SELF-DEALING RULES IN THE LAW OF PRIVATE EXPRESS TRUSTS: A SUGGESTION FOR IMPLEMENTATION OF PROFESSOR EDWARDS'S SUGGESTION

Amy Morris Hess[*]

INTRODUCTION

In his paper "*The Fate of State Investor Protection*," Professor Benjamin P. Edwards advocated for state legislatures to enact laws governing financial advisors that would prohibit them from selling customers investment products from which they would receive the largest commissions but that would not be the best investments to implement the customers' goals. By and large, I agree with Prof. Edwards's suggestion. Rather than criticize it, therefore, my remarks this morning will show that states already have a body of law to draw from in enacting such legislation: the law that prescribes the extent to which trustees of private express trusts[1] are permitted to benefit from transactions involving trust assets and trust beneficiaries. In addition, I will demonstrate that these trust rules are not as draconian as many believe and that, as they are currently interpreted, would serve both individual investors and their investment advisors well as a model of best practices for investment advisors. First, I will outline the history of the rules that govern private trustees in their dealings with trust assets and trust beneficiaries. Then I will discuss a recent trust case applying these rules in a situation in which a trustee reaped a benefit from the administration of a trust. Finally, I will show how these rules might be

---

[*] The University of Tennessee Distinguished Service Professor Emerita, Waller, Lansden, Dortch & Davis and Williford Gragg Distinguished Professor of Law, The University of Tennessee College of Law, Knoxville, Tennessee; B.A. Barnard College, J.D. University of Virginia School of Law. The author would like to thank Kathryn V. Haaquist of the University of Tennessee College of Law class of 2020 for her excellent research assistance. Any errors are solely my own.

[1] A "private express trust" is a trust created by one or more individuals to benefit individuals rather than charity. *See* GEORGE G. BOGERT, GEORGE T. BOGERT, & AMY MORRIS HESS, THE LAW OF TRUSTS AND TRUSTEES § 1, text accompanying notes 34–45 (3d ed. 2005). In this paper, I will refer to trustees of a private express trust as "private trustees" to distinguish them from other types of fiduciaries, including trustees of charitable trusts and corporate officers and directors.

applied to dealings of financial advisors dealing with their customers' accounts. Because of the time and page-length constraints that we agreed to in advance of this symposium, my comments will summarize, rather than explain in detail, the development of the law.[2]

I. HISTORICAL DEVELOPMENT OF TRUSTEE'S DUTY OF LOYALTY

The duty of a trustee to administer a trust solely for the benefit of the beneficiaries and not to derive any personal benefit from transactions involving trust assets or trust beneficiaries traditionally is called the "duty of loyalty,"[3] and is sometimes referred to as the "duty against self-dealing."[4] Traditionally, it has been one of the mostly strictly-construed duties in the law of trusts. As then Judge (later Justice) Benjamin Cardozo said in the famous case of *Meinhard v. Salmon*, "[a] trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate."[5]

With respect to dealings between trustees and trust beneficiaries or dealings in which trustees benefit from trust property, this eloquent but rather opaque statement of the rule has been interpreted to mean:

> (1) Except as otherwise provided in the terms of the trust, a trustee has a duty to administer the trust solely in the interest of the beneficiaries, or solely in furtherance of its charitable purpose.
>
> (2) Except in discrete circumstances, the trustee is strictly prohibited from engaging in transactions that involve self-dealing or that otherwise involve or create a conflict between the trustee's fiduciary duties and personal interests
>
> (3) Whether acting in a fiduciary or personal capacity, a trustee has a duty in dealing with a beneficiary to deal fairly and to

---

[2] Responders agreed to keep their remarks to five minutes during the presentation and to five written pages for publication.

[3] *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS § 78 (2007).

[4] *See, e.g.*, GEORGE G. BOGERT, GEORGE T. BOGERT, SUSAN N. GARY, & AMY MORRIS HESS, THE LAW OF TRUSTS AND TRUSTEES § 543, text accompanying note 5 (3d ed. 2019).

[5] Meinhard v. Salmon, 249 N.Y. 458, 464 (1928).

> communicate to the beneficiary all material facts the trustee knows or should know in connection with the matter.[6]

Interestingly, and perhaps somewhat counter-intuitively, all of the traditional statements of this rule seem to assume that a transaction cannot be fair to the beneficiaries and also benefit the trustee.[7] Indeed, a corollary to the duty of loyalty is the "no-further-inquiry" rule. This rule states that once a beneficiary has proven that a trustee benefited financially from a transaction involving the trust, the transaction is either entirely void or voidable at the option of the beneficiary, without any proof that the trust was harmed by the transaction.[8]

In the United States today, however, private express trusts are governed largely by statute rather than by case law. Two uniform acts contain provisions dealing with a trustee's duty of loyalty: the Uniform Prudent Investor Act ("UPIA"), which the Uniform Law Commission ("ULC") promulgated in 1994,[9] and has now been enacted in virtually all fifty states and the District of Columbia,[10] and the Uniform Trust Code

---

[6] RESTATEMENT (THIRD) OF TRUSTS § 78 (AM. LAW INST. 2007). A similar statement of the rule appeared in RESTATEMENT (SECOND) OF TRUSTS § 170 (AM. LAW INST. 1959).

[7] *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS § 78, Reptr's Notes to cmts a. & b. (AM. LAW INST. 2007).

[8] *See* RESTATEMENT (THIRD) OF TRUSTS § 78, cmt. d. (Am. Law Inst. 2007).

[9] UNIFORM PRUDENT INVESTOR ACT (UNIF. LAW COMM'N 1994) (available at https://www.uniformlaws.org/committees/community-home/librarydocuments/viewdocument?DocumentKey=6d0f762f-5934-4bf2-b8e4-960c53087674).

[10] As of October 1, 2019, the enactments of the UPIA were codified as follows: ALA. CODE §§ 19-3B-901 to 19-3B-906; ALASKA §§ 13.36.225 to 13.36.290; ARIZ. REV. STAT. ANN. §§ 14-10901 to 14-10909; ARK. CODE §§ 28-73-901 to 28-73-908; CAL. PROB. CODE §§ 16045 to 16054; COLO. REV. STAT. §§ 15-1.1-101 to 15-1.1-115; CONN. GEN. STAT. §§ 45a-541 to 45a-541l; D.C. CODE ANN. §§ 19-1309.01 to 19-1309.06; HAW. REV. STAT. ANN. §§ 554c-1 to 554c-12; IDAHO CODE ANN. §§ 68-501 to 68-514; IND. CODE ANN. §§ 30-4-3.5-1 to 30-4-3.5-13; IOWA CODE ANN. §§ 633a.4301 to 633a.4309; KAN. STAT. ANN. § 58a-901; ME. REV. STAT. ANN. tit. 18-B, §§901 to 908; MD. CODE ANN., EST. AND TRUSTS, tit. 15 § 114; MASS. GEN. LAWS ch. 203C, §§ 1 to 11; MICH. COMP. LAWS ANN. § 700.7803; MINN. STAT. ANN. § 501c.0901; MISS. CODE ANN. §91-9-601 to 91-9-27; MO. ANN. STAT. §§ 469.900 to 469.913; MONT. CODE ANN. §§ 72-38-901 to 72-38-906; NEB. REV. STAT. ANN. §§ 30-3883 to 30-3889; NEV. REV. STAT. ANN. §§ 164.700 to 164.775; N.H. REV. STAT. ANN. §§564-B:9-901 to 564-B:9-907; N.J. REV. STAT. §§ 3b:20-11.1 to 3b:20-11.12; N.M. STAT. ANN. §§ 45-7-601 to 45-7-612; N.C. GEN. STAT. ANN. §§ 36c-9-901 to 36c-9-907; N.D. CENT. CODE ANN. §§ 59-17; OHIO REV. STAT. ANN. § 5809; OKLA. STAT. ANN. tit. 60, §§175.60 to 175.72; OR. REV. STAT. ANN. §§ 130.750 to 130.775; 18 R.I. GEN. LAWS §§ 18-15-1 to 18-15-13; S.C. CODE ANN. § 62-7-933; S.D. CODIFIED LAWS § 55-5-7; TENN. CODE ANN. §§ 35-14-101 to 35-14-114; TEX. PROP. CODE §§ 117.001 to 117.012; UTAH CODE ANN. §§ 75-7-901 to 75-7-907; VT. STAT. ANN. tit. 14A, §§ 901 to 908; VA. CODE ANN. §§ 64.2-780 to 64.2-791; WASH.

("UTC"), which the ULC published originally in 2000,[11] and which has now been enacted, in some cases with some variation from the ULC prototype, in 30 states and the District of Columbia.[12]

The UPIA contains a one-sentence provision that states the traditional common-law rule.[13] The commentary to the UPIA indicates that the drafters believed the traditional analysis that a transaction involving a benefit to a trustee could not be fair to the beneficiaries.[14]

In contrast, the UTC contains a more detailed provision that distinguishes between transactions that involve the trustee and those that involve entities or persons related to the trustee.[15] Transactions directly

---

REV. CODE ANN. §§ 11.104a.001 to 11.104a.040; W. VA. CODE ANN. § 44d-9-901; WIS. STAT. ANN. § 881.01; and WYO. STAT. ANN. §§ 4-10-901 to 4-10-913.

11 UNIF. TRUST CODE (UNIF. LAW COMM'N. 2010), https://www.uniformlaws.org/home.

12 As of October 1, 2019, the enactments of the UTC were codified as follows: ALA. CODE §§ 19-3b-101 to -1305 (2019); ARIZ. REV. STAT. ANN. §§ 14-10101 to -11102 (2019); ARK. CODE ANN. §§ 28-73-101 to -1106 (West 2019); COLO. REV. STAT. §§ 15-5-101 to -1404 (West 2019); D.C. CODE ANN. §§ 19-1301.01 to -1311.03 (West 2019); FLA. STAT. ANN. §§ 736.0101 to -1303 (West 2019); KAN. STAT. ANN. §§ 58a-101 to -1107 (West 2019); KY. REV. STAT. ANN. §§ 386B.1-010 to.11-050 (West 2019); ME. REV. STAT. ANN. tit. 18-B, §§ 101–1104 (2019); MD. CODE ANN., EST. & TRUSTS §§ 14.5-101 to -1006 (West 2019); MASS. GEN. LAWS ANN ch. 203E, §§ 101–1013 (West 2019); MICH. COMP. LAWS ANN. §§ 700.7101–.7913 (West 2019); MINN. STAT. ANN. §§ 501c.0101–1304 (West 2019); MISS. CODE ANN. §§ 91-8-101 to -1206 (West 2019); MO. ANN. STAT. §§ 456.1-101 to.11-1106 (West 2019); MONT. CODE ANN. §§ 72-38-101 to -1111 (West 2019); NEB. REV. STAT. ANN. §§ 30-3801 to 30-38,110 (West 2019); N.H. REV. STAT. ANN. §§ 564-B:1-101 to 12-1210; N.J. STAT. ANN. §§ 3b:31-1 to -84 (West 2019); N.M. STAT. ANN. §§ 46a-1-101 to -1105 (West 2019); N.C. GEN. STAT. ANN. §§ 36c-1-101 to -11-1106 (West 2019); N.D. CENT. CODE ANN. §§ 59-09-01 to -19-02 (West 2019); OHIO REV. CODE ANN. §§ 5801.011–5811.03 (West 2019); OR. REV. STAT. ANN. §§ 130.001–.910; 20 PA. STAT. AND CONS. STAT. ANN. §§ 7701.–7799.3 (West 2019); S.C. CODE ANN. §§ 62-7-101 to -1106 (2019); TENN. CODE ANN. §§ 35-15-101 to -1301 (West 2019); UTAH CODE ANN. §§ 75-7-101 to -1201 (West 2019); VT. STAT. ANN. tit. 14A, §§ 101–1204 (West 2019); VA. CODE ANN. §§ 64.2-700 to -808 (West 2019); W. VA. CODE ANN. §§ 44D-1-101 to -11-1105 (West 2019); WIS. STAT. ANN. §§ 701.0101–.1205 (West 2019); and WYO. STAT. ANN. §§ 4-10-101 to -1103 (West 2019).

13 UNIFORM. PRUDENT INVESTOR ACT § 5 (UNIF. LAW COMM'N 1994).

14 *Id.* § 5 cmt.

15 UNIFORM TRUST CODE § 802 (UNIF. LAW COMM'N 2010), provides in pertinent part as follows:

SECTION 802. DUTY OF LOYALTY.

(a) A trustee shall administer the trust solely in the interests of the beneficiaries.

(b) Subject to the rights of persons dealing with or assisting the trustee as provided in Section 1012, a sale, encumbrance, or other transaction involving the investment or management of trust property entered into by the trustee for the trustee's own personal account or which is otherwise affected by a conflict between the trustee's fiduciary and personal interests is voidable by a beneficiary affected by the transaction unless:

involving the trustee and the beneficiaries or trust assets are void at the option of the beneficiary, as was true at common law. Transactions involving entities or persons related to the trustee, on the other hand, are merely *voidable* upon a showing of harm.

Surely modern trust law should be able to envision a transaction that benefits the trustee but also benefits the beneficiaries. Equally clearly, such a transaction should be valid under modern trust law, and the law governing such a transaction should be useful in crafting the law governing investment advisors in the situations that Professor Edwards discusses. In the next section, I will discuss a case that is instructive in this regard.

---

(1) the transaction was authorized by the terms of the trust;
(2) the transaction was approved by the court;
(3) the beneficiary did not commence a judicial proceeding within the time allowed by Section 1005;
(4) the beneficiary consented to the trustee's conduct, ratified the transaction, or released the trustee in compliance with Section 1009; or
(5) the transaction involves a contract entered into or claim acquired by the trustee before the person became or contemplated becoming trustee.

(c) A sale, encumbrance, or other transaction involving the investment or management of trust property is presumed to be affected by a conflict between personal and fiduciary interests if it is entered into by the trustee with:
(1) the trustee's spouse;
(2) the trustee's descendants, siblings, parents, or their spouses;
(3) an agent or attorney of the trustee; or
(4) a corporation or other person or enterprise in which the trustee, or a person that owns a significant interest in the trustee, has an interest that might affect the trustee's best judgment.

* * *

(h) This section does not preclude the following transactions, if fair to the beneficiaries:
(1) an agreement between a trustee and a beneficiary relating to the appointment or compensation of the trustee;
(2) payment of reasonable compensation to the trustee;
(3) a transaction between a trust and another trust, decedent's estate, or [conservatorship] of which the trustee is a fiduciary or in which a beneficiary has an interest;
(4) a deposit of trust money in a regulated financial-service institution operated by the trustee; or
(5) an advance by the trustee of money for the protection of the trust.

(i) The court may appoint a special fiduciary to make a decision with respect to any proposed transaction that might violate this section if entered into by the trustee.

II. A RECENT CASE: CAN AN INVESTMENT BE GOOD FOR BOTH THE TRUSTEE AND THE BENEFICIARIES?

My research assistant and I searched for all reported cases decided since 2000 that involved self-dealing allegations against private trustees.[16] From the reported cases, I selected one as an illustration of the analysis that might be used to determine whether an investment advisor breached the duty of loyalty to a customer. In *French v. Wachovia Bank*, 722 F.3d 1079 (7th Cir. 2013), the beneficiaries of an irrevocable trust created by their father sued the trustee for investing in a life insurance policy on the grantor's life that it purchased from an affiliate.[17] There was extensive evidence that the grantor had changed trustees from another corporate fiduciary to Wachovia Bank partly because he was dissatisfied with the investment strategy of the original corporate fiduciary.[18] The trust officer in charge of the account at Wachovia determined that the insurance policies that comprised part of the assets of the trust did not include terms that best satisfied the grantor's goals and recommended that those policies be surrendered and new policies, issued by an affiliate of the bank, should be purchased to replace them.[19] The grantor was notified of the proposed change and objected to some aspects of the transaction, including the amount of the premiums.[20] The trustee concluded, however, that it did not need the grantor's approval to proceed and completed the policy exchange.[21] Thereafter, the grantor's children, as trust beneficiaries, sued Wachovia for engaging in self-dealing by purchasing the replacement insurance policies.[22]

At the time of the purchases of the insurance policies, Wisconsin, which was the situs of the trust, had enacted the UPIA but not the UTC.[23] The trust agreement in *French*, however, exonerated the trustee from liability for actions taken in good faith even if they might otherwise be a

---

[16] The results of this research are far too voluminous to summarize here. The results are on file with the author.

[17] French v. Wachovia Bank, 722 F.3d 1079, 1081 (7th Cir. 2013).

[18] *Id.* at 1082.

[19] *Id.*

[20] *Id.* at 1083.

[21] *Id.*

[22] *Id.*

[23] WIS. STAT. ANN. § 701.0901 (West 2019). After *French* was decided, Wisconsin enacted the UTC, including § 802. *See* WIS. STAT. ANN. § 701.0802 (West 2019).

violation of the trustee's statutory fiduciary duties.[24] The court held that the good faith standard, and not the stricter standard of the traditional duty of loyalty, applied to the trustee's actions in recommending and purchasing the replacement insurance policies.[25] It then held that for the trustee on the issue of breach of fiduciary duty.[26]

The *French* decision is instructive here for several reasons. First, the court in *French* validated the reduced standard of fiduciary duty, even in a case of self-dealing. The opinion indicates that the fact that the grantor, a sophisticated businessman, was kept informed of every step in the contemplated exchange, as were his lawyers, was important in the court's reasoning.[27] Second, the decision clearly demonstrates that a decision can be in the best interest of the beneficiaries of a trust even though it benefits the trustee.[28]

In arriving at its decision, the Court of Appeals notes with approval an article by Professor John H. Langbein, advocating to change the standard of conduct required of trustees in self-dealing cases from the sole interest of the beneficiaries to the best interest of the beneficiaries.[29] Although a detailed discussion of whether such a change would be appropriate in all cases of self-dealing is clearly beyond the scope of my remarks today, the facts in *French* are instructive concerning exactly the sort of investment decisions that Professor Edwards wishes to regulate. Clearly, an investment advisor could receive a large commission on an investment that also would be an excellent choice to fulfill the investment objectives of a customer. Indeed, it may even be the best choice. A rule that requires investment advisors to act in the best interests of their customers should not worry scrupulous investment advisors and should protect customers from unscrupulous ones.

CONCLUSION

Professor Edwards has urged the states to assume the task of regulating investment advisors in a way that will require them to act in the

---

[24] This type of exculpatory clause is commonly found in trusts. *See* GEORGE G. BOGERT, GEORGE T. BOGERT, SUSAN N. GARY, & AMY MORRIS HESS, THE LAW OF TRUSTS AND TRUSTEES § 542 (3d ed. 2019).

[25] *French*, 722 F.3d at 1087.

[26] *Id.* at 1088.

[27] *Id.*

[28] *Id.*

[29] John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE. L.J. 929 (2005).

best interests of their customers when selecting from various investment choices in which the investment advisors receive different commissions. The law governing the actions of private express trustees in transactions involving trust assets and trust beneficiaries can provide a template for such state regulation. States should look to modern developments in trust law that abandon the traditional thinking that any transaction that benefits a trustee is a breach of fiduciary duty. Clearly, a transaction can benefit a trustee (and, by extension, an investment advisor) and still be in the best interests of the beneficiaries of a trust (and, by extension, an investment advisor's customers).