\(^\text{115}\) Restatement (Third) of Trusts § 50 ("[T]he discretionary power conferred upon the trustee ... is subject to judicial control only to prevent misinterpretation or abuse of the discretion by the trustee ... .").

\(^\text{116}\) Id. § 15.

\(^\text{117}\) See supra notes 17-18 and accompanying text.
beneficiaries usually do not consent to the trust agreement nor are they a party to the deemed contract in obtaining the trustees’ services and defining the trustees’ role. In this regard, the trustee-beneficiary relationship is more akin to type of stewardship relationship than principal-agent relationship. Moreover, a principal-agent analogy of the relationship between the trustee and beneficiary becomes more attenuated when different beneficiaries have varying interests (e.g., current beneficiaries, remainder beneficiaries, contingent beneficiaries) or as the number of beneficiaries grows. Beneficiaries have a myriad of interests—some of which could be inherently antagonistic to each other. In such a situation, a trustee must balance the interests of the beneficiaries according to the terms of the trust; in doing so, she may be forced to choose one beneficiary over another—a behavior totally uncharacteristic of an agent and contrary to the role of an agent. Suffice it to say, a principal-agent analogy is, at best, ill fitting and imperfect.

Regardless of whether there are no principal-agent relationships in trust law or that the concept is imperfect but can be stretched to find one, it seems that the application of the subsets of agency analysis to trust law could be less than optimal. In addition, imbuing quasi-principal status on the beneficiaries may have unintended deleterious effects. Notwithstanding the awkward fit of the principal-agent relationship, in the interest of a more thorough discussion of the relative merits of agency cost theory in trust law, this Article will proceed with the assumption that a principal-agent relationship might exist between beneficiary and trustee.

2. Settlors Are More than Wealth Maximizers

The application of an agency cost analysis to trust law loses some of its normative value when applied to a legal discipline like property succession law, where many individuals become entrenched with idiosyncratic and personal preconceptions about death, mortality, emotional family issues, property rights, personal legacies, paternalism, altruism, or other affective interests. Estate planning is inherently emotional and the interests of the settlor cannot be easily monetized. Trying to monetize the interests of the settlor imposes a monetary goal that might not exist, or at least might not exist to the exclusion of other important goals of the settlor.

118 After all, if there is no principal and no agent, how can there be agency costs?
119 For a more detailed discussion, see infra Part II.D.
2011]  AGENCY COST THEORY OF TRUST LAW  2607

As part of the traditional neoclassical school of law and economics, agency cost theory assumes that human beings are "ruthless optimizers of their utility,"120 who perform instantaneous cost-benefit analyses which lead them to choose the option that maximizes their wealth.121 Wealth maximization’s trust law corollary is that settlors create trusts with the overriding purpose of maximizing the wealth of the beneficiaries.122

Although agency cost theory of trusts presents an informative view of the world, it ignores a good bit of the complexity of human nature. As one scholar has noted, "[t]he rational utility or profit maximizers of microeconomic theory seem to bear very little correlation to the flesh-and-blood human beings with whom the law deal[s]."123 The correlation is even more suspect in the realm of trusts where the interests of settlors may go far beyond their own wealth maximization or the wealth maximization of their beneficiaries.

In the real world some important goals attendant to creating a trust include family concerns, promoting social issues, or even "fetish" interests, which remain difficult to monetize.124 For instance, studies show that affluent Americans are worried about the ability of their children to handle money.125 In addition, a number of wealthy entrepreneurs, including Warren Buffett and Bill and Melinda Gates,126 are planning to leave most of their wealth to charity on the theory that

120 Korobkin & Ulen, supra note 29, at 1059.
121 This Article is using the wealth-maximization theory because it is the one used by Professor Sitkoff in his article and seems to be the most predictive of all of the rational choice approaches. See id. at 1066 (describing the wealth-maximization version of rational choice theory as the “thickest conception,” which “provide[s] . . . specific predictions about the ends of the decision makers”). For a discussion of the wealth maximization theory, see supra Part II.B.2.
122 Sitkoff, Agency Costs, supra note 6.
124 Behavioral law and economics offers a promising advancement in the area. However, the framework seems largely out of reach because of the difficulty in accounting for and quantifying all the affective interests across the entire market. Still, even without robust data to satisfy a richly nuanced algorithm that accurately describes the motivations and behaviors of actors within the trust realm, a behaviorally economic framework might help pose important questions even if it is incapable of producing adequate answers.
125 A 2000 survey of the wealthiest Americans (defined as the top ten percent by wealth or income) who have children revealed that more than half of these affluent parents are concerned that their children “will place too much emphasis on material possessions,” “will be naïve about the value of money and how hard it is to earn,” and “will spend beyond their means.” U.S. TRUST, U.S. TRUST SURVEY OF AFFLUENT AMERICANS XIX, at 3 (Dec. 2000) [hereinafter U.S. TRUST SURVEY]. Almost half worry that their children “will have their initiative and independence undermined by having material advantages.” Joshua C. Tate, Conditional Love: Incentive Trusts and the Inflexibility Problem, 41 REAL PROP. PROB. & TR. J. 445 (2006) (citing U.S. TRUST SURVEY, supra).
too much inherited money would be bad for their children. These individuals fear that their children will have too much, not that their children will have too little. Moreover, those non-monetizable goals may be difficult even to rank in some sort of lexical ordering.

Making agency cost theory applicable to trust law requires adopting a stilted view of human nature and the basic purposes of trusts. Regardless of the inability to reduce trust preferences to the metric of selfish wealth maximization, even if any individual actor’s preferences were easily calculable, nothing ensures that the values attached to one individual’s interests remain coherently commensurable with any other actor. Agency cost theory seems only capable of comparing apples to oranges, an exercise of little ultimate value regardless of the metric.

3. Unsubstantiated Party Preferences

Utilizing an agency cost analysis to trust law could provide incomplete answers to open questions because agency cost theory of trusts cannot accommodate actual preferences of relevant parties. From a law and economics perspective, the only way to craft default rules for trust creation is to be able to predict preferences in trust creation. Any number of factors complicates trust analysis, though. In fact, trust law is littered with trusts whose terms seem highly irrational, if one is looking only for wealth maximization.

There is no optimal result upon which agency cost reducing trust default rules can be based. And even if an optimal result could be discerned from all of the decision-making permutations in trust law, humans—purposely or otherwise—often settle for a non-optimal choice that is nonetheless satisfactory for them. Any attempt to determine settlor and trustee preferences—and then transform them into default rules that reduce agency costs—should be tempered with the reality that

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127 Apparently, the late Notorious B.I.G. agreed with Messieurs Buffet and Gates in regarding money as a source of problems. See NOTORIOUS B.I.G. (FEATURING PUFF DADDY, MASE & KELLY PRICE), Mo Money, Mo Problems, on LIFE AFTER DEATH (Bad Boy Records 1997).
129 See supra Part II.A.
130 For a non-exhaustive list of trust terms that has been categorized as on the “fringe,” see Horton, supra note 6, at 1704 (citing to trusts which disinheret a party for remarrying or joining a particular faith, or which require the destruction of the settlor’s house or the settlor’s money).
131 See Korobkin & Ulen, supra note 29, at 1075 ("In some cases, actors faced with a decision might aim to make a satisfactory choice—one that meets a specified aspiration level—rather than one that maximizes their utility."); Herbert A. Simon, Rational Choice and the Structure of the Environment, in MODELS OF MAN: SOCIAL AND RATIONAL 261, 270-71 (1957) (coining the term “satisficing” as the process of “finding a choice mechanism that will lead [one] to pursue . . . a path that will permit satisfaction at some specified level of all its needs").
a large divide exists between preferences and consent. Observable behavior does not necessarily reveal preferences conclusively, as scholars have attempted to demonstrate.\textsuperscript{132} While a settlor’s trust decisions could represent true preferences, they could also represent acquiescence or consent to someone else’s preferences, a misunderstanding of the choices, or even indifference to other options. Additionally, a settlor’s trust choices could result from a ranking of multiple preferences. “[S]ome values—those afforded priority—simply are not interchangeable with others.”\textsuperscript{133} For example, consider a wealthy couple who values money, but has a twenty-year-old son who has a serious addiction to drugs. The couple wants to ensure that their son is taken care of financially after they die but they do not want to hand over great unencumbered sums of money to him and simply fuel his drug addiction.\textsuperscript{134} Does their decision to create a spendthrift trust represent a preference for control, paternalism, wealth-maximization, or a combination of the three?

Construing preferences in trust law is very difficult and seems to be based largely on personal observations. Problems arise from confounding results with behavior, especially when one looks at existing trust agreements for empirical evidence of settlor’s intent. For example, Professor Sitkoff relies upon anecdotal evidence in trust agreements that suggests modern settlors regularly opt out of the default trustee removal rules in favor of easier trustee removal rules.\textsuperscript{135} Note that the actual trust agreements are used as support for determining “settlor’s preference.” However, Professor Sitkoff ignores actual trust agreements when opining about why settlors may have chosen not to draft out of the \textit{Claflin} doctrine, a concept which Professor Sitkoff finds to increase agency costs.\textsuperscript{136} Even though the anecdotal evidence seems to imply that the settlor’s preference is to implement the \textit{Claflin} doctrine, Professor Sitkoff asserts that, in this case, the reason that trust agreements do not opt out of the default \textit{Claflin} regime is because settlors’ legal advisors failed to call their attention to the matter or

\begin{footnotesize}
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  \item \textsuperscript{132} STANLEY WONG, FOUNDATIONS OF PAUL SAMUELSON’S REVEALED PREFERENCE THEORY: A STUDY BY THE METHOD OF RATIONAL RECONSTRUCTION (rev. ed. 2006).
  \item \textsuperscript{133} Harrison, supra note 29, at 1328. This issue is sometimes referred to as “lexical ordering.” \textit{Id.} at 1328-38.
  \item \textsuperscript{134} This situation is very similar to the one facing Farrah Fawcett, whose son, Redmond, was incarcerated on drug-related charges at the time of her death. \textit{See} Andrew W. Mayoras, \textit{Preview into Farrah’s Fawcett’s Will and Trust}, PROB. LAW. BLOG (July 27, 2009, 7:57 PM), http://www.probatelawyerblog.com/2009/07/preview-into-farrahs-fawcetts-will-and-trust.html.
  \item \textsuperscript{135} \textit{See} Sitkoff, \textit{Agency Costs}, supra note 6, at 665; \textit{see}, e.g., \textit{RESTATEMENT (THIRD) OF TRUSTS} § 34 cmt. c (“It is also common for the terms of trusts to provide for the appointment of new trustees.”); 17C AM. JUR. LEGAL FORMS 2D Trusts §§ 251:370-251:373, 251:388 (2001); JOHN R. PRICE, PRICE ON CONTEMPORARY ESTATE PLANNING § 10.41 (2d ed. 2000).
  \item \textsuperscript{136} For a discussion of agency cost theory’s misconception of equitable deviation and the \textit{Claflin} doctrine, see \textit{infra} notes 202-26 and accompanying texts.
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settlor preferences to altering trust law) while on the other hand trust agreements are discounted as evidence of settlor preferences for revisions of other laws. Suffice it to say, data to support an agency cost theory of trust law based on preferences is weak.

The status quo bias lends additional credence to the idea that trust agreements do not reveal preferences. The status quo bias simply posits that people like things the way they are and are somewhat averse to change. This bias is particularly important vis-à-vis default rules, whether changing them or creating them, because default rules become the status quo. The law and economics approach—in the traditional contract realm—says that default rules do not in any major way affect the actual terms that two parties end up choosing because they can simply contract around them to attain the most efficient result. However, skeptics of the rational choice theory have challenged this assumption: “[C]ontracting parties are likely to see default terms as part of the status quo and, consequently, prefer them to alternative terms, all other things equal.” As such, individuals are less inclined to opt out of default rules simply by virtue of their existence. Default rules, then, should not be viewed as just benign suggestions, but rather as rules that alter how people mentally process the law. Efficiency advancing trust law default rules are a nice concept, but the scholars promoting them should tread lightly until they can determine what effect they will have on the status quo.

4. Disproportionate Reliance on the Managerial Aspect of Trusts

By overemphasizing the managerial evolution of trusts, agency cost analysis creates a skewed framework to base trust analysis. For example, two other important developments of trusts could dramatically affect the articulated model of agency costs—the pedestrianization of trusts and the advent of the perpetual trust.

137 Sitkoff, Agency Costs, supra note 6, at 625.
139 Korobkin & Ulen, supra note 29, at 1112.
140 See Hoffman & O’Shea, supra note 138, at 392 (“[I]ndividuals tend to prefer default contract terms over new ones (even though the new ones might benefit them).”).
An initial question should be asked before adopting an agency cost model of trusts: Should the default and mandatory rules of trusts be developed with an eye towards the greatest number of trusts or the trusts with the greatest concentration of wealth? For example, would a brother of moderate means who named his beloved sister to be the trustee of a trust for the benefit of his child only during the child's minority years need or desire the application of the same default and mandatory rules that apply to large, perpetual managerial trusts with corporate trustees? Would the same trust questions and problems arise? Can a single economic model account for the various uses, purposes, and forms of trusts? The determination of which set of trusts that will be used as evidence of party behavior makes a substantial difference to an economic model. In fact, the questions that plague trust creation and administration probably vary significantly between the two.

By over-focusing on the managerial evolution of the trust, an agency cost model might assume that all trusts are long-term or perpetual dynasty trusts used by the very affluent. But trusts are no longer only for the wealthy. In fact, many trusts are created by individuals of modest means. A number of reasons have been given explaining this development, including the modern desire to avoid probate, the increase in the number of estates subject to the estate tax, increased human longevity, allowing lawyers to advertise, other marketing efforts by the trust industry, the advent of trust mills, and the increased availability of self-help trust books and software. For these Americans, trusts are used in a relatively short-term manner, they do not involve a great deal of money, and they appoint individuals to serve as trustees—typically, family or friends of the family who serve for no compensation. For example, a very common use is to create a marital trust for the life of the surviving spouse that will terminate upon the surviving spouse's death. Another common use of short term trusts are trusts created for minors. A surviving parent might create a trust for her child that will terminate upon the child attaining majority (or, more commonly in my practice, to distribute one-third of the trust corpus at

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141 For a discussion of the use of default and mandatory rule in the probate code, see Lee-ford Tritt, Technical Correction or Tectonic Shift: Competing Default Rule Theories Under the New Uniform Probate Code, 61 ALA. L. REV. 273 (2010).
142 By way of anecdote, I recently saw an advertisement in the local newspaper by an attorney claiming that the creation of a trust saves money for families with assets over $100,000.
143 See Dobris, supra note 3, at 764–67; see also Bill Steigerwald, For Boomers Getting Older Will Be a Trip, PITT. POST-GAZETTE, Dec. 14, 1995, at B1 (discussing the proposition that many baby boomers are poor savers and are persuading their parents to use trusts to pass as much wealth as possible at death); Karen Hube, Some Revocable Living Trusts Can Cost Thousands of Dollars in Needless Taxes, WALL ST. J., Feb. 6, 1998, at C1 (discussing problems with "trust mills" which aggressively market revocable inter vivos trusts to the elderly, stating that "retirees and others are often paying thousands of dollars for fill-in-the-blank documents ‘that have little chance of accomplishing their goals’").
age twenty-five, one-half of the remaining trust corpus at age thirty and the remainder of the trust corpus at age thirty-five).

To illustrate how the differences in the conception of the use of trusts might influence or change an economic model, let us return to the example of our brother of moderate means and his beloved sister. First, we will use the example to shed light on the claim that trusts are similar to firms in that they both have perceived information asymmetry and that trust creators are not repeat players.\(^{144}\) There might be a difference, though, between information asymmetries between the parties involved in the vast amount of trusts and the parties involved with the trusts that hold the largest amount of wealth. Unlike the settlor who might have had an attorney advise him and counsel him, the individual trustee generally accepts this position out of familiar loyalty or duty—typically without advice of counsel. An individual trustee neither is likely to have been involved in the trust creation nor tends to be a repeat player.\(^{145}\) Therefore, the appointment of the sister as an individual trustee might create a reverse information asymmetry, or an agency cost to the sister. On the other hand, very wealthy individuals, at least, often have legal counsel (in addition to other financial advisers) even if corporate trustees have an information edge.\(^{146}\) In addition, the very wealthy individuals might actually be repeat players. On a personal note, I am hard pressed to remember a client that did not create multiple trusts, for some of which they were beneficiaries. These clients were financially sophisticated.\(^{147}\) This example is not used to dismiss any articulate informational asymmetries in trust law, but is merely used to illustrate the important point that the parties to different kinds of trusts might have very different preferences, concerns, and experiences.

The brother-sister example sheds lights on other issues as well. For instance, serving as a trustee for free (waiving fees) seems to undermine in part the agency cost assumption that trustees are ruthless optimizers of their own self interest and, therefore, will take advantage of their stewardship of the trust assets. Yet, it has been my observation that many individual trustees waive fees. And, during the time the sister is administering that trust for the benefit of her niece, will the interests of the sister and the brother be as divergent as the interests of a corporate trustee and the brother? Finally, would the brother want the

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\(^{144}\) Sitkoff, *Agency Costs*, supra note 6, at 643.


\(^{146}\) It has been argued that trust and estates lawyers might not serve their independent clients well, because they are beholden to corporate trustees for referrals. See id. at 2715-16. This has not been my observation of the legal field.

\(^{147}\) The settlor’s sophistication and experience with trusts, though, does not necessarily transfer to the beneficiaries’ understanding of issues.
beneficiaries to have the same powers over the sister trustee as a corporate trustee—or, would the brother want the sister to be exposed to the same liabilities as the corporate trustee?

In determining trust law, one might legitimately argue that trust law default rules should be geared to accommodate the trusts now being created by the masses (a type of majoritarian approach), in that the sophisticated, wealthy individuals can seek counsel to draft out of any undesirable default rule. On the other hand, a legitimate argument may be made that trust law should tilt towards the dynasty type trusts because it is these long term trusts that experience the most issues or problems. If an agency cost model cannot account for the various uses, purposes, and forms of trusts, then a determination will need to be made.

5. An Idiosyncratic Decision Making Process

The hypothetical bargain analysis and the economics of agency cost theory is not easily transmutable to trust law because the decision making process involved in creating a trust is distinct from firms and other business organizations. Therefore, the application of agency cost theory to create default rules seems misplaced.

The hypothetical bargain philosophy is clearest when applied to the realm of contracts and corporate law. For instance, in contract law, two (or more) parties with adverse interests come together contemporaneously to bargain for the terms that each is willing to accept. When the parties have each found the point at which both are most satisfied with the conditions of the contract, an optimal result has been achieved. Default rules for the formation of contracts are written so as to reflect this optimal result and even encourage it.148

Decision making in trust law is significantly different from these other areas of law. In contracts and corporate law, the parties to the negotiations, to some extent, are personally affected by the repercussions of their decision making. Settlors, though, do not necessarily bear the consequences of their behavior in creating a trust.149 Lifetime decisions that affect the decision maker might be of a different thought process than death time decisions where the decision maker does not bear the consequences of her actions. When a settlor creates a trust, the trust might not be intended to take effect until years later, and often after the settlor has died. This means that at the time the

148 See Schwartz, supra note 128.

149 Private trust has been characterized as ""essentially a gift, projected on the plane of time."
settlor is creating the trust, he is making decisions without the prospect of feeling the consequences of the trust’s creation any time soon (if ever).\textsuperscript{150} When parties are bargaining to create a contract, usually the terms that the parties are haggling over—the consequences of their bargaining—will be felt shortly thereafter by both parties. The temporal incongruity between trust creation and trust administration should make anyone skeptical of a comparison of trusts and contracts vis-à-vis a law and economics analysis.

Another way in which decision making in trust law differs from the law of contracts is that the negotiation that occurs between the settlor and the trustee is not even roughly equivalent to the bargaining that occurs between two parties trying to form a contract. This bargaining process in contracts is what leads to an efficient, or optimal, result.\textsuperscript{151} However, in the creation of trusts, it cannot be taken for granted that a settlor and potential trustee approach the terms of the creation of a trust with the same level of bargaining as in contract formation; indeed, it cannot be assumed that \textit{any} bargaining occurs at all. And even if bargaining does occur, it cannot be taken for granted that both the settlor and the trustee have their eyes on the same issues. It is perfectly conceivable that both the settlor and the trustee could have different concerns that do not even overlap. When this is the case, it cannot always be said that an ultimate contract or meeting of the minds occurs between the settlor and the trustee at all. In this case, no preferences were necessarily revealed either.

6. Beneficiaries Are Not (Conceptual) Parties to the Bargain

A nexus of contracts analogy applied to the relationships between settlor, trustee, and beneficiary is ill suited. Agency cost theory envisions some form of bargain or exchange between the parties (a cost-benefit analysis), but trust beneficiaries are merely passive recipients of a gift—not a party to the bargain.\textsuperscript{152} In fact, they may not know of the terms of the trust, or even its existence, until well after it is finalized. The idea that the beneficiaries are part of a “nexus of contracts” cannot

\textsuperscript{150} Some legal scholars view this temporal incongruity as a form of moral hazard, i.e., when an individual’s decision-making changes as a result of being insulated from the risks his decision entails. \textit{See} Horton, supra note 6, at 1704 (“Since the settlor may be dead when a trust becomes effective, a testamentary instrument, unlike a contract, raises the specter of moral hazard.”).

\textsuperscript{151} \textit{See}, e.g., Larry A. DiMatto et al., \textit{Visions of Contract Theory} 16, 18 (2007) (“Economics argues that freedom of contract should almost always be honored because private bargaining by rational people should, in light of the Coase Theorem, maximize wealth.”).

\textsuperscript{152} Conceptualizing a beneficiary as a contractual third party beneficiary is plausible. However, Professor Sitkoff seems to view beneficiaries as more than mere third party beneficiaries to a contract. \textit{See} Sitkoff, \textit{Agency Costs}, supra note 6, at 630, 670.
be an accurate depiction. Agency cost theorists resolve this problem by claiming that a beneficiary is a conceptual party to the negotiation, not an actual one.\textsuperscript{153} However, just because an individual is affected by another individual’s decision or behavior or choice does not mean that the affected individual is an interested or entitled party to the bargain. Simply, not all individuals get a seat at the bargaining table. This assumption that beneficiaries are a party to the cost-benefit analysis has far greater implications than might be evident at first blush.\textsuperscript{154}

7. Risk Aversion

Agency cost theory envisions beneficiaries as residual claimants, and accordingly deem that beneficiaries bear the residual risks. By applying the model developed for firms, Professor Sitkoff assumes that beneficiaries are risk adverse similar to other residual claimants found in firms. In fact, this is a fundamental assumption of agency cost theory. This assumption is based on the belief that there is no well-developed market for beneficial interests in trusts, therefore the beneficiaries cannot easily diversify, and when diversification is unavailable, the standard economic assumption is that of risk averseness.\textsuperscript{155}

However, the mental accounting heuristic may shed a different light on this risk aversion assumption. Mental accounting is an important process whereby individuals “conceptually pigeonhole different assets into different ‘mental accounts’ and assign different consumption functions to each.”\textsuperscript{156} This is an apparent contradiction to the notion of wealth fungibility—that is, the idea that a dollar is a dollar, no matter where it came from.\textsuperscript{157} This concept is important in trusts because the mental account that a settlor has placed part of his wealth will contribute to the decision of whether to create a trust in the first place, what kind of trust to create, and what the terms of the trust are. For beneficiaries, how they treat the income they receive from a trust is going to be directly affected by which mental account they place the income.

\textsuperscript{153} See Sitkoff, Agency Costs, supra note 6, at 654.
\textsuperscript{154} For example, see the discussion infra Part II.D.1, concerning how the endowment effect might alter the cognitive perception of how beneficiaries view trust property.
\textsuperscript{155} See Sitkoff, Agency Costs, supra note 6, at 654; see also HAL R. VARIAN, INTERMEDIATE MICROECONOMICS: A MODERN APPROACH 228 (6th ed. 2003); Kathleen M. Eisenhardt, Agency Theory: An Assessment and Review, 14 ACAD. MGMT. REV. 57, 60-61 (1989).
\textsuperscript{156} Hirsch, supra note 23, at 34.
\textsuperscript{157} Id.
There is evidence that individuals deem inheritance as a gratuity, rather than earned income, depending upon the amount\textsuperscript{158} and the form\textsuperscript{159} of the inheritance.\textsuperscript{160} Contrary to the conclusion drawn by agency cost theory, these models predict that individuals will, in fact, have greater risk tolerance with wealth that is inherited wealth.\textsuperscript{161} Regardless, because there is little evidence that beneficiaries are risk averse, this unfounded assumption adds to the wake of problems of an agency cost theory of trust.

C. A Critique of the Agency Cost Formula of Trusts

In addition to the questionable and unverifiable assumptions that limit the utility of an agency cost theory of trusts, the model for calculating agency costs of trusts is based upon a skewed formula and unworkable methodology that inevitably could produce inaccurate results. Therefore, an agency cost theory of trusts may prove to be less than useful.

1. All Costs Are Not Agency Costs

The agency cost calculation associated with trusts may lead to inaccurate results because it includes all costs associated with the settlor’s decision to use a trust mechanism, not just costs that arise from bad faith or negligence of the trust parties. Accordingly, the calculation both overemphasizes perceived costs to beneficiaries and overinflates perceived costs to the settlors.

All costs resulting from the settlor’s choice of splitting the legal ownership of the gift from the beneficial enjoyment of the gift should not be considered agency costs. The shirking concept, however, includes not only culpable cheating and negligence, but also mistakes, oversights, and other inevitable costs in creating a trust. If properly understood from a settlor-oriented perspective, the agency cost

\textsuperscript{158} Id. (finding that smaller inheritances are likely to be viewed as income and therefore spent more easily while larger, lump-sum inheritances are viewed as capital and are therefore more prudently saved).

\textsuperscript{159} Id. (finding that bequests of money are treated and spent as income while bequests of securities or real estate are viewed more as capital and are therefore saved).

\textsuperscript{160} Id. (finding that bequests of money are treated and spent as income while bequests of securities or real estate are viewed more as capital and are therefore saved).

\textsuperscript{161} MILTON FRIEDMAN, A THEORY OF THE CONSUMPTION FUNCTION 20-31 (1957); Nicholas Barberis \& Ming Huang, Mental Accounting, Loss Aversion, and Individual Stock Returns, 56 J. FIN. 1247, 1254 (2001); Franco Modigliani, Life Cycle, Individual Thrift, and the Wealth of Nations, 76 AM. ECON. REV. 297 (1986).
calculation is flawed because, quite simply, there is no "cost" to the beneficiary that results directly from the settlor's choice of using a trust or the settlor's instructions concerning the administration of a trust. Of course, there are costs associated with potential bad faith, criminal actions, or negligence, but the perceived costs that arise from the actual bifurcation of the ownership from the enjoyment of the gift should not be considered agency costs because it leads to an exaggerated perception of the beneficiary's stake in the trust.

"Cost" is defined in the dictionary as "a loss or penalty incurred especially in gaining something." Viewed in this light, a beneficiary may suffer few costs outside of bad faith, negligence and the like. As Professor Sitkoff notes, trusts may produce less wealth for beneficiaries than an outright transfer would. This discrepancy, though, is better classified as a "value differential" than a "cost" with respect to the beneficiary. A gift to a trust rather than an outright gift to a beneficiary is neither a loss nor a penalty to the beneficiary; it is merely the amount that the settlor chose to give the beneficiary as compared to the amount that the settlor could have chosen to give the beneficiary. The "cost" is imposed upon the settlor—an imposition which by choosing the trust form, the settlor has implicitly accepted. Thus, to the extent, if any, that a beneficiary receives less wealth from a trust than from an outright transfer, the discrepancy is best understood not as a loss or penalty to the beneficiary, but rather as a calculated trade by the settlor, exchanging the value differential for the benefits imparted by the trust form. Two vignettes concerning wedding gifts might serve as examples.

In the first vignette, let us suppose that my friend who is getting married registered for china. I decide to buy her a gravy bowl, which costs around forty dollars at a local department store. However, before I buy the gravy bowl, my friend informs her wedding guests that she would prefer cash instead of actual china pieces because if she buys the china herself then she can receive some free pieces for buying in bulk—she wants to leverage her buying potential. After regarding her request, I decide to still buy her the actual gravy bowl. This could be for a number of reasons. First, maybe I feel that a cash gift is socially impolite or rude. Maybe I don't think she would use the cash for the gravy bowl (perhaps she is a recovering drug addict and I think she will be tempted to buy drugs with so much cash around). Maybe I can get a

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163 Sitkoff, Agency Costs, supra note 6.
164 It is equally true that a trust could in fact produce more wealth than would an outright transfer to a spendthrift.
165 The settlor may simply forgo making the gift in that a settlor may disinherit descendants in the United States (except for some limitations on disinherition in Louisiana). Max Nathan, Jr., An Assault on the Citadel: A Rejection of Forced Heirship, 52 TUL. L. REV. 5, 15 (1977).
discount on the gravy bowl and do not have to spend the forty dollars. Or, maybe I think forty dollars cash seems cheap for a wedding gift (compared to a gravy bowl of the same value) and I might feel pressured to give more money. Regardless of my reasoning, my friend might think this is a cost to her—a type of loss. But it is a gift. Anything above “nothing” is a benefit to my friend. To classify it otherwise presumes an entitlement that simply does not exist. How could buying a gravy bowl for my friend ever really be a “cost” to her?

Now, let us suppose that I decide to send my friend who is getting married a wedding gift in the form of a $100 check. I could send it by regular mail using the U.S. Postal Service and spend $0.44. Alternatively, I could send it by Priority Mail using the U.S. Postal Service and spend $18.30. I could also decide to use a private delivery company for a considerably greater cost. When making my selection, I will weigh, *inter alia*, the costs and reliability associated with each method. Regardless of what I spend on the delivery, my friend will still receive a $100 check. The cost I pay depending on the “agent” I use to deliver the gift is borne by me and is internalized when I make the decision. Viewing the difference between $0.44 and $18.30 as a “cost” to the gift recipient seems out of place. Similarly, it seems unsuitable to consider the costs associated with the very essence of a gift to a trust (the bifurcation of ownership from benefit) as agency costs.

Instead of including all costs associated with the choice to use trusts in the calculation of agency costs, trust law should focus on the unintended costs from a settlor’s perspective—what I will call “slippage.” When a settlor decides to create a trust, she understands that somebody will be managing the funds for the benefit of the beneficiaries. If the settlor wanted to avoid agency costs, the settlor could have given the gift outright to the beneficiaries. Therefore, certain agency costs are understood and accepted. Depending on whether the settlor chooses an independent trustee or corporate trustee, the settlor knows there will be trustee’s fees and compensation. The settlor also knows there will be some shirking and accepts this as part of creating a trust.\footnote{This might arise from choosing an individual trustee who might be less financially sophisticated, but who the settlor trusts to care for the beneficiaries (thereby, accepting the agency costs associated with choosing a family member or friend). In addition, a settlor probably understands that corporate trustees have many clients and that the trust assets will not be given maximum attention and will be administered in a more general, less tailored manner.}

In addition, the settlor understands (and, often times, desires) that trusts limit the flexibility of trustees and restricts a beneficiary’s interests in the assets. Slippage, though, concerns unintended or undesired costs—for example, theft, gross negligence, or a disregard of the settlor’s instructions. Slippage is the difference between the *ex ante* expectations and the *ex post* outcome. Although
the settlor might understand there is a small chance of slippage, slippage in not an acceptable value differential in the creation of a trust from the settlor’s perspective. Fortunately, trust fiduciary law already recognizes the possibility of slippage and has created a robust concept of fiduciary duties to curtail this concern.

An agency cost calculation of trusts offers few new insights into the concerns associated with slippage. On the other hand, the agency cost calculation might muddy the waters of established trust doctrine. First, the agency cost calculation exaggerates the beneficiary’s role in a trust by including perceived costs to the beneficiary derived from the settlor’s simple choice of using a trust to implement a gift. Second, viewing fiduciary duties as agency costs associated with contracting parties could undermine the social and moral impact of the conceptual concept of fiduciary duties. These issues curtail the usefulness of an agency cost model to trust law.

2. An Incomplete Calculation of Agency Costs

The model for calculating agency costs associated with trusts may lead to faulty results because the formula is narrowly focused on costs created by the actions of the trustee rather than encapsulating all costs associated with a principal-agent relationship. A theory based upon a calculation of costs that discounts major sources of costs is potentially crippled in both its descriptive and normative functions. First, agency cost theory’s ex post descriptions of the costs associated with a principal-agent relationship are inherently incomplete because it primarily focuses on costs created by the trustee. Second, agency cost theory’s ex ante predictions concerning the affects of agency cost reducing rules are limited by the failure to account for its behavioral impact on the trustee. Such analysis places a thumb on the scale of the cost-benefit balancing of the actions of all the actors under agency cost theory.

Professor Sitkoff’s agency cost calculation is partially skewed in that it is principal-centric—his analysis tends to center on costs derived from the preconceived self-interested nature and actions of the trustee. Like other agency cost theorists, Professor Sitkoff ignores...
any costs created by the principal—so called “sharking” by the principal.\footnote{See Orts, supra note 49, at 278-80 (discussing such costs in detail and terming them “sharking”). In trusts, sharking might occur when beneficiaries, without merit, threaten trustees with a removal action or surcharge in order to intimidate the trustee to act in a favorable way.} Though many possible sources of cost to the principal are haphazardly hypothesized and closely scrutinized, sources of cost to the agent remain conspicuously unexamined.\footnote{See Orts, supra note 49, at 278.} Similar to principals, however, agents face risks in a principal-agent relationship as well.\footnote{Id. at 279.}

For example, issues concerning trust investment standards might shed some light on the implications of a skewed agency cost calculation. The more discretion a trustee has in making investment decisions, the higher the trustee agency costs because the trustee will be exposed to more liability. On the other hand, restricting trustee investment options to an articulated list of proper trust investments would reduce trustee agency costs because of the reduction in discretion that might be second-guessed by potential litigants. Of course, the trustee’s agency costs might be inapposite to beneficiary agency costs, who might desire less conservative investments. And, although particular investment rules might benefit the beneficiaries, these rules might increase settlors’ costs in that settlors will have to seek other avenues to effectuate their desired investment directives.\footnote{Cooper, supra note 16.}

By focusing on costs created by trustee actions, an agency cost model of trusts loses some of its descriptive and normative value. In addition, even if the calculation could accommodate the various costs of the various parties, creating agency cost reducing rules would be difficult from an economic perspective because it inevitably would have to weigh the costs to each party and an individual’s interests remain incommensurable with other individuals.

3. An \textit{Ex Post} Solution to an \textit{Ex Ante} Problem

An agency-cost analysis of trust law also has limited utility because “costs” are only readily identifiable \textit{ex post}, while decisions must be made \textit{ex ante}.
Professor Sitkoff’s agency cost model is illustrated by his example of shirking by an improperly incentivized real estate agent who fails to undertake an additional $10 of effort that will only result in a $5 payoff, thus causing the client to forgo $100 in unrealized profit. According to Professor Sitkoff, reducing such shirking will lower agency costs. From an *ex post* perspective, the cost-benefit analysis could not be more apparent; after all, who would do $10 of work for $5 of compensation? But a more realistic *ex ante* approach illustrates a potential concern for this type of reasoning. In approaching the opportunity to increase the sale price of the home, how would the real estate agent know how much effort it would involve or, for that matter, exactly what the payoff would be?

Bar examinations provide a more realistic model of the *ex ante* problem faced by any decision-maker. In order to pass the bar some minimal effort will have to be expended. Looking at the situation *ex ante*, no bar-taker knows what effort is “minimal” so, given the necessity of passing the bar, they simply do the best they can. Only the unforgiving lens of hindsight could describe the bar-taker’s actions that produced minimal results as “shirking.”

An agency cost model inevitably seems to result in confounding the act of shirking with the results that any action might produce. From a practical perspective, then, shirking requires not just the avoidance of obligations, but also a negative result flowing from such avoidance; otherwise, a reduction in shirking would not necessarily cause a reduction in agency costs.

For example, consider the case of an indolent trustee of a trust worth $1000. In 2000, the trustee invests all the trust assets in gold for $270 per ounce. Afterwards, the trustee never reconsiders the investment strategy of the trust—obviously shirking her duties in many ways. Today, gold is worth over $1300 per ounce and the trust assets will have grown nearly fivefold. Obviously, the trustee shirked her fiduciary duties, but what are the resulting agency costs? Similarly, an apathetic trustee who simply left all the trust assets in a bank account since 2007 avoided one of the greatest recessions in nearly a century. Paradoxically, these examples, though perhaps somewhat contrived, illustrate that the act of shirking does not always correspond to a cost. Conversely, a trustee might not shirk, but still preside over a devaluation of trust assets (as many trustees surely have seen over the last few years during the downturn in the economy).

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176 In truth, agency cost theory need not be perfectly predictive in order to meaningfully contribute to the normative discussion. Agency cost theory, however, seems to be aimed at curtailing undesirable *results* rather than undesirable *behavior*. This is most evident in the theory’s definition, or lack thereof, of “shirking.”
The concept of agency cost, therefore, seems particularly susceptible to the harms associated with hindsight biases. Realistically, trustees only will be liable if there is a perceived loss to the beneficiaries regardless of whether the trustee shirked or not. Hindsight bias is a simple process by which individuals overestimate the predictability of a certain outcome after the outcome has occurred.\(^7\) In colloquial terms, it is sometimes referred to as “Monday-morning quarterbacking.” Hindsight bias ignores the ex ante dilemma faced by the “shirking” actor and is influenced by the outcome. Beneficiaries and judges presiding over litigation might unconsciously be influenced by the result rather than the process. In addition, beneficiaries and judges might subconsciously impute contemporary information in their analysis rather than relying on the information available at the time of the potential shirking.

The ex post nature of agency cost theory may be highlighted by its application in determining the prudence of settlor investment directions and trustee investment strategies. Much of the supposed inefficiency that occurs in trust law is related to investment issues. Prudent investing currently takes a portfolio theory approach.\(^7\) Put simply, each investment is judged on its risk from the perspective of the entire portfolio, rather than investment by investment. This approach allows a trustee to balance riskier investments with non-correlated investments in crafting a diversified portfolio. Professor Sitkoff, writing before the current economic downturn, posits that modern portfolio theory will reduce agency costs.\(^7\) Recently, another scholar opinioned that modern portfolio theory will tend to increase agency costs.\(^7\) One wonders if some hindsight bias contributed to the new analysis of agency costs.

Because agency costs are only readily identifiable ex post, while decisions must be made ex ante, agency cost theory increases the risks associated with decision making, which could increase agency costs (for example, trustees buying more insurance and increasing rates). The ex post nature of agency cost theory leaves its ultimate worth to trust law suspect.


\(^7\) See Sitkoff, Agency Costs, supra note 6, at 652-54 (noting that total return investing is an “agency-costs-minimizing” rule).

\(^7\) See Sterk, supra note 6, at 879 (“[T]o the extent that modern portfolio theory underestimates particular investment risks, the doctrinal structure magnifies the risk to trust beneficiaries.”).
4. An Overstatement of Agency Costs

By focusing solely on contractual incentives and ignoring concepts such as trust, social norms, altruism, reputational enhancement, reciprocity, job satisfaction, etc., from its calculation, agency cost theory overstates agency costs. The calculation of agency costs begins with a clean slate, in that it attributes no value to social, moral, ethical, or psychological incentives or penalties of an agent. Contrary to rich historical development of trust law’s concept of a fiduciary, agency cost analysis does not view a trustee as a fiduciary in that the principal places zero trust in the agent. The absence of trust in agency cost theory comes from the view that trust is irrational. Ignoring the social and moral evolution of trust fiduciary law, however, not only overstates agency costs, but could also jeopardize an important norm-enforcing function of established fiduciary law.181

D. Unintended Consequences of Agency Cost Theory of Trusts

The application of agency cost theory may create results that are antipodal not only to trust law but to agency cost theory’s ostensible objectives as well. For example, agency cost theory posits that settlors will use trusts if the benefits of such arrangements outweigh the agency costs. If by reducing beneficiaries’ agency costs the equation is somehow tilted in a way that the settlor no longer perceives her potential benefits as outweighing the potential risks, her willingness to create a trust may wane. A possible corollary may be the general reduction in the use of trusts, and possibly less gifting to potential beneficiaries. The potential influences that the application of an agency cost theory of trust has on behavior and preferences are not limited to settlors—agency cost theory’s impact on trustees and beneficiaries may result in unintended consequences as well. Therefore, understanding the potential results of a thick agency cost theory of trusts may shine some light on its limited utility.

181 For a discussion concerning how the recharacterization of fiduciary duties as default rules would strip fiduciary duties of their moral content, see, for example, Leslie, Trusting Trustees, supra note 6, at 70 (noting the “erosion of the social norm” by creating significant external costs for all future settlors and beneficiaries).
1. Evolving Preferences

Employing an overly simplistic agency analysis to guide the evolution of trust law could actually create wholly new preferences that undermine the very reason for using economic analysis in the first place.

From a settlor’s perspective, if trusts historically facilitate the ability of settlors to transfer wealth while promoting some other non-monetizable goals, then changing the ability of trusts to meet those diverse interests might have the instrumental effect of creating new market preferences. As a result, individuals who previously would utilize trusts to implement their dispositive wishes will have an incentive to pursue non-trust mechanisms. Those who remain willing to use trusts will represent a new market, a group with newly created preferences. Therefore, agency cost theory would beat a new path that settlors have not historically chosen to follow.

From a beneficiary’s perspective, newly perceived property rights (or perceived diminished property rights) may manifest changes in preferences different from those that the agency framework ostensibly attempted to heed. For instance, the mere act of imbuing quasi-principal status in beneficiaries and focusing on the beneficiary’s agency costs (instead of the settlor’s interests) may create an endowment effect that could alter a beneficiary’s cognitive perception and expectations of her interests. The endowment effect is a well documented heuristic that shows the propensity of individuals to value something more when they have a property right to it. For example, if an individual is selling a television that he owns, he is likely to believe the television’s monetary worth is higher than if he were looking to buy the same television from someone else. Changing the rules changes the way people approach the entire trust creation and administration process. "[I]n some situations it might be efficiency enhancing to leave property rights somewhat unclear, in an effort to

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182 See, e.g., Harrison, supra note 29, at 1358-61 (discussing the various experiments that have revealed the endowment effect); Korobkin & Ulen, supra note 29, at 1107-13. For a broader review of the literature on the endowment effect, see generally Hoffman & Spitzer, supra note 138.

183 For this reason, the endowment effect is also sometimes referred to as the "offer/asking gap" or the "willingness to accept/willingness to pay gap." See Duncan Kennedy, Cost-Benefit Analysis of Entitlement Problems: A Critique, 33 STAN. L. REV. 387, 401 (1981) (referring to the "offer/asking" problem); Korobkin & Ulen, supra note 29, at 1108 ("Because the [endowment] effect also results in actors' placing a higher dollar value on goods they are selling than on goods they are buying, it is also referred to as the 'offer/asking gap' or the 'Willingness to Accept.../Willingness to Pay... gap'.")

184 As one legal scholar has put it, "legal rules have ex ante consequences: they affect the world both after and before the fact." Hirsch, supra note 23, at 70.
prevent an endowment effect from taking hold.”  

If an endowment effect does occur, beneficiary sharking might increase and correspondingly, litigations might increase—a result that efficiency-valuing scholars would surely decry.

By asking the wrong questions and failing to attend to actual preferences, agency cost theory would direct the development of trust law in a way that discounts the prevailing market preferences. Whatever preferences agency cost theory might heed exist themselves as new byproduct of a theory that distorts the basic purpose and goals of trusts. As a result, agency cost theory as applied to trusts remains suspect at its core, for the analysis produces a distorted market for the particular kind of trust law principles that the theory can readily accommodate.

2. Settlor’s Standing

Allowing settlors standing to legally enforce the terms of the trust would lead to two negative implications of trust law. One of the implications is that settlor standing could render the gift of property via trust incomplete\(^\text{186}\) by granting settlors standing to sue.\(^\text{187}\) At the outset it is important to note that any benefits that could be derived from settlor standing are probably overstated since it would only apply to a limited number of trusts: irrevocable \textit{inter vivos} trusts during the settlor’s lifetime (not to testamentary trusts or irrevocable trusts after the settlor’s lifetime, unless Professor Sitkoff imagines that this standing is transferrable to the settlor’s estate).\(^\text{188}\) These trusts are generally created for tax minimization benefits and asset protection advantages, and would most likely be advantageous only for the wealthy. As Professor Sitkoff notes, settlor standing has negative implications for tax and asset protection issues, thus negating the very purpose of \textit{inter vivos} irrevocable trusts.\(^\text{189}\)

There are significant tax advantages to \textit{inter vivos} transfers over testamentary transfers.\(^\text{190}\) Lifetime gifts are highly tax favored, but this

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\(^{185}\) Korobkin & Ulen, \textit{supra} note 29, at 1110.


\(^{187}\) See Sitkoff, Agency Costs, \textit{supra} note 6, at 666-69 (advocating settlor standing as a method of reducing agency costs).

\(^{188}\) Moreover, the degree to which settlors would be granted standing to sue is not entirely clear. Professor Sitkoff seems to view settlor standing as a binary paradigm, but in order to completely appreciate the implications of such a radical departure from existing doctrine, it would be necessary to determine the exact conditions under which a settlor would have standing to sue.

\(^{189}\) See Sitkoff, Agency Costs, \textit{supra} note 6.

\(^{190}\) See, e.g., Crummey v. Comm’r, 397 F.2d 82 (9th Cir. 1968); Treas. Reg. § 25.2503-3(b) (2004); Lee-ford Tritt, \textit{Liberating Estates Law from the Constraints of Copyright}, 38 RUTGERS L.J. 109, 173-77 (2006) (discussing the tremendous tax advantages of lifetime giving, such as: (i)
generally applies to completed gifts by settlors who relinquish dominion and control of the property.\textsuperscript{191} Thus, these tax advantages could be unavailable to settlors who retained standing to sue.\textsuperscript{192}

The creditor protection nature of trusts may be unavailable to settlors who retain the right to enforce the terms of the trusts. The right might cause certain trust assets to be included in the settlor's bankruptcy estate.\textsuperscript{193} In addition, recognizing rights of the settlor's creditors, in and of itself, could deem the transfer incomplete from a tax perspective and thus cause the property to be included in the settlor's gross federal estate.\textsuperscript{194}

In addition, granting settlor standing undermines the perception of a trust being a separate entity from the settlor (except for revocable trusts). This concept is one of the special attributes of the trust. Although the Article acknowledges the desirability of this power, the lack of this power is simply an implication of choosing the trust mechanism.

Professor Sitkoff posits that settlor standing might be beneficial because beneficiaries might not be capable of serving as a check to trustee shirking. This seems to undermine agency cost theory's other reasons for liberalizing beneficiaries' right to modify, terminate and remove trustees. If there is a "lack of faith in the beneficiaries' judgment" and the "likelihood of feckless, unborn, minor, unidentifiable, or otherwise incompetent beneficiary" and the

maximizing the use of the $13,000 per year per donee annual exclusion by transferring the amount to so-called crummey trusts (crummey trusts grant one or more beneficiaries the right to withdraw trust property for a limited period of time to satisfy the present interest requirements of the annual exclusion rules); (ii) the benefits of utilizing the "applicable credit amount" in creating a trust, under which a settlor may shelter transfers up to $1,000,000 from federal gift tax, and; (iii) the highly tax favored nature of lifetime gifts in that gift taxes are tax exclusive and estate taxes are tax inclusive and gifts have an estate tax-free nature concerning the income and appreciation of the transferred assets) (citing I.R.C. §§ 2503(b), 2505(a)(1) (2004)); see also KATHRYN G. HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION: STRATEGIES AND SOLUTIONS n.293 (abr. ed. 1998) (noting that "gifts are highly tax-favored as compared to transfers at death")


\textsuperscript{192} Again, the extent to which settlors would be granted standing under an agency cost theory of trust is unclear. The broader the grant of standing, the more likely a court could rule that such standing rendered the gift incomplete by allowing the settlor to continue to exercise his or her "dominion and control" over the property. See 26 C.F.R. § 25.2511-2(b) (2011).


\textsuperscript{194} See Phyllis C. Smith, The Estate and Gift Tax Implications of Self-Settled Domestic Asset Protection Trusts: Can You Really Have Your Cake and Eat It Too?, 44 NEW ENG. L. REV. 25, 47 (2009) (noting that if assets in an irrevocable trust are subject to the claims of the settlor's creditors, then the transfer will be considered an incomplete gift).
“possibility of the free-rider problem,”¹⁹⁵ maybe agency cost theory should give greater weight to the implications of these observations in analyzing the liberalization of trusts to benefit beneficiaries.

In addition, granting this power might harm settlors. Unsophisticated settlors may not know to opt out of a default settlor standing rule or not understand the implications when they opt into the rule (if it is allowable, but not the default). If settlors create inter vivos irrevocable trusts for tax benefits and asset protection advantages, there is no reason to muddy the waters with granting the settlor a right to enforce trusts. Thus, even though settlor standing may in fact reduce agency costs, it is not a particularly practicable solution.

3. Settlors vs. Beneficiaries

Agency cost theory of trust law could render unstable the normative foundation of donative freedom out of which trust law naturally grows. When conflict between the settlor’s interests and the beneficiaries’ interests inevitably arise, resolving this conflict will require making objective measures of very different subjective experiences and goals. But where interests are difficult to quantify, interpersonal preferences remain incommensurable.

Despite the rhetoric to the contrary, the indiscriminate application of the agency cost theory would predictably emphasize the concerns of the living beneficiaries (or, the market) over that of the settlor (who might be long dead). Such an approach would turn trust law upside down and give beneficiaries a primary status that trust law never intended to afford. While in one breath academics and rule makers pay lip service to the idea of donative freedom, they tend, in the same breath, to construe the “settlor’s intent” in a such a vague and meaningless way so as to render the principle of donative freedom impotent. By imposing on the actors within the trust regime an ill-fitting agency relationship simply to facilitate economic analysis, the fundamental principles of donative freedom gets cast to the periphery of relevance. Analyzing some of the suggested agency cost reducing measures will demonstrate the potential of undermining settlor’s intent.

a. Modification and Termination

A useful example of the potential for divergent interests between the settlor and the beneficiaries involves the possibility of the

¹⁹⁵ Sitkoff, Agency Costs, supra note 6, at 668 (emphasis added).
beneficiaries seeking premature termination of the trust. This problem includes the issue of whether the beneficiaries can obtain judicial modification of the trust’s terms, because the power to terminate subsumes the power to modify.196 The American rule, which originated with *Claflin v. Claflin*,197 is unfriendly to modification and termination.198 Under the *Claflin* doctrine, a trust may be terminated prematurely only with the settlor’s consent or, in the absence of the settlor’s consent, if termination would not frustrate a “material purpose” of the trust.199 Settlor’s consent, however, is by definition unavailable when dealing with testamentary trusts, and courts have had little difficulty finding a “material purpose” that would be offended by a modification or termination.200 Thus, as a practical matter, unless the trustee consents,201 American trusts are difficult to amend or terminate once established.202 Even if all the competent beneficiaries and the trustee were inclined to strike a deal, the frequency of unidentified or minor beneficiaries reduces the viability of this alternative.

The upshot of the *Claflin* doctrine is that it helps align the interests of the settlor and the trustee. The rule allows the trustee to preserve the settlor’s original design, regardless of the beneficiaries’ wishes, which is what the settlor likely would have wanted. The settlor, after all, chose a trust rather than an outright transfer or another organizational form.203 Thus, the *Claflin* doctrine is consistent with the model of the settlor as the primary principal.

In arguing against the rule, Professor Sitkoff’s concern is that the fundamental decision whether or not to continue the trust is not in the hands of those that bear the marginal costs and benefits of that

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196 Cf. 2 SCOTT ON TRUSTS, supra note 15, § 107.3. Note, however, that the relevant considerations for modification versus termination are not entirely the same. See RESTATEMENT (THIRD) OF TRUSTS § 65 cmt. f (2003). In practice, termination usually pits the current against the remainder beneficiaries, whereas modification usually touches only the settlor/beneficiary tension.

197 20 N.E. 454 (Mass. 1889); see RESTATEMENT (THIRD) OF TRUSTS § 65 cmt. a (2003).

198 See DUKEMINIER ET AL., supra note 5, at 1328 (noting under *Claflin*, “termination or modification by a court[ ] is only grudgingly available”).

199 See RESTATEMENT (THIRD) OF TRUSTS § 65 & cmt. a (2003); RESTATEMENT (SECOND) OF TRUSTS § 337 (1959); 4 SCOTT ON TRUSTS, supra note 15, §§ 337-340.2.

200 See generally 4 SCOTT ON TRUSTS, supra note 15, §§ 337.1-337.8 (collecting and describing cases). For a specific example, see *In re Estate of Brown*, 528 A.2d 752, 755 (Vt. 1987) (“We believe that the settlor’s intention to assure a life-long income to [the beneficiaries] would be defeated if termination of the trust were allowed.”).

201 See RESTATEMENT (SECOND) OF TRUSTS § 342 (1959); ROGER W. ANDERSEN, UNDERSTANDING TRUSTS AND ESTATES 110-11 (3d ed. 2003); 4 SCOTT ON TRUSTS, supra note 15, § 342.


203 Cf. Langbein, Contractarian Basis, supra note 22, at 632 (“The donor who structures a gift in this way expects compensating advantages.”).
decision—the beneficiaries.\textsuperscript{204} Professor Sitkoff, therefore, sees merit in the liberalization of the \textit{Claflin} doctrine\textsuperscript{205} and points to the \textit{Pulitzer} case\textsuperscript{206} for authority. In \textit{Pulitzer}, the court showed a willingness to authorize deviation from the settlor's specific administrative instructions by construing that the settlor had a broader aim of benefiting the beneficiaries than the limitations of the administrative instructions allowed.\textsuperscript{207} With law and economics and agency costs in mind, the \textit{Uniform Trust Code} and the \textit{Restatement (Third) of Trusts} extend the \textit{Pulitzer} deviation doctrine to the idea that courts should permit modification of even the \textit{dispositive} instructions of the trust instrument in light of circumstances not anticipated by the settlor.\textsuperscript{208} Although this change has been paid limited attention, this is a dramatic deviation from American trust law.

Because the application of agency cost theory necessarily assumes that the main purpose of creating a trust is to maximize the wealth of the beneficiaries, corrosion of the settlor's intent may occur. Under an agency cost theory, the living beneficiaries could easily demonstrate a reason to deviate from the trust instructions in order to maximize their wealth. In fact, because the trustee is deemed an agent of the beneficiaries under agency cost theory, the trustee is incentivized to cooperate. Even further, the trustee is enticed to collude with the beneficiaries in these cases for fear of being sued, or under the potential threat of being removed, which is discussed in the following subpart.

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\textbf{b. Trustee Removal}
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The question of on what grounds beneficiaries may obtain the removal of a trustee is another example of the potential for tension between the interests of the settlor and those of the beneficiaries. An important consideration for settlors when choosing a trustee is the

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\textsuperscript{204} See Sitkoff, \textit{Agency Costs}, \textit{supra} note 6, at 660.
\textsuperscript{205} \textit{Id.}
\textsuperscript{208} See \textit{UNIF. TRUST CODE} \textsection 412 (2003); \textit{RESTATEMENT (THIRD) OF TRUSTS} \textsection 66 \& cmt. a (2003); Edward C. Halbach, Jr., \textit{Uniform Acts, Restatements, and Trends in American Trust Law at Century's End}, 88 \textit{CALIF. L. REV.} 1877, 1900-01 (2000); \textit{cf.} N.Y. \textit{EST. POWERS \\& TRUSTS LAW} \textsection 7-1.6(b) (McKinney 2002); Paul G. Haskell, \textit{Justifying the Principle of Distributive Deviation in the Law of Trusts}, 18 \textit{HASTINGS L.J.} 267, 294 (1967) (arguing in favor of flexibility to modify dispositive trust terms that would cause hardship without modification); Peter J. Wiedenbeck, \textit{Missouri's Repeal of the Claflin Doctrine—New View of the Policy Against Perpetuities?}, 50 \textit{MO. L. REV.} 805 (1985) (analyzing recent statutory reforms).
trustee’s expected fidelity to the wishes of the settlor in the future exercise of discretion.

Because Professor Sitkoff views beneficiaries as residual claimants, they bear the marginal costs and benefits of the trustee’s decisions. Hence, the beneficiaries have an incentive to monitor the trustee’s performance and, under standard trust doctrine, only the beneficiaries have standing to bring an action against the trustee for breach of trust. Professor Sitkoff opines that the goal, therefore, should be to minimize beneficiary agency costs, subject to the ex ante constraints imposed by the settlor.

The law’s default approach authorizes courts to remove trustees who are dishonest or who have engaged in a “serious breach of trust,” but it does not necessarily permit removal for breaches that are not “serious” or for simple disagreements. Trustees who were chosen by the settlor, as compared to those named by a third party or a court, are even less readily removed; there is something of a thumb on the scale for them. Further, if the settlor was aware of an asserted ground for removal at the time of naming the trustee, that ground will not serve as a basis for the later removal of the trustee unless the trustee is entirely unfit to serve.

Professor Sitkoff posits that these default rules appear to reflect the bargain to which the settlor and trustee would have agreed when trusts were used predominately for the preservation of family land and when the typical trustee was an amateur rather than a fee-paid professional. Thus the traditionally high threshold for trustee removal served the interests of the settlor while imposing a tolerable level of agency costs on the beneficiaries. In contrast, agency cost theory notes that modern prudent investor standards now allow for greater discretion in portfolio

209 See Sitkoff, Agency Costs, supra note 6, at 663.
210 See, e.g., Restatement (Second) of Trusts § 107 cmts. b-c (1959); Restatement (Third) of Trusts § 37 cmt. e(1) (2003); 2 Scott on Trusts, supra note 15, § 107.
211 See, e.g., Restatement (Second) of Trusts § 107 cmt. f (1959); Restatement (Third) of Trusts § 37 cmt. f (2003); 2 Scott on Trusts, supra note 15, § 107.1, at 117-18; cf. David M. English, The Uniform Trust Code: Significant Provisions and Policy Issues, 67 Mo. L. Rev. 143, 197-99 (2002) (discussing removal under the UTC in situations “where the personal link between the settlor and trustee has been broken”).
212 See, e.g., Restatement (Second) of Trusts § 107 cmt. g (1959); Restatement (Third) of Trusts § 37 cmt. f (2003); 2 Scott on Trusts, supra note 15, § 107.1.
213 See Sitkoff, Agency Costs, supra note 6, at 664 (“When the trustee’s mission was simply to hold ancestral land, there were fewer opportunities for conflict between beneficiaries and trustees (where the agent’s tasks are fewer and are readily observable, shirking is less of a problem).”); see, e.g., Gregory S. Alexander, A Cognitive Theory of Fiduciary Relationships, 85 Cornell L. Rev. 767, 775 (2000) (“Today, the vast majority of trusts are administered by large financial institutions, such as trust companies and trust developments of commercial banks.”); Langbein, Contractarian Basis, supra note 22, at 632-33, 637-39 (“Private trustees still abound, but the prototypical modern trustee is the fee-paid professional, whose business is to enter into and carry out trust agreements.”); Peering into Trust Industry Archives, 115 TR. & Est. 452, 504 (1976) (describing such changes within the trust profession).
management and the overarching aim of trusts has shifted to maximization of total return.\footnote{214} Professor Sitkoff looks to the apparent shift toward the use of professional trustees, which suggests a weakened personal link between the settlor and the trustee. With these changes, fiduciary law has replaced limited trustee powers as the beneficiaries' chief protective device.\footnote{215} Although modern trustees can delegate to specialists,\footnote{216} the trustee remains ultimately responsible for the exercise of the broader discretion afforded by modern law. Professor Sitkoff advocates that this evolution means not only that the potential for managerial agency costs has increased, but the importance of removal as a check on these costs has likewise increased. Therefore, Professor Sitkoff believes beneficiaries should have greater rights to remove the trustees.\footnote{217} In fact, this standard has recently found its way into the new Uniform Trust Code and Restatement (Third) of Trusts.\footnote{218}

To support this significant change to American trust law, agency cost first looks to anecdotal evidence that may suggest modern settlors regularly contract out of the default removal rules in favor of easier substitution of trustees and then claims this is analogous to the robust econometric evidence regarding the negative impact on shareholder welfare of corporate takeover defenses such as classified boards.\footnote{219} From an agency cost theory perspective, Professor Sitkoff states that “[p]utting aside concern about the effect of deterring the settling of trusts in the first place, this analogy lends support to the view that reducing the threshold for the removal of trustees should improve beneficiary welfare.”\footnote{220} Note that the focus is on the beneficiaries' welfare, not the intent of the settlor.

By granting beneficiaries more control over the removal of the trustees, the beneficiaries have more control over the trustee generally. In effect, it could encourage the trustee and the beneficiaries to enter into side bargains to avoid any restraints the settlor might have imposed in the trust agreement. For example, the beneficiaries might threaten to

\footnote{214} For a discussion arguing the total return investing actually creates agency costs, see Sterk, supra note 6.
\footnote{215} See Langbein, Contractarian Basis, supra note 22, at 640-43; see also Alexander, supra note 213, at 775 (arguing that the rise of institutional trustees required “trust-inducing mechanisms” such as fiduciary law); Gareth H. Jones, The Dead Hand and the Law of Trusts, in DEATH, TAXES AND FAMILY PROPERTY 187 (Edward C. Halbach, Jr. ed., 1977) (noting the historically limited powers of trustees).
\footnote{216} Professor Sitkoff argues that modern trustees “should delegate” to specialists to reduce agency costs. Sitkoff, Agency Costs, supra note 6, at 665. However, for a discussion that views this delegation as potentially increasing agency costs, see Sterk, supra note 6.
\footnote{217} Sitkoff, Agency Costs, supra note 6, at 665.
\footnote{218} See UNIF. TRUST CODE § 706 (2003); RESTATEMENT (THIRD) OF TRUSTS § 37 & cmt. c (2003).
\footnote{219} Sitkoff, Agency Costs, supra note 6, at 665.
\footnote{220} Id. (emphasis added).
remove the trustee unless the trustee distributed the trust corpus. There would be no check protecting settlor’s intent.

c. Disabling Clauses (Spendthrift Provisions and Other Conditions)

The spendthrift trust\(^{221}\) is a device whereby settlors shield their gratuitous transfers to trusts from immediate consumption by the beneficiaries. With this disabling clause, the settlor provides a benefit that is legally inalienable. Though the trust might generate a steady stream of income, the beneficiary is powerless to accelerate her interest by selling it for a lump sum; and creditors cannot satisfy their claims by levying execution against the corpus.\(^{222}\)

Spendthrift trusts have become a major aspect of estate planning. In fact, it might be considered bordering on malpractice if an estate lawyer drafted a trust agreement without a spendthrift disabling clause.

Neoclassical agency cost theory would contend that these restraints on alienability hamper the efficient reallocation of property that would be allowed when property flows into the hands of its most productive uses—those who are willing to pay the most for it. In addition, a neoclassical economist would note that beneficiaries enjoy the greatest welfare when they decide for themselves how much to consume and how much to save, in that an individual knows better than others what will make her happy and always will act to advance her own self-interest.\(^{223}\) Under an agency cost theory, one would have to measure the utility gained by the settlor from imposing a disabling restraint against the utility of the beneficiaries from bearing the cost of the restraint (as deemed residual claimants). Because under agency cost theory, beneficiaries will have the right to petition for a modification of the trust terms,\(^{224}\) beneficiaries could argue that they possess full

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\(^{224}\) See *supra* Part II.D.3.a.
competency, are financially sophisticated, and no longer needs this type of intrusive paternalism.225

Restraints on alienation and any other restraint could be deemed "capricious" depending upon how agency cost theory interprets the "benefit of the beneficiary rule."226 For instance, under the rubric of the benefit of the beneficiary rule, restraints based on faith could be voided—such as a condition that a beneficiary marries within a certain faith, like Mr. Feinberg in this Article's opening example. Maybe the preservation of the property owner's faith is more important than the beneficiary receiving any income. However, an agency cost analysis assumes that the primary purpose of the trust creation is to maximize the wealth of the beneficiaries, in connection with the benefit of the beneficiary rule, any trust agreement provision seems negotiable.

4. Litigation

The main agency cost reducing mechanism that Professor Sitkoff articulates is to increase trustee liability. Simply, the threat of litigation is the sole check on agency costs because market-based governance devices are of limited use due to the beneficiaries' restrictions on alienation and the difficulty in removing a trustee. Of course, the threat of litigation is somewhat empty without actual litigation, which inherently increases agency cost.

For example, liberalizing and increasing the number of litigation tools that a beneficiary may utilize may encourage beneficiaries to "shark," similar to corporate law sharking by principals. What is to prevent this? Professor Sitkoff posits, ipsa dixit, that fiduciary litigation in trust law is more likely to be prompted by the merits than in corporate law.227 First, there is no basis for this assumption. Second, the emotions involved with family succession of property issues and a fuller understanding of the cognitive motives of actors228 would tend to suggest the opposite result.

Potential trust litigation will be affected by the way in which the parties are inclined to either avoid risks or embrace risks, depending on

225 A number of commentators have proposed such a position. RONALD CHESTER, INHERITANCE, WEALTH, AND SOCIETY 125, 139-40 (1982); Willard M. Bushman, The (In)validity of Spendthrift Trusts, 47 OR. L. REV. 304, 313-15 (1968); Richard E. Manning, The Development of Restraints on Alienation Since Gray, 48 HARV. L. REV. 373, 405-06 (1935) (noting that it would be against public policy "to enforce the capricious whims of an owner of property").

226 This is a rule mandating that the trust and its terms must be for the benefit of the beneficiaries. It basically reworks an older doctrine, the rule against capricious purposes. See Langbein, Mandatory Rules, supra note 6, at 1107.

227 Sitkoff, Agency Costs, supra note 6, at 679.

228 See the Mental Accounting and Endowment Effect discussions, supra Parts II.B.7, II.D.1.
how the decision is framed in the individual’s mind. One of the best illustrations that human decision-making is based on more than a simple objective weighing of pros and cons is demonstrated by the concept of framing or prospect theory.\footnote{Daniel Kahneman & Amos Tversky, \textit{The Framing of Decisions and the Psychology of Choice}, 211 Sci. 453 (1981).} Psychologists and social scientists have gone to great lengths to show that when humans face a decision, the outcome is controlled by how the question is framed.\footnote{*Id. at 453 ("A decision problem is defined by the acts or options among which one must choose, the possible outcomes or consequences of these acts, and the contingencies or conditional probabilities that relate outcomes to acts.").} "Choices involving gains are often risk averse and choices involving losses are often risk taking."\footnote{Id.} Therefore, a question that needs to be answered is whether any change in trust rules would make trustees or beneficiaries view litigation costs and proceeds as gains or as losses. This would seem to directly affect how they approach possible litigation.

In addition, the confirmatory bias is likely to affect lawsuits over trusts. This bias occurs when individuals “interpret information in ways that serve their interests or preconceived notions.”\footnote{Id.} It is also referred to as the self-serving bias.\footnote{Korobkin & Ulen, supra note 29, at 1093.} For example, once a beneficiary has decided that a trustee is not performing his duties or that the settlor’s trust scheme is unlawful or unjust, any additional information that is provided to that beneficiary will be molded and warped to bolster the conclusion he has already reached. This, in turn, will make settlements harder. This bias shows that, contrary to the tenets of law and economics, more information does not always correspond with more efficiency. If a beneficiary is already unhappy with the terms of a trust or the performance of a trustee and feels somewhat lawsuit happy, any additional information provided to the beneficiary will not likely assuage his fears, but rather encourage litigation. More information is not necessarily the efficiency advancing silver bullet that it is made out to be.

Increasing trustee liability may increase the number of lawsuits. Whether these actions have merit or not, trustee agency costs will rise and trustees will have to compensate for the increased cost somehow. Suffice it to note, increasing trustee liability as the main check on agency cost, to some degree, seems less than an optimal solution.
5. Coasean Corollaries: The Settlor's Dilemma

Agency cost theory potentially pits beneficiaries and trustees against the settlor, by creating a pseudo-prisoner's dilemma. The classic formulation of the prisoner's dilemma is as follows: Prisoner A and Prisoner B have been arrested by the police and are being separately interrogated. The police have insufficient evidence for a full conviction and thus, offer deals to the prisoner's to confess against each other. If A testifies against B while B remains silent, A is given a sentence of six months while B is given a sentence of ten years and vice versa. If neither A nor B testifies, both will be charged (and, for the sake of the game, convicted) of a more minor crime with a sentence of one year. However, if both A and B testify against each other they will each be given a sentence of five years. The situation is often illustrated by a chart such as the following:

<table>
<thead>
<tr>
<th>Prisoner B</th>
<th>Remain Silent</th>
<th>Testify (Betray)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prisoner A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Remain Silent</td>
<td>(1, 1)</td>
<td>(10, .5)</td>
</tr>
<tr>
<td>Testify (Betray)</td>
<td>(.5, 10)</td>
<td>(5, 5)</td>
</tr>
</tbody>
</table>

The dilemma creates a paradigm in which the most effective strategy for either A or B is to testify against the other although the best overall option is for them to cooperate. Game theorists call the testify-testify option the "dominant strategy" because it produces the best average results for each prisoner regardless of the opposite prisoner's actions.

This point can be illustrated numerically by looking at the problem from the perspective of each prisoner. If A remains silent he will receive either 1 year in jail or 10 years in jail for an average of 5.5 years in jail. If, on the other hand, A testifies against B, he will receive either .5 years in jail or 5 years in jail, for an average of 2.75 years in jail. The same would hold true for B. The game becomes different when human interactions are introduced but that misses the point. The game is one

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234 The prisoner's dilemma problem was first introduced as a part of game theory by Merrill Flood and Melvin Dresher.

235 For example, prisoner A and B could be fiercely loyal to each other and refuse, on a sense of duty alone, to testify against each other.
in which each prisoner must act *ex ante* and without knowledge of the other’s actions.

Professor Sitkoff’s application of agency cost analysis to trust law creates a similar, though not identical, situation. This pseudo-prisoner’s dilemma perversely pits Beneficiary and Trustee (B&T) against Settlor (S). For instance, under Professor Sitkoff’s regime, Beneficiaries would have the ability to seek an “equitable deviation” from trust terms despite dispositive instructions, thus giving Beneficiaries an incentive to challenge the trust in order to obtain greater control over or a greater amount of the trust property. Further, the more liberal trustee removal standards suggested by Professor Sitkoff could encourage Beneficiary arm-twisting of Trustees by threat of removal. These changes would create a perverse incentive scheme whereby the trustee and beneficiary are effectively encouraged to collude against the trust and betray the settlor’s intent. Faced with this scenario, a settlor acting *ex ante* will be strongly incentivized to choose an alternative to trust form that will more predictably effectuate his intent, even at a higher cost. The following chart illustrates the dilemma graphically:

<table>
<thead>
<tr>
<th>Beneficiary and Trustee</th>
<th>Follow Intent</th>
<th>Not Follow Intent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trust Form</td>
<td>(0, 2)</td>
<td>(10, 1)</td>
</tr>
<tr>
<td>Alternative Form</td>
<td>(1, 10)</td>
<td>(5, 5)</td>
</tr>
</tbody>
</table>

The first two scenarios are those in which a settlor, notwithstanding the new risks introduced by Professor Sitkoff’s agency cost regime, chooses the trust form. This choice presents the binary choice to beneficiaries and trustees: honor the settlor’s intent, or betray his wishes. In the first scenario the cost to settlor, in terms of “psychic currency” is essentially zero because, using the predictable form of

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236 Sitkoff, *Agency Costs*, supra note 6, at 660 (citing to the Pulitzer case and noting his assumption that “settlers of today’s managerial trusts ultimately want to maximize the welfare of the beneficiaries”).

237 Sitkoff, *Agency Costs*, supra note 6, at 665-66 (arguing in favor of “the somewhat more liberal removal standards stated in the Uniform Trust Code and Restatement (Third) of Trusts”).

238 See Harrison, *supra* note 29, at 1318-19 (describing psychic income as a “filler,” but noting that it supplies “a fictionalized compensation for any seemingly altruistic transfer”). We will utilize the concept of psychic income here to illustrate the broader notion that a settlor has some motivation to bequeath, regardless of the nature or source of that motivation. For more on a testator or settlor’s motivation, see Tritt, *supra* note 190.
trust, he is able to bequeath his property essentially as he sees fit and, as a postulate of the scenario, the bequest will be honored by trustee and beneficiary alike. The cost to the beneficiary and trustee,\textsuperscript{239} measured in actual currency,\textsuperscript{240} arises from the beneficiary’s lack control over the trust property and the trustee’s substantially greater liability and risk of removal.\textsuperscript{241} The second scenario imposes the maximum cost upon the settlor because his intent is ignored and the minimum cost on the beneficiary because it would result in actual or effective control over the property; the trustee would likely incur a cost by forfeiting the future business of settlors who value enforcement of trust terms.

The third and fourth scenarios are those in which a settlor, because of the new risks, has chosen to opt out of the familiar realm of trust law in favor of an alternative method which provides a greater likelihood that the settlor’s intent will be effectuated.\textsuperscript{242} Here, the beneficiary is presented with the same binary choice as above, but the trustee—lacking a trust to oversee—is no longer an actor. In the third scenario, the settlor incurs the expense of creating an alternative to trusts and the beneficiary chooses to follow that intent. The cost to the settlor\textsuperscript{243} is derived from the inherent uncertainty of the new alternative; regardless of what method is developed, it will be less predictably intent effectuating than the well developed area of pre-agency costs trust law.\textsuperscript{244} Both the beneficiary and trustee suffer costs here; the trustee because there is no trust to oversee and the beneficiary because the creation of a trust alternative would presumably be significantly less efficient than current trust law thus draining the trust property. In the fourth scenario the settlor incurs the same cost as above but incurs the additional psychic costs resulting from the probability of success of the

\textsuperscript{239} Like all other values in this example, it is set arbitrarily, though somewhat relativistically for purposes of demonstration.

\textsuperscript{240} Though the term is meant literally, it is also meant to encompass a broader concept including the value of actual control over a sum of money as compared to passive income.

\textsuperscript{241} See Sitkoff, Agency Costs, supra note 6, at 665 (supporting more liberal trustee removal standards); id. at 666-71 (supporting unqualified settlor and trust protector standing to sue trustee).

\textsuperscript{242} The exact method is not postulated here, nor need it be. It is enough to presume, as Sitkoff does, that some solution could be had by combining elements of contract law, property law, and organizational law. Id. at 632-33. Unfortunately this “blending,” as all changes in the law, implicates costs in its creation and in the uncertainty of its enforcement. Additionally, it is probably safe to assume that at least some settlors would opt out of legal methods altogether, thus imposing a cost on society generally.

\textsuperscript{243} Note that the cost to the settlor is still psychic; even though the settlor will be forced to expend additional funds in order to find or create an alternative method to bequeath his property, those costs will be passed to his beneficiaries, not to him. This is somewhat similar to the idea that increasing a tax on a corporation only taxes that corporation’s customers since the extra cost is simply passed on to them.

\textsuperscript{244} See, e.g., Sitkoff, Agency Costs, supra note 6, at 628-31 (discussing the valuable “proprietary functions” of trust as compared to the available alternatives in property and contract law).
beneficiary’s challenge. Here the trustee’s cost remain the same but the beneficiary’s cost is somewhat lowered given the probability of success of his challenge.

The incentive for the beneficiary and trustee to betray the settlor’s intent is clear in that the only cost of not following the settlor’s intent falls on the trustee in the form of potential lost clientele. The average cost to the settlor of creating a trust, though, would be double that of choosing the more predictably intent effectuating alternative. Such a choice is truly no choice at all.

Accordingly, an agency cost model of trusts may lead to a reduction in the use of trusts. The prisoner’s dilemma is, if not directly applicable to trust law, at least useful in that it demonstrates the predicament faced by the settlor and illustrates the incentive for the beneficiary and trustee to betray the settlor.

III. A Return to First Principles

At the conclusion of an agency cost analysis of trust law, we are left with little more than conjecture regarding the normative direction of trust law under an agency cost theory framework. In light of the difficulties presented by an agency cost theory of trust, this Article urges a return to first principles that focuses on the processes for achieving the settlor’s goals and methodologies for fostering a healthy level of trust in the trustee’s stewardship of trust property.

For centuries, trust law existed as a vehicle for transferring wealth coupled with some preference regarding the conditions for distribution. Embedded within this notion of private property and the orderly transfer thereof is the principle that individuals have the freedom (or right) to control the disposition of their property during life and at death. American society has long recognized the value inherent in protecting

245 The average cost of a trust form being 5.5 and the non-trust alternative being 2.75.
246 Rationales for donative freedom vary, and many theories have been proffered in support for the principle of this theory—some widely accepted, others controversial. See, e.g., Adam J. Hirsch & William K.S. Wang, A Qualitative Theory of the Dead Hand, 68 IND. L.J. 1, 5-18 (1992) (discussing various arguments for testamentary freedom). The most fundamental rationale for donative freedom is that, in a society based on the theory of private property, honoring donative freedom might be the least objectionable arrangement for dealing with property succession. Id. Others argue that robust donative is natural, creates happiness, promotes wealth accumulation, encourages industry, creativity and productivity, reinforces family ties, promotes responsibility, and allows the property owner to adapt to the needs and circumstances of his particular family. See Tritt, supra note 190, at 117-30. Each rationale has its proponents and skeptics, but the very breadth of jurisprudential and pragmatic justifications for donative freedom is, in itself, a testament to why this concept is at the core of American succession law.
an individual’s ability to acquire and transfer private property.\textsuperscript{247} Donative freedom is derived from this well-established property law right and is accordingly the governing principle underlying American succession law.\textsuperscript{248} Just as individuals have the right to accumulate, consume, and transfer personal property during life, individuals generally are, and should be, free to control the disposition of personal property at death.\textsuperscript{249} Thus, donative freedom can be viewed simply as one stick in the bundle of rights referred to as property rights.\textsuperscript{250}

In addition, although the United States Constitution does not speak specifically about donative freedom as a property right, a robust public policy favoring donative freedom has been fostered in America. For example, states’ probate codes have placed very limited restrictions on the testator’s ability to transfer property (mainly, a surviving spouse’s elective share);\textsuperscript{251} Article III, Section 3 of the United States Constitution prohibits corruption of blood; the vast majority of the states have abolished the Rule in Shelley’s Case;\textsuperscript{252} and there is a growing trend in the United States of abolishing the Rule Against Perpetuities.\textsuperscript{253} These examples tend to demonstrate a strong public policy of favoring donative freedom.

While the practice of estate and trust law undoubtedly will become even more sophisticated, the complexity of the question posed does not require ignoring relatively simple solutions. Ultimately, trusts would be viewed as a means to fulfill donative freedom. Rather than using economic principles to change the basic normative principles supporting the legal regime governing trusts, scholars and legislators should advocate developments in trust law with an eye to making more secure the foundations upon which the legal regime rests. As is the case in other facets of the law of trusts and estates which are undergoing potential normative makeovers,\textsuperscript{254} a return to first principles that focuses on the processes for achieving the settlor’s goals should be encouraged.


\textsuperscript{248} See supra note 245.

\textsuperscript{249} Testamentary freedom extends the concept of absolute property ownership beyond the grave. See Joshua C. Tate,\textit{ Caregiving and the Case for Testamentary Freedom}, 42 U.C. DAVIS L. REV. 129, 148 (2008).

\textsuperscript{250} Hodel v. Irving, 481 U.S. 704 (1987) (stating that the right to transmit wealth at death is a separate, identifiable stick in the bundle of rights called property).

\textsuperscript{251} See, e.g., Tritt, supra note 190, at 132.

\textsuperscript{252} See, e.g., DUKEMINIER ET AL., supra note 5, at 876.

\textsuperscript{253} See id. at 905-09.

\textsuperscript{254} See, e.g., Cooper, supra note 16; Adam J. Hirsch,\textit{ Default Rules in Inheritance Law: A Problem in Search of Its Context}, 73 FORDHAM L. REV. 1031 (2004); Tritt, supra note 141.
CONCLUSION

The recent insurgence of law and economics theory into the realm of trust law jurisprudence via the analytical lens of agency cost theory seems to have captivated the hearts and minds of trust scholars, progressively becoming the fulcrum upon which to focus debate. The application of an agency cost theory to trust law, however, reduces the complex, idiosyncratic, and emotionally charged nature of trust law into a simple business relationship. Given the special nature of trust law and practice—where interests remain difficult to quantify, interpersonal preferences remain incommensurable and normative principles trump other preferences—slavish attention to economic analysis resembles the youthful mistake of forcing square pegs into round holes.

An agency cost theory of trusts produces not only a positively inaccurate account of modern trusts but a normatively incoherent philosophy to guide the evolution of trust law. Because the underlying assumptions of agency cost theory cannot be verified and because agency cost theory causes distortions of trust law theory and practice, utilizing agency cost analysis would provide inaccurate if not incoherent answers to open trust law questions.

Therefore, trust law analysis should return to the progenitor of trust principles: effectuating the intent of the property owner and fostering a healthy level of trust in the trustee’s stewardship of trust property. Settlor’s intent is, and should continue to be, the “polestar’ which guide[s] all aspects of trust administration.”255 While the policy of effectuating settlor’s intent is grounded in a wealth of theoretical and jurisprudential literature, it also has the added benefit of being the most practical policy in this case. Rather than using economic concepts to change the basic normative principles supporting the legal regime governing trusts, scholars and legislators should advocate developments in trust law with an eye to making more secure the foundations upon which the legal regime rests. Legal trends ebb and flow like the tides but, in trust law at least, there remains one constant: the intent of the settlor must be effectuated.

255 See In Re Sherman Trust, 179 N.W. 109, 112 (Iowa 1920) (citing Wilberding v. Miller, 106 N.E. 665, 667 (Ohio 1913)).