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Recommended Citation
Peter T. Wendel, Examining the Mystery behind the Unusually and Inexplicably Broad Provisions of Section Seven of the Uniform Trustees' Powers Act: A Call for Clarification, 56 Mo. L. Rev. (1991)
Available at: http://scholarship.law.missouri.edu/mlr/vol56/iss1/7

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Examining the Mystery Behind the Unusually and Inexplicably Broad Provisions of Section Seven of the Uniform Trustees’ Powers Act: A Call For Clarification

Professor Peter T. Wendel

I. INTRODUCTION

The sole trustee of a charitable foundation calls a not-for-profit organization and proposes the following deal: the foundation will make two donations of $1,000,000 each to the organization if the organization will use one of the donations to purchase a residence and deed it back to the foundation as a gift to be used as the trustee’s residence. The not-for-profit organization will be free to keep the other $1,000,000 as a charitable donation towards its operating costs. The not-for-profit organization relies heavily upon private donations for its budget and therefore is extremely interested in the proposal. The organization does not understand why the trustee does not buy the residence directly, but the organization decides it is better not to ask and risk jeopardizing the proposal. If the not-for-profit organization decides to go through with the proposal, and the purchase of the residence turns out to constitute an impermissible use of the charitable foundation’s funds, is the organization liable for participating in the trustee’s breach of its fiduciary duties to the foundation?

1. This hypothetical is based loosely upon a newspaper article which appears at St. Louis Post-Dispatch, Oct. 25, 1987, at 1, col. 1.

At common law, there is no doubt that the not-for-profit organization is liable for participating in the breach of trust. At common law, a third party dealing with a trustee has a duty to inquire into the trustee's powers; if the party fails to inquire, the party is chargeable with knowledge of the information a diligent inquiry would reveal. The not-for-profit organization knows it is dealing with a trustee. The broad common law duty of inquiry charges the organization with knowledge of information the organization would obtain if it conducted a diligent inquiry into the trustee's powers. Assuming a diligent inquiry reveals that the proposed transaction constitutes a breach of trust, the organization is liable for participating.

Similarly, under the Uniform Commercial Code and the Uniform Fiduciaries Act, the not-for-profit organization also is liable for participating in the breach of trust. Both the Uniform Commercial Code and the Uniform Fiduciaries Act require that third parties dealing with a trustee act in good faith. The not-for-profit organization's suspicions about the proposal, coupled with the organization's conscious decision not to ask any questions in the hope of avoiding damaging information, constitute bad faith.

3. RESTATEMENT (SECOND) OF TRUSTS, supra note 2, § 297 comments c-f; G. BOGERT, supra note 2, § 894; A. SCOTT & W. FRATCHER, supra note 2, § 297.4.

4. In addition, to receive trust property free of the trust, at common law, the third party had to give valuable consideration. RESTATEMENT (SECOND) OF TRUSTS, supra note 2, §§ 284, 298-309; G. BOGERT, supra note 2, §§ 881, 887; A. SCOTT & W. FRATCHER, supra note 2, §§ 284, 297A-309. Accordingly, even if the third party has no notice that it is dealing with a trustee, if the third party is a donee, the third party receives the trust property subject to the trust. RESTATEMENT (SECOND) OF TRUSTS, supra note 2, § 289; G. BOGERT, supra note 2, § 868; A. SCOTT & W. FRATCHER, supra note 2, § 289.

5. Assuming that the trustee made the donations by check, article 3 of the Uniform Commercial Code would apply, as would section 5 of the Uniform Fiduciaries Act. See U.C.C. § 3-104 (1977); UNIF. FIDUCIARIES ACT § 5, 7A U.L.A. 140-41 (1990) [hereinafter U.F.A.].

6. The Uniform Commercial Code expressly requires that for a party to receive the negotiable instrument free from all claims to it the party must be acting in good faith. See U.C.C. §§ 3-302, 3-305 (1977). The Uniform Fiduciaries Act implicitly requires that the party be acting in good faith by imposing liability in the absence of good faith. If the party "takes the instrument with actual knowledge of such breach [that the fiduciary is committing a breach of his obligation as fiduciary] or with knowledge of such facts that his action in taking the instrument amounts to bad faith." U.F.A. § 5, 7A U.L.A. 140-41 (1990); see also U.F.A. §§ 4, 6-9, 7A U.L.A. 139, 144-52 (1990).

for-profit organization’s bad faith would subject it to liability for participating in the breach of trust. In addition, although both the Uniform Commercial Code and the Uniform Fiduciaries Act reject the broad common law duty of inquiry arising simply because one knows or should know it is dealing with a trustee, both uniform laws retain a limited duty of inquiry if the third party knows that the fiduciary will benefit personally from the transaction. The not-for-profit organization knows that the trustee will benefit personally from the proposal: the trustee intends to move into the residence. If the not-for-profit organization fails to inquire into the propriety of the proposal, and the proposal in fact constitutes a breach of trust, the organization is liable for participating in the breach of trust.

Under the Uniform Trustees’ Powers Act, however, the not-for-profit organization would not be liable for participating in the breach of trust. Section seven of the Uniform Trustees’ Powers Act provides unusually broad protection to third parties dealing with a trustee. Section seven rejects both: (1) the broad common law duty of inquiry, and (2) the good faith and limited duty of inquiry standard prevailing in the other uniform laws addressing the liability of a third party dealing with a fiduciary. Instead, section seven of the Uniform Trustees’ Powers Act fully protects a third party dealing with a trustee unless the third party has actual knowledge that the transaction constitutes a breach of trust, and, further, the third party has absolutely no duty of inquiry. Accordingly, even though the organization strongly suspects that there is something wrong with the proposal, and consciously shields its eyes to avoid acquiring damaging information, the organization does not have actual knowledge that the proposal constitutes a breach of trust.

8. Neither the U.C.C. nor the U.F.A. expressly retains any duty of inquiry, but both uniform laws subject the party receiving the instrument to liability if the party has knowledge that the transaction is for the benefit of the fiduciary. U.C.C. §§ 3-304(2), 3-302, 3-305 (1977); U.F.A. § 5, 7A U.L.A. 141 (1990). The effect of imposing liability where the party has such knowledge is to impose upon such party a duty to inquire into the propriety of the transaction if the party wants to take the property free from all claims. See U.F.A. § 6, 7A U.L.A. 144-45 commissioner’s note (1978).

9. In addition, the U.C.C. expressly requires that for a party to receive the negotiable instrument free from all claims to it the party must give value. U.C.C. §§ 3-302, 3-303, 3-305 (1977). The U.F.A. is silent with respect to whether the party must give value, but the principal focus of the U.F.A. is "to establish uniform and definite rules in place of the diverse and indefinite rules now prevailing as to 'constructive notice' of breaches of fiduciary obligations." 7A U.L.A. 128 commissioner’s note (1978). The limited focus of the Act implicitly indicates that the Act does not change the common law requirement that a third party has to give valuable consideration to receive property free from all claims.

The not-for-profit organization knows that the trustee will benefit personally from the proposal, and yet the organization has absolutely no duty to inquire under any circumstances. Absent actual knowledge, the Uniform Trustees' Powers Act provides that the not-for-profit organization can go through with the proposal with confidence that it has no liability exposure.\(^\text{11}\)

In light of the unusually broad protection accorded third parties dealing with a trustee under section seven of the Uniform Trustees' Powers Act, one would expect to find a thorough and well reasoned explanation for section seven's "actual knowledge with no duty of inquiry" standard. In fact, however, the exact opposite is the case. The legislative history behind section seven indicates that the Special Committee of the Uniform Law Commission responsible for drafting section seven never realized that section seven rejected the prevailing good faith and limited duty of inquiry standard. In fact, the only comments attributable to the Committee indicate that the Committee thought section seven retained the good faith and limited duty of inquiry requirements. The Committee's mistake appears to arise from its blind acceptance of the actual knowledge standard as rhetorically proposed by Professor Fratcher in an historic article which called for and proposed the key provisions of the uniform trustees' powers legislation.\(^\text{12}\) The unusually broad provisions of section seven of the Uniform Trustees' Powers Act are not the result of a well researched and reasoned decision by the Committee. The unusually broad provisions are the result of blind acceptance of an inadequately researched and analyzed tentative proposal.

The conflict between the unusually broad provisions of section seven of the Uniform Trustees' Powers Act and the legislative history behind section

\(^{11}\) Section 7 of the U.T.P.A. is also silent with respect to whether the third party must give valuable consideration to receive the trust property free from all claims. Unlike the U.F.A., however, the express language of § 7 implies that the traditional requirement that the third party give valuable consideration is no longer necessary. Section 7 expressly provides that a third party is "fully protected" unless the third party has "actual knowledge that the trustee is exceeding his powers or improperly exercising them." U.T.P.A. § 7, 7B U.L.A. 758 (1990) (emphasis added). Unlike under the common law, the U.C.C., and the U.F.A., the fact that the not-for-profit organization is a donee appears to have no effect on its liability under the U.T.P.A.

\(^{12}\) Unlike the Uniform Law Commission's Special Committee, Professor Fratcher no doubt realized that his actual knowledge proposal rejected the good faith and limited duty of inquiry requirements. Moreover, a strong case can be made that Professor Fratcher wanted to go further. He wanted complete immunity for third parties dealing with a trustee, even when the third party had actual knowledge that the transaction constituted a breach of trust. See infra note 94. It is unclear, however, why Professor Fratcher proposed the actual knowledge standard instead of his preferred complete immunity standard, and it is unclear why Professor Fratcher presented his actual knowledge standard rhetorically.
seven has not surfaced previously because section seven is for all practical purposes an ineffective statutory provision. The vast majority of transactions governed by section seven of the Uniform Trustees' Powers Act also fall within the scope of the corresponding provisions of the Uniform Commercial Code and the Uniform Fiduciaries Act. Section seven's "actual knowledge with absolutely no duty of inquiry" standard conflicts with the "good faith and limited duty of inquiry" standard required by the corresponding provisions of these other uniform laws. Faced with the conflicting standards of liability, third parties interested in dealing with a trustee no doubt conform their conduct to the good faith and limited duty of inquiry standard to avoid any risk of liability created by the conflict. Even if the Uniform Law Commission adopted section seven intending to reject the good faith and limited duty of inquiry standard, absent a clearer statement to that effect, section seven is ineffective.

Accordingly, section seven of the Uniform Trustees' Powers Act cries out for clarification. The Uniform Law Commission adopted section seven without proper research or analysis. Section seven currently adds only conflict and confusion to the law of trusts, and in particular to the law governing transactions with trustees.13 Any re-examination of section seven should begin with the presumption that the proper standard of liability for third parties dealing with a trustee is the good faith and limited duty of inquiry standard. The good faith and limited duty of inquiry standard imposes minimal costs on trust administration efficiency while providing greater protection for trust beneficiaries than is provided by the actual knowledge standard. In accordance with the spirit and intent of the uniform law system, section seven of the Uniform Trustees' Powers Act should be amended to incorporate the good faith and limited duty of inquiry requirements so that the uniform laws addressing the liability of third parties dealing with a fiduciary will in fact be uniform.14

13. Section 7 also adds confusion to the law of trusts with respect to the traditional requirement that to receive trust property free from claims the third party must give valuable consideration. Although the legislative history behind § 7 indicates that 7's actual knowledge with no duty of inquiry standard is a mistake, the legislative history provides no clue with respect to why the Committee made no mention of the valuable consideration requirement. The only conclusion is that the Committee did not even think about this traditional requirement.

14. The status of the valuable consideration requirement should also be clarified.
II. LEGISLATIVE BACKGROUND TO SECTION SEVEN OF THE UNIFORM TRUSTEES' POWERS ACT

A. The Common Law and Statutory Importance of the Good Faith and Duty of Inquiry Requirements

At common law, to receive property from a trustee free of the trust and free of liability to the trust beneficiaries, the third party has to meet the requirements of a *bona fide* purchaser: (1) pay valuable consideration, (2) act in good faith, and (3) lack notice that the transaction constitutes a breach of trust. Although the last requirement, the absence of notice, does not on its face appear to be that difficult to satisfy, one has to remember the

15. RESTATEMENT (SECOND) OF TRUSTS, supra note 2, § 284; G. BOGERT, supra note 2, § 881; A. SCOTT & W. FRATCHER, supra note 2, § 284. The common law rule results from applying basic equity principles to the trust relationship. Equity provides that where two parties claim competing interests in a matter, the party first in time will prevail unless the later party is a *bona fide* purchaser. 1 J. POMEROY, A TREATISE ON EQUITY JURISPRUDENCE §§ 413-417 (4th ed. 1918); 2 J. POMEROY, A TREATISE ON EQUITY JURISPRUDENCE § 745 (4th ed. 1918). To constitute a *bona fide* purchaser, a party has to: (1) pay valuable consideration, (2) act in good faith, and (3) lack notice of any competing interest in the matter. 2 J. POMEROY, supra, §§ 745-761.

16. RESTATEMENT (SECOND) OF TRUSTS, supra note 2, § 284; G. BOGERT, supra note 2, § 881; A. SCOTT & W. FRATCHER, supra note 2, § 284. Both Bogert and Scott and Fratcher are unclear with respect to whether good faith is a separate requirement or simply an element of the notice requirement. The RESTATEMENT (SECOND) OF TRUSTS implicitly sets forth the good faith requirement as a distinct requirement, but restates it as requiring that the third party "not knowingly tak[e] part in an illegal transaction." RESTATEMENT (SECOND) OF TRUSTS §§ 284,290 (1959). The traditional common law view is that good faith is both a distinct requirement of the *bona fide* purchaser requirement and a component of the notice requirement. If the party has notice of a competing interest, the party lacks good faith and takes the property in question subject to the competing interest. 2 J. POMEROY, supra note 15, §§ 745-761.

17. RESTATEMENT (SECOND) OF TRUSTS, supra note 2, § 284; G. BOGERT, supra note 2, § 881; A. SCOTT & W. FRATCHER, supra note 2, § 284. The common law notice element is a broad concept. Notice of a competing interest can be either actual or constructive. 2 J. POMEROY, supra note 15, §§ 593, 595-603, 604-09. It is generally accepted that the distinction between actual notice and constructive notice turns on the manner in which the notice is received. Id. § 595. Notice is actual when knowledge of a particular fact has been personally communicated to the individual. Id.; 66 C.J.S. *Notice* § 3 (1950). Notice is constructive when knowledge of a particular fact is imputed to the party even in the absence of any evidence that the fact has been personally communicated to the individual. 2 J. POMEROY, supra note 15, § 604; 66 C.J.S. *Notice* §§ 5-7.
common law duty of inquiry.\textsuperscript{18} Under the broad common law duty of inquiry, if the third party simply knows or should know that it is dealing with a trustee, then the third party has notice of a potentially competing interest (the interest of the trust beneficiaries). Accordingly, in any transaction involving a trustee, the third party has a duty to inquire into the trustee’s powers to consummate the transaction.\textsuperscript{19} If the third party fails to inquire into the trustee’s power to consummate a transaction which constitutes a breach of trust and which a reasonably diligent inquiry would reveal as a breach of trust, the third party receives the property subject to a continuing trust and is equally liable with the trustee for participating in the breach of trust.\textsuperscript{20} The effect of such a broad common law standard of liability is to make third parties who transact with a trustee guarantors of the trustee’s power to consummate the transaction—a guarantee that effectively deters third parties from dealing with trustees.\textsuperscript{21}

The \textit{bona fide} purchaser and duty of inquiry requirements worked well in the relatively slow-paced, land-oriented economy of medieval England. As society progressed and commerce grew increasingly investment oriented, however, the \textit{bona fide} purchaser and duty of inquiry requirements grew increasingly burdensome. This was particularly true with respect to transactions involving commercial paper, negotiable instruments, and investment securities, and even more so with respect to such transactions when a fiduciary was involved. Accordingly, to facilitate transactions involving such commodities generally, and in particular such transactions when a fiduciary is involved, the National Conference of Commissioners on Uniform Laws adopted uniform laws which address the liability of parties involved in such

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\item \textsuperscript{18} The duty of inquiry provides that where a party has notice (again, either actual or constructive) of facts which raise the possibility of a competing interest, but do not establish conclusively a competing interest, the party has a duty to inquire further into the existence of the competing interest. If the party fails to inquire further, the party is chargeable with the knowledge which it could have acquired if it had conducted a reasonably diligent inquiry. G. Bogert, supra note 2, § 894.
\item \textsuperscript{19} Restatement (Second) of Trusts, supra note 2, § 297 comments c-f; G. Bogert, supra note 2, § 894; A. Scott & W. Fratcher, supra note 2, § 297.
\item \textsuperscript{20} Restatement (Second) of Trusts, supra note 2, § 297 comments c-f; G. Bogert, supra note 2, § 894; A. Scott & W. Fratcher, supra note 2, § 297.
\item \textsuperscript{21} W. Fratcher, Trust, in IV Int’l Encyclopedia of Comparative Law § 100 (F. Lawson ed. 1972). Although there is no equity stronger than the equity of a \textit{bona fide} purchaser, the broad common law absence of notice requirement coupled with the broad common law duty of inquiry make achieving the \textit{bona fide} purchaser status a potentially burdensome task. 1 J. Pomeroy, supra note 15, §§ 413-415, 416-417; 2 Pomeroy, supra note 15, § 745. Achieving the \textit{bona fide} purchaser status is nowhere more burdensome at common law than it is for third parties dealing with a fiduciary, and in particular, a trustee.
\end{itemize}
transactions. Although these uniform laws retain the traditional common law principle that the purchaser has to be a *bona fide* purchaser, the uniform laws modify substantially (1) the notice element of the common law *bona fide* purchaser principle (which directly affects the third parties' duty to inquire), and (2) the good faith element of the common law *bona fide* purchaser principle.

First, the uniform laws modify the basic *bona fide* purchaser principle by narrowing the common law notice concept and its concomitant duty of inquiry. The uniform laws reject the broad common law concept of notice of a potentially adverse claim and specifically provide that a party has notice of a potentially adverse interest only if the party has knowledge of certain limited enumerated facts which create a presumption of impropriety. In addition, the enumerated definitions specifically address what constitutes notice of an adverse claim when dealing with a fiduciary. The uniform laws expressly reject that notice of an adverse claim may arise simply from the fact that a third party has notice that it is dealing with a fiduciary. The uniform laws expressly provide that a third party dealing with a fiduciary has notice of a potentially adverse claim if the third party has knowledge that the fiduciary personally will benefit from the transaction. The effect of narrowing when a third party has notice of an adverse claim is to narrow the third party's duty to inquire. Inasmuch as a third party's duty to inquire is limited to situations where it has notice of the potentially adverse claim, the uniform laws limit the third party's duty to inquire by the definition of notice. Accordingly, a third party has no duty to inquire simply because it knows it is dealing with a fiduciary. Under the uniform laws, a third party dealing with

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23. *Supra* note 17.


25. See U.C.C. §§ 3-304(4)(e), 8-304(2) (1977). The U.F.A. does not expressly reject the broad common law duty of inquiry based simply on the fact that a party knows it is dealing with a fiduciary, but the rejection of the broad common law duty of inquiry is implicit in the wording of the provisions and the official comments thereto (especially the comments to § 6). U.F.A. §§ 4-9, 7A U.L.A. 139-52 (1990).


27. Although the uniform laws make no express reference to a limited duty of inquiry, the effect of notice under the uniform laws is tantamount to a limited duty of inquiry. If the third party wants to receive the property free from any adverse claims, but the party has notice (as narrowly defined by the uniform laws) of a potentially adverse claim, in essence the third party has a limited duty to inquire into the transaction to ensure that it is not a breach of the fiduciary's obligation.
a fiduciary has only a limited duty to inquire when the third party has notice (as defined by the uniform laws) of those enumerated situations which create a presumption of impropriety (that is, if the third party knows that the fiduciary will benefit personally from the transaction).28

Second, the uniform laws modify the common law *bona fide* purchaser principle by narrowing the common law good faith concept. Because the common law defines good faith objectively, good faith is practically synonymous with and subsumed under the notice requirement.29 At common law, if a party has actual or constructive notice of an adverse claim and proceeds with the transaction, the third party lacks good faith.30 The uniform laws modify the common law good faith concept by defining it subjectively.31 Accordingly, under the uniform laws, the third party lacks good faith only if it has actual knowledge of an adverse claim to the property (that is, if the party has actual knowledge that the transaction constitutes a breach of fiduciary obligation), or *bad faith* constructive notice (as opposed to mere *negligent* constructive notice)32 of an adverse claim. The effect of the

28. U.C.C. § 3-304(2), 8-304(2) (1977). In addition, the uniform laws' good faith requirement implicitly contains a limited duty of inquiry. If a third party has notice of facts which raise questions about the propriety of the transaction, but the third party intentionally (as opposed to negligently) fails to inquire into the propriety of the transaction so as to avoid actual knowledge of the impropriety, the third party is guilty of bad faith and takes the property subject to any adverse claims. Accordingly, while the uniform laws do not expressly set forth a duty of inquiry, the limited absence of notice requirement is tantamount to imposing a limited duty of inquiry where the party has notice (as statutory defined by the uniform laws) of a potentially adverse claim, and the good faith requirement implicitly contains a limited duty of inquiry if a failure to inquire would constitute subjective bad faith.

29. *Supra* note 16.

30. *Id*.

31. The U.C.C. defines good faith as "honesty in fact in the conduct or transaction concerned." U.C.C. § 1-201(19) (1977). The U.F.A. defines good faith similarly: "A thing is done 'in good faith' within the meaning of this act, when it is in fact done honestly, whether it be done negligently or not." U.F.A. § 1(2), 7A U.L.A. 396 (1990).

32. At common law there is great disagreement over what constitutes constructive notice and the number of different types of constructive notice. For purposes of this discussion, however, constructive notice can be divided into two general types: negligent constructive notice and bad faith constructive notice. Negligent constructive notice is when the party charged with notice has actual notice of a particular fact or facts which place upon the party a duty to inquire further, and the party negligently fails to inquire further; the party is charged with constructive notice of those facts which a diligent inquiry would have revealed. 2 J. POMEROY, *supra* note 15, § 605. Bad faith constructive notice is when the party charged with notice has actual notice of a particular fact or facts which place upon the party a duty to inquire further, and
uniform laws' subjective good faith definition coupled with the limited notice definition is to reject common law constructive notice as the basis of liability unless (1) the constructive notice falls within one of the limited statutory definitions of notice, or (2) the constructive notice is bad faith constructive notice.

The uniform laws' modifications of the *bona fide* purchaser principle increase the protection accorded third parties dealing with a fiduciary. The uniform laws reject the broad common law duty of inquiry in favor of a much narrower limited duty of inquiry standard. Further, the uniform laws reject the broad, objective common law notice concept in favor of the narrower, subjective good faith requirement. It was against this common law and statutory background that the Uniform Trustees' Powers Act was drafted and adopted, and it is against this common law and statutory background that section seven of the Act should be evaluated.

**B. Section Seven of the Uniform Trustees' Powers Act:**
*Unusually and Inexplicably Broad Protection for Third Parties Dealing With a Trustee*

Section seven of the Uniform Trustees' Powers Act expressly governs the liability of third parties transacting with a trustee. Section seven provides:

§7. [Third parties Protected in Dealing with Trustee]

With respect to a third party dealing with a trustee or assisting a trustee in the conduct of a transaction, the existence of trust powers and their proper exercise by the trustee may be assumed without inquiry. The third party is *not bound to inquire* whether the trustee has power to act or is properly exercising the power; and a third party, *without actual knowledge* that the trustee is exceeding his powers or improperly exercising the party *intentionally refuses* to inquire further because the party wants to avoid *knowledge of damaging facts*; the party is charged with constructive notice of those facts which a diligent inquiry would have revealed. *Id.* The critical distinction between negligent constructive notice and bad faith constructive notice is that in the former the party charged with notice objectively should have inquired further, but subjectively was unaware of this duty; in the latter, the party charged with notice subjectively knew he or she should have inquired further but intentionally refused to do so in the hope of avoiding potentially damaging information. *See infra* notes 58-60.

33. It should be noted that although the U.C.C. modifies the valuable consideration requirement, the U.C.C. expressly retains the requirement that a third party transacting with a fiduciary must give value to take the property free of any adverse claims. *See U.C.C.* §§ 3-302, 8-302 (1977). In light of the U.C.C.'s express retention of the for value requirement, the U.T.P.A.'s failure to retain or even address the requirement is a complete mystery. *See U.T.P.A.* § 7, 7B U.L.A. 758 (1990).
them, is fully protected in dealing with the trustee as if the trustee possessed and properly exercised the powers he purports to exercise. A third person is not bound to assure the proper application of trust assets paid or delivered to the trustee.\textsuperscript{34}

Section seven expressly rejects both the broad common law duty of inquiry and the limited duty of inquiry retained by the other uniform laws. In addition, section seven implicitly rejects both the common law \textit{bona fide} purchaser standard of liability and the good faith standard of liability adopted by the other uniform laws. Section seven's actual knowledge with absolutely no duty of inquiry standard of liability constitutes a significant departure from both common law and the other uniform laws. Inasmuch as section seven sets forth a new standard of liability for third parties dealing with a trustee, one would expect to find a thorough explanation for why the Uniform Law Commission adopted section seven's actual knowledge with no duty of inquiry standard and rejected both the common law \textit{bona fide} purchaser and broad duty of inquiry standard and the prevailing uniform law good faith and limited duty of inquiry standard. Yet the Uniform Law Commission gives absolutely no explanation. There is neither an official comment to section seven\textsuperscript{35} nor an official prefatory note to the Uniform Trustees' Powers Act.\textsuperscript{36} The closest one can get to an official explanation of the Act in general, and section seven in particular, is an article by Charles Horowitz, the chairman of the Uniform Law Commission's Special Committee which drafted the Uniform Trustees' Powers Act.\textsuperscript{37}

\textsuperscript{36} U.T.P.A. § 1, 7B U.L.A. 743 (1990); \textit{but see} 1964 \textsc{Handbook of the Nat'l Conf. of Commissioners on Unif. State Laws and Proc. of the Ann. Conf. Meeting in Its Seventy-Third Year} 265 (1964) (setting forth a Prefatory Note to the U.T.P.A., which is merely descriptive and contains no analysis of or explanation for the different statutory provisions).
\textsuperscript{37} 1964 \textsc{Handbook}, \textit{supra} note 36, at 15. The other members of the Special Committee responsible for drafting the U.T.P.A. were Howard Dresbach, Robert B. Harwood, A. Pratt Kesler and R. Jasper Smith. All of the members of the Committee have either passed away or were unable to provide information about the Committee's thought processes with respect to § 7.
C. Chairman Horowitz's Article: The Uniform Law Commission Never Realized Section Seven Rejects the Good Faith and Limited Duty of Inquiry Requirements

Horowitz's article claims to address the basic approach of the Uniform Trustees' Powers Act and the changes the Act makes in the traditional law of trusts. Horowitz acknowledges that section seven "makes important changes" from the common law rules of liability. Horowitz fails, however, to state exactly how section seven differs from the common law. Reading between the lines, Horowitz appears to be referring to section seven's rejection of the broad common law duty of inquiry and to section seven's rejection of liability based upon the broad constructive notice which followed from the broad common law duty of inquiry. There is no doubt that section seven's rejection of these common law trust principles constitutes an important change in the standard of liability for third parties dealing with a trustee. There is no evidence, however, that the Special Committee responsible for drafting the Uniform Trustees' Powers Act intentionally rejected the good faith and limited duty of inquiry standard prevailing in the other uniform laws addressing the liability of a third party dealing with a fiduciary. In fact, the only evidence available indicates that the Special Committee thought section seven retained the good faith and limited duty of inquiry requirements.

After acknowledging that section seven constitutes an important change from the common law, Horowitz claims that this change is "vital in order to make section 3 workable." Section three of the Uniform Trustees' Powers Act is the heart of the Act. Section three drastically changes the law of trusts by granting a trustee all the powers a prudent man would have with respect to his own property. Horowitz claims that without section seven, "third persons might never safely deal with a trustee for fear that he was exceeding his trust powers under the prudent man standard." It is true that the Uniform Trustees' Powers Act's enhanced powers for trustees would be ineffective without greater protection for third parties dealing with a trustee than was accorded third parties at common law. It does not automatically follow, however, that the appropriate degree of protection for the third parties is complete abolition of the duty of inquiry and complete protection unless the third party has actual knowledge that the trustee is exceeding his or her powers. Inasmuch as the other uniform laws retain a limited duty of inquiry

39. Id. at 28.
40. Id.
41. Id. at 8-25.
42. Id. at 28.
and apply a good faith standard (either expressly or implicitly by imposing liability in the case of actual knowledge or bad faith), the obvious question is why the Special Committee in charge of drafting the Uniform Trustees' Powers Act rejected the prevailing approach adopted by the other uniform laws and decided not to retain a limited duty of inquiry and good faith standard.

Surprisingly, Horowitz fails to address why the Special Committee decided to break with the other uniform laws. Moreover, Horowitz's only references to the other uniform laws and to the duty of inquiry and good faith requirements imply that the Committee thought it was retaining a limited duty of inquiry and good faith requirement. In a footnote to Horowitz's claim that the trustees' enhanced powers would be unworkable without the broad protection accorded third parties under section seven, Horowitz mused:

The substance of section seven, in part at least, might in time be adopted decisionally. Thus it has been held that where a trustee, by terms of the trust, has power to transfer or encumber trust property, a third party dealing with him in good faith is not bound to ascertain whether the act of the trustee is justified unless the transaction, in view of the trust relation, is an unusual one. 54 Am. Jur. Trusts § 270 (1945). Section seven follows, but on a broad front, the more limited precedent changing the common law set by the Uniform Fiduciaries Act which protects third persons acting in good faith in certain types of dealings with the fiduciary.44

Read carefully, the footnote indicates that the Committee thought that section seven retained a limited duty of inquiry and a good faith requirement. The first sentence's reference to the "substance of section seven" coupled with the second sentence's reference to "good faith" imply that the substance of section seven is that a third party dealing with a trustee in good faith is protected from liability. This good faith implication is buttressed by the latter half of the second sentence which qualifies the protection offered the third party. In the event the transaction is an unusual one, the third party is not protected absolutely but rather has a limited duty to inquire into whether the trustee is authorized to act. Although the footnote clearly indicates the Committee rejected the broad common law duty of inquiry based solely on the fact that the third party has notice that it is dealing with a trustee, the footnote implies a limited duty to inquire when the transaction is an unusual one, with potential liability based upon a bad faith failure to inquire. Although the express language of section seven contains no reference to either a "good faith" or "bad faith" standard, and the express language of section seven repudiates any duty to inquire, the first two sentences of the footnote indicate

43. Supra notes 27-28, 31-32.
44. Horowitz, supra note 38, at 28 n.153 (emphasis added).
that the Committee thought section seven contained the good faith and limited duty of inquiry standard.

The footnote's discussion of the Uniform Fiduciaries Act further supports a finding that the Committee thought section seven retained the good faith and limited duty of inquiry requirements. The Uniform Fiduciaries Act has a rather limited purpose: to facilitate banking and financial transactions involving negotiable instruments when one of the parties is a fiduciary.45 Likewise, the Uniform Fiduciaries Act has rather limited application, applying to only three classes of people: "1. Persons paying money or transferring other property to fiduciaries. . . . 3. Persons receiving negotiable instruments. . . . [and] 4. Depositories of fiduciary funds."46 Like the Uniform Commercial Code,47 with respect to these limited transactions the Uniform Fiduciaries Act rejects the general common law duty of inquiry based upon mere notice that one is dealing with a fiduciary and instead retains a limited duty of inquiry where the third party knows the fiduciary is benefitting personally from the transaction.48 Moreover, the Uniform Fiduciaries Act rejects the

46. U.F.A., Prefatory Note, 7A U.L.A. 392 (1990); see also Colby, 92 F.2d at 188-93. As the numbers in the quotation indicate, the U.F.A. originally covered four types of transactions. But the third enumerated type of transaction, "corporations, etc., whose securities are registered in the names of fiduciaries," has been "superseded by the Uniform Act for Simplification of Security Transfers, or by Uniform Commercial Code, Art. 8." U.F.A., Prefatory Note, 7A U.L.A. 392 (1990).
48. Sections 4-5 and 9 expressly provide that the third party dealing with the fiduciary "is not bound to inquire whether the fiduciary is committing a breach of his obligation as fiduciary" by engaging in the specific conduct governed by the particular provision. U.F.A. §§ 4-5, 9, 7A U.L.A. 405-07, 417 (1990). Sections 7-8 implicitly reject the broad common law duty of inquiry by limiting the third party's liability to cases where the third party (1) has "actual knowledge that the fiduciary is committing a breach" of its fiduciary obligation; (2) has knowledge of such facts that the third party's participation in the transaction constitutes bad faith; or (3) receives the instrument from the fiduciary "in payment of or as security for a personal debt of the fiduciary," and the transaction in fact constitutes a breach of the fiduciary's obligation. U.F.A. §§ 7-8, 7A U.L.A. 413-15 (1990). The effect of the last class of liability is, in essence, to create a limited duty of inquiry where the transaction is for the personal benefit of the fiduciary. See RESTATEMENT (SECOND) OF TRUSTS § 297 comment o (1959). This limited duty of inquiry is required under §§ 4, 5, 7 and 8. U.F.A. §§ 4-5, 7, 8, 7A U.L.A. 405-07, 413, 415 (1990). Section 6, which governs checks drawn by and payable to the fiduciary, eliminates this limited duty of inquiry on the grounds that the payment to the fiduciary may be a legitimate payment of expenses or compensation. U.F.A. § 6 comment, 7A U.L.A. 410-12 (1990); see also A. SCOTT & W. FRATCHER, supra note 2, § 297.6.
common law bona fide purchaser requirement and instead imposes liability upon a third party for participating in a breach of fiduciary obligation only if the third party has actual knowledge of the breach or has knowledge of such facts that the third party’s participation in the transaction constitutes bad faith.\(^{49}\) Although the Act does not define the term "bad faith," it defines an act done "in good faith" as "when it is in fact done honestly, whether it be done negligently or not."\(^{50}\) The courts consistently interpret and apply the bad faith test consistent with the bad faith constructive notice concept at common law.\(^{51}\) If the third party knows of facts that raise its suspicions as to the propriety of the transaction, but the third party intentionally decides to avoid investigating further in the hope of avoiding potentially damaging information, the party is charged with the information a diligent inquiry would have revealed.\(^{52}\)

As noted above, and as Horowitz correctly states in the footnote, the Uniform Fiduciaries Act protects third parties acting in good faith in certain types of dealings with the fiduciary.\(^{53}\) The question then is how to interpret the footnote’s statement that section seven "follows, but on a broad front, the more limited precedent . . . set by the Uniform Fiduciaries Act."\(^{54}\) Should this phrase be construed to mean that the limited precedent set by the Uniform Fiduciaries Act is that third parties acting in good faith are protected only in limited types of dealings and that section seven follows this precedent by adopting the good faith requirement and applying it on a broad front to all dealings with a trustee? Or should the phrase be construed to mean that the limited precedent set by the Uniform Fiduciaries Act is that the Act rejected

\(^{49}\) U.F.A. §§ 4-9, 7A U.L.A. 405-17 (1990); supra notes 31-32.


\(^{51}\) Supra note 32.

\(^{52}\) See Davis v. Pennsylvania Co. for Ins. on Lives and Granting Annuities, 337 Pa. 456, 460, 12 A.2d 66, 69 (1940). The court states:

> At what point does negligence cease and bad faith begin? The distinction between them is that bad faith, or dishonesty, is, unlike negligence, wilful. The mere failure to make inquiry, even though there [may] be suspicious circumstances, does not constitute bad faith unless such failure is due to the deliberate desire to evade knowledge because of a belief or fear that inquiry would disclose a vice or defect in the transaction, -that is to say, where there is an intentional closing of the eyes or stopping of the ears.

\(\text{Id. (citation omitted); accord Robinson Protective Alarm Co. v. Bolger & Picker, 512 Pa. 116, 125-26, 516 A.2d 299, 304 (1986); Research-Planning, Inc. v. Bank of Utah, 690 P.2d 1130, 1132 (Utah 1984).}\)

\(^{53}\) Horowitz, supra note 38, at 28 n.153; supra notes 45-48.

\(^{54}\) Horowitz, supra note 38, at 28 n.153.
the broad common law *bona fide* purchaser standard but moved only so far as protecting third parties acting in good faith? Interpreted this way, section seven follows the principle of increased protection for third parties but on a broad front by extending protection to third parties unless they have actual knowledge that the trustee is acting improperly.

The footnote's reference to the Uniform Fiduciaries Act should be construed to mean that the Uniform Trustees' Powers Act follows the limited precedent set by the Uniform Fiduciaries Act by adopting the good faith requirement and extending it to all dealings with a trustee. This is the more reasonable and logical interpretation. This interpretation is supported by the footnote's first two sentences which expressly refer to the good faith requirement and limited duty of inquiry. Moreover, if the proper interpretation were the latter interpretation, inasmuch as the actual knowledge standard does not just follow the standard set forth by the other uniform laws but rather constitutes a new and significantly narrower standard of liability, one would expect a more thorough analysis and justification for the new standard. The only statement even approaching an explanation is the conclusory claim that without greater protection for third parties dealing with a trustee the prudent man standard for the trustees' powers would not work because third parties could not safely deal with the trustee for fear that the trustee was exceeding the trust powers. Again, while this claim is correct with respect to the change section seven made in repudiating the broad common law duty of inquiry based simply upon the third party's notice that it is dealing with a trustee, it does not necessarily follow that the standard to apply should be one of actual knowledge as opposed to good faith. Taken as a whole, the footnote indicates that Horowitz, and no doubt the rest of the Committee, believed that section seven, like the other uniform laws addressing the liability of third parties dealing with a trustee, retained the good faith and limited duty of inquiry requirements.

At first glance the impression created by the footnote appears to be in direct conflict with the accompanying text of the article which discusses section seven. The text of the article expressly provides that

> [i]t is to be noted that constructive knowledge, as distinguished from actual knowledge, is not enough [for a third party to lose the protection of the act]. Therefore, mere suspicion that limitations exist or knowledge of facts which, if pursued, would show that limitations exist do not deprive a third person of this protection.  

55. *Id.*  
56. *Infra* note 94.  
58. *Id.* at 28-29 (footnote omitted).
The key to understanding this text, however, is understanding what Horowitz meant when he used the term "constructive knowledge."

At common law, there are basically two types of constructive knowledge: negligent constructive knowledge, and bad faith constructive knowledge. Negligent constructive knowledge occurs when the party has actual notice of a particular fact or facts which impose upon the party a duty to inquire further, but the party negligently fails to inquire further. Bad faith constructive knowledge occurs when the party has actual notice of a particular fact or facts which impose upon the party a duty to inquire further, but the party intentionally refuses to inquire into the facts in question because the party wants to avoid knowledge or notice of the facts in question. The critical difference between negligent constructive knowledge and bad faith constructive knowledge is that in the former the party charged with constructive knowledge objectively should have inquired further but negligently failed to do so. In the latter, the party charged with bad faith constructive knowledge subjectively knew it should have inquired further but consciously decided not to inquire further in the hope of avoiding potentially damaging information. At common law, it does not matter whether the constructive knowledge is negligent or bad faith, the party is charged with knowledge of those facts which a reasonably diligent inquiry would reveal. On the other hand, the other uniform laws addressing the liability of a third party dealing with a fiduciary reject the broad common law duty of inquiry and liability based upon negligent constructive knowledge, but retain liability based upon bad faith.

Horowitz neither defines the term "constructive knowledge," nor expressly indicates whether the Committee was rejecting liability based upon negligent constructive knowledge or bad faith constructive knowledge or both. A close reading of his use of the term, however, indicates that the Committee was rejecting only liability based on the broad common law negligent constructive knowledge imputed to a third party dealing with a trustee simply because the third party knew or should have known it was dealing with a trustee. In a footnote to his discussion of the Committee's rejection of liability based upon constructive knowledge, Horowitz notes that "[a]t common law, constructive knowledge was enough [to impose liability on the third party for participating in the breach of trust]." In support of that

59. See supra note 32.
60. Id.
61. 2 J. POMEROY, supra note 15, § 605.
62. Id.
63. Supra notes 31-32.
64. Id.
comment, Horowitz cites the reader to a previous footnote which sets forth the general common law duty of inquiry and the negligent constructive knowledge which flows at common law from that general duty of inquiry: "At common law, third persons knowingly dealing with trustees are generally held to a duty of inquiry and are chargeable with constructive knowledge of a trustee's breach of duty which they might reasonably have discovered in the exercise of due care." The statement that the third party is chargeable with the "constructive knowledge" it could have "reasonably . . . discovered in the exercise of due care" corresponds with the broad common law concept of negligent constructive knowledge. When Horowitz uses the term "constructive knowledge," he is referring to the broad common law concept of negligent constructive knowledge, not liability based upon bad faith constructive knowledge.

That Horowitz used the term "constructive knowledge" to mean negligent constructive knowledge is supported by a close reading of the text. After stating that section seven rejects liability based upon constructive knowledge, the text states, "Therefore, mere suspicion that limitations exist or knowledge of facts which, if pursued, would show that limitations exist do not deprive a third person of this protection." Read in connection with the text's prior sentence which expressly rejects liability based upon constructive knowledge, it is clear that the quoted sentence implicitly defines Horowitz's use of the term constructive knowledge as negligent constructive knowledge. More importantly, this definition tracks the language the courts have repeatedly and consistently used when applying the bad faith standard contained in the other uniform laws, to indicate the difference between a party's negligent failure to inquire as opposed to a party's bad faith. The courts have repeatedly and consistently held that a third party's mere suspicion of an adverse interest constitutes at best negligence and does not constitute bad faith on the part of the third party dealing with the fiduciary. Therefore, the text's express rejection of liability based upon mere suspicions indicates that the Committee rejected only the broad common law negligent constructive knowledge which was imputed to a third party simply because the third party was dealing with

66. Id.
67. Id. at 4 n.24.
68. Id. at 28 (footnote omitted).
69. For U.F.A. cases, see supra note 52; for U.C.C. article 3 cases, see Valley Nat'l Bank v. Porter, 705 F.2d 1027, 1029 (8th Cir. 1983); Scarsdale Nat'l Bank & Trust Co. v. Toronto-Dominion Bank, 533 F. Supp. 378, 386 (S.D.N.Y. 1982) and cases cited in U.C.C. § 3-302 n.6 (1977); for U.C.C. article 8 cases, see In re Legel, Braswell Gov't Sec. Corp., 648 F.2d 321, 328-29 (5th Cir. 1981); Matthysse v. Securities Processing Serv., Inc., 444 F. Supp. 1009, 1021-22 (S.D.N.Y. 1977) and cases cited in U.C.C. § 8-302 n.4 (1977).
a trustee. The text's discussion of section seven is consistent with the position that the Committee believed that section seven contained the good faith and limited duty of inquiry requirements.

That Horowitz's use of the term constructive knowledge should be construed to mean negligent constructive knowledge is further supported by the footnotes accompanying the text. Construing the term constructive knowledge to mean negligent constructive knowledge avoids any conflict between the text and the accompanying footnote's references to the good faith requirement and the Uniform Fiduciaries Act. Further, Horowitz's whole discussion of the changes effected by section seven is but several conclusory sentences. While the sentences note the changes between section seven and the common law, the sentences make no reference to any changes between section seven and the corresponding provisions of the other uniform laws addressing the liability of a third party dealing with a fiduciary. If section seven were intended to be a break with the prevailing good faith and limited duty of inquiry standard set forth in the other uniform laws, one would expect Horowitz at least to note the difference and present some analysis of the reasons for the break from the other uniform laws.

Therefore, based upon Horowitz's comments as Chairman of the Special Committee responsible for drafting the Uniform Trustees' Powers Act, it is apparent the Committee believed that section seven retained the good faith and limited duty of inquiry requirements. The Committee focused on the indisputable need to reject the broad common law duty of inquiry and the negligent constructive knowledge which flowed from this duty. There is no evidence that the Committee specifically rejected or even considered the prevailing good faith and limited duty of inquiry standard of liability adopted by the other uniform laws. Instead, the Committee thought section seven contained the good faith and limited duty of inquiry requirements. Moreover, the draft of the Uniform Trustees' Powers Act which came out of the Special Committee responsible for drafting the legislation was adopted by the National

70. See supra notes 45-47.
71. Horowitz, supra note 38, at 28-29.
72. Id.
73. Horowitz repeatedly footnotes the whole discussion of § 7 back to his earlier footnote discussion of the common law duty of inquiry. Horowitz, supra note 38, at 28-29 & nn. 152-57. With respect to the common law duty of inquiry, Horowitz noted: "At common law, third persons knowingly dealing with trustees are generally held to a duty of inquiry and are chargeable with constructive knowledge of a trustee's breach of duty which they might reasonably have discovered in the exercise of due care." Id. at 4 n.24. Again, the focus is on the constructive knowledge arising out of the common law duty of inquiry. There is no evidence that the Special Committee responsible for drafting section seven considered the duty of inquiry implicit in the bad faith standard of liability.
Conference of Commissioners on Uniform State Laws without discussion. Accordingly, the only available direct evidence from the drafting process itself indicates that section seven's actual knowledge with absolutely no duty of inquiry standard appears to have been more of a mistake than the result of a carefully researched and analyzed decision.

The only other evidence which may shed some light on the issue of whether the Committee knowingly rejected the good faith and duty of inquiry requirements or whether their rejection was accidental is a 1962 article by Professor William F. Fratcher, one of the leading authorities on the law of trusts. Although not an official part of the Special Committee's decision-making process, Professor Fratcher's article appears to have played a significant role in the Special Committee's drafting process. Horowitz's article expressly acknowledges that the Uniform Trustees' Powers Act in general, and the no duty of inquiry and actual knowledge standard for third party liability in particular, are based upon Professor Fratcher's article. If Professor Fratcher's article presents a clear statement that the no duty of inquiry and actual knowledge standard is a break from the prevailing standard expressed in the other uniform laws, and if the article presents a thorough analysis of the reasons for the break, then one must assume that the Committee's adoption of Professor Fratcher's article as the basis for the Uniform Trustees' Powers Act includes this analysis. On the other hand, if Professor Fratcher's article does not present a clear and thorough discussion of the no duty of inquiry and actual knowledge standard, this omission only further supports the position that the Committee not only did not realize section seven killed the good faith and limited duty of inquiry requirements but that in fact the Committee thought that section seven retained the good faith and limited duty of inquiry requirements.

74. 1964 HANDBOOK, supra note 36, at 133.
76. It is impossible in a footnote to do justice to Professor Fratcher's contributions to the law of trusts and estates. As this Article implicitly states, for all practical purposes Professor Fratcher adhered the U.T.P.A., and he was one of the reporters who drafted the Uniform Probate Code. For a more thorough discussion of Professor Fratcher's contributions to the law of trusts and estates, see the tribute to Professor Fratcher in the Missouri Law Review on the occasion of his retirement from the faculty. 48 Mo. L. REV. 313, 313-24 (1983).
77. Horowitz's Uniform Trustees' Powers Act article cites Professor Fratcher's Trustees' Powers Legislation article fifty-nine times; see also 1964 HANDBOOK, supra note 36, at 265, wherein the Uniform Law Commissioners' Prefatory Note to the U.T.P.A. expressly provides that "for a basic review of the underlying theory of the Uniform Trustees' Powers Act, see Professor William F. Fratcher's article entitled Trustees' Powers Legislation."
78. Horowitz, supra note 38, at 1, 7-8.
An examination of Professor Fratcher’s article reveals that not only does the article not clearly indicate that the no duty of inquiry and actual knowledge standard constitute a significant break from the other uniform laws addressing the liability of a third party dealing with a fiduciary. The article implies the exact opposite: that the no duty of inquiry and actual knowledge standard is the prevailing standard in the other relevant uniform laws. The article downplays the significance of the no duty of inquiry and actual knowledge standard and presents no analysis of why the no duty of inquiry and actual knowledge standard, as opposed to the prevailing good faith and limited duty of inquiry standard, is necessary.

D. Professor Fratcher’s Trustees’ Powers Article: The Apparent Source of the Special Committee’s Confusion

Over Section Seven’s Standard of Liability for Third Parties Dealing with a Trustee

In 1962, Professor Fratcher authored a comprehensive and detailed article which severely criticized the common law restrictive rules with respect to trustees’ powers as archaic, inefficient and inapplicable to the increasingly common investment trust. Professor Fratcher similarly criticized the common law duty of inquiry as "the great barrier to third party participation and assistance in trustees’ transactions." With respect to the issue of trustees’ powers, Professor Fratcher advocated legislative adoption of a broad prudent man standard: "to confer upon every trustee power to do whatever a prudent man would do in the management of his own property for the trust purposes." Recognizing that such broad powers would be ineffective without correspondingly broad protection for third parties interested in dealing with trustees, Professor Fratcher argued for the abolition of the common law duty of inquiry and for the adoption of the actual knowledge standard of liability:

The Uniform Fiduciaries Act and the Uniform Commercial Code have abolished the duty of inquiry in virtually all transactions concerning negotiable instruments and investment securities, but little has been done as

79. See infra notes 105-09 and accompanying text.
80. Id.
81. Fratcher, supra note 75, at 627-57.
82. Id. at 662; see also id. at 645-64.
83. Fratcher, supra note 75, at 660.
84. "No matter how broad his powers may be, a trustee cannot enter into transactions involving third parties unless the third parties are willing to deal with or assist him." Id. at 662.
to other types of transactions. One who purchases half a million dollars worth of corporate bonds from a trustee need not inquire into his powers to sell and to give a receipt for the price, but one who buys a pig or a rocking chair at a trustee's auction is bound to study the terms of the trust and determine at his peril their correct legal meaning. The duty of inquiry is especially onerous in land transactions because, if notice of a trust appears in the chain of title, not only the original purchaser from the trustee but every subsequent purchaser must diligently inquire into his powers. Might it not be better to eliminate the duty of inquiry in all transactions with trustees and make third parties who engage or assist in such transactions liable to the cestui que trust only when they have actual knowledge that the trustee is committing a breach of trust? 85

The quoted excerpt constitutes the whole discussion presented by Professor Fratcher with respect to his proposed no duty of inquiry and actual knowledge standard. In light of the prominent role played by the duty of inquiry and good faith requirements at common law, 86 and the prevailing limited duty of inquiry and good faith requirements contained in the other uniform laws addressing the liability of third parties dealing with a fiduciary, 87 the article's discussion of both the proposed no duty of inquiry and the proposed actual knowledge standard of liability arguably is inadequate.

First, with respect to the duty of inquiry, although Professor Fratcher notes that both the Uniform Fiduciaries Act and the Uniform Commercial Code have abolished the duty of inquiry in virtually all transactions with trustees, 88 he recommends abolishing the duty of inquiry in all transactions with trustees. 89 Yet Professor Fratcher fails to address why the Uniform Trustees' Powers Act should abolish the duty of inquiry in all transactions. 90 Why should not the Uniform Trustees' Powers Act expressly preserve, as the Uniform Fiduciaries Act and the Uniform Commercial Code do, a limited duty of inquiry in cases where the transaction is prima facie wrongful? 91

Second, there is no real analysis or explanation for why Professor Fratcher proposes the actual knowledge standard. By juxtaposing the references to the Uniform Fiduciaries Act and the Uniform Commercial Code

85. Id. at 662-63 (footnotes omitted).
86. See supra notes 15-20.
87. Supra notes 23-33.
88. Fratcher, supra note 75, at 662-63.
89. Id.
90. Id.
91. Supra note 28. Fratcher himself acknowledges this limited duty of inquiry where the third party has "knowledge that the transaction is for the individual benefit of the trustee or otherwise in breach of trust." Fratcher, supra note 75, at 648 (footnote omitted).
with the proposal for the actual knowledge standard, the article implies that these other uniform acts apply the actual knowledge standard; but that is not the case. Both the Uniform Fiduciaries Act and the Uniform Commercial Code require good faith by a third party dealing with a trustee. At least with respect to the proposed no duty of inquiry, a careful reading of Professor Fratcher’s proposal indicates that it constitutes a break with the prevailing standard in the other uniform laws addressing the liability of a third party dealing with a fiduciary. With respect to the proposed actual knowledge standard, however, the proposal, and for that matter the whole article, never indicates that the actual knowledge standard constitutes a break with the prevailing good faith standard in the other uniform laws.

92. Fratcher, supra note 75, at 662-63.
93. See supra note 6.
94. The inadequacy of the article’s discussion of the proposed no duty of inquiry and actual knowledge standard is so obvious, it prompts the obvious question of why the article did not present a more thorough analysis of the proposal. There are three possible explanations.

The first possible explanation for the lack of a more thorough analysis of the no duty of inquiry and actual knowledge standard is that Professor Fratcher did not really intend to eliminate completely the good faith and limited duty of inquiry requirements. Like the Special Committee responsible for drafting the U.T.P.A., Professor Fratcher could have simply been using the term ‘actual knowledge’ loosely and assumed that it would be interpreted to include the good faith and limited duty of inquiry components. But this explanation is difficult to accept. In the same paragraph in which Professor Fratcher proposes his no duty of inquiry and actual knowledge standard, he notes that the U.F.A. and the U.C.C. have not completely abolished the duty of inquiry. Fratcher, supra note 75, at 662-63. In both of these uniform laws, the limited duty of inquiry is inherently reserved in both the ‘absence of notice’ requirement and in the good faith requirement. See supra notes 27-28. In addition, these other uniform laws either expressly set forth the good faith requirement or do so implicitly by imposing liability if the third party has "actual knowledge" that the transaction constitutes a breach of fiduciary obligations or if the third party is acting in "bad faith." See supra note 6. No doubt Professor Fratcher was well aware of the exact language used in the other prevailing uniform laws and would have likewise included an express language creating a good faith or limited duty of inquiry component if he had intended to retain either requirement.

Another possible explanation for the lack of a more thorough discussion of the no duty of inquiry and actual knowledge standard is that Professor Fratcher really had not thought much about the standard of liability for a third party dealing with a trustee, and he was simply throwing out the no duty of inquiry and actual knowledge standard as a preliminary proposal for discussion. This possibility is supported by the manner in which the standard was proposed. The proposal is phrased as a question, with the introductory phrase "might it not be better" implying that this is simply a preliminary idea for consideration and debate. Fratcher, supra note 75, at 662. On the other hand,
Professor Fratcher himself emphasized in his article that the standard of liability for a third party dealing with a trustee is critical to the success of his principal proposal that the trustee inherently have all the powers that a prudent man would have with respect to his own affairs. *Id.* at 658, 662. To then say that Professor Fratcher had not really thought much about what would be the appropriate standard of liability for a third party dealing with a trustee is difficult to accept. Moreover, this was not the first time Professor Fratcher had proposed the actual knowledge standard. Professor Fratcher had previously analyzed the issue of the standard of liability for third parties dealing with guardians and had presented a more thorough analysis of the issue and a more detailed argument that such third parties should be protected against liability "in the absence of actual knowledge of wrongdoing." Fratcher, *Powers and Duties of Guardians of Property*, 45 Iowa L. Rev. 264, 329 (1960). Clearly Professor Fratcher had thought through the actual knowledge standard of liability.

One last possible explanation for the lack of a more thorough explanation of the no duty of inquiry and actual knowledge standard is that Professor Fratcher knew exactly what he was doing when he rhetorically recommended the no duty of inquiry and actual knowledge standard; he was proposing a radically new standard of liability for third parties dealing with a trustee. There is no direct evidence to support this possibility, but there is ample circumstantial evidence. First, as noted above, it is difficult to believe that a person of Professor Fratcher’s standing in the area of the law of trusts would either be sloppy in his use of the term actual knowledge or would not have thought seriously about the standard of liability for third parties dealing with a trustee. In drafting his landmark article on trustees’ powers legislation, Professor Fratcher no doubt thought long and hard about the standard of liability for third parties dealing with a trustee in the context of his proposal for the scope of the trustees’ powers. Professor Fratcher’s trustees’ powers proposal was driven by the goal of maximizing trust administration effectiveness and efficiency:

In this country today trusts are commonly created for the investment and active management of a fund. The settlor is not interested in keeping particular land or other property in the family or in preserving its ancient condition. He ordinarily intends that the trustee shall have *all powers needed for efficient and economical management* with a view to production of adequate income and enhancement of the principal for the benefit of the cestuis que trust. . . . [I]n the absence of legislative augmentation of trustees’ powers, *effective trust administration is too often prevented by actual lack of power to enter into desirable transactions or by what is equally obstructive, fear on the part of the trustee or those who deal with him that he lacks the power to act.*

Fratcher, *supra* note 75, at 658 (emphasis added).

Professor Fratcher dismissed other legislative attempts at augmenting the trustees’ powers as inefficient for the effective administration of the trust. *Id.* at 659. He concluded that the "only wholly adequate solution" to the problem is the grant the trustee all the powers which a prudent man would have for the efficient management of his own property. *Id.* at 660.
Just as Professor Fratcher strove to maximize the powers of the trustee so as to maximize the efficient and effective administration of the trust, for those powers to be effective Professor Fratcher needed to maximize the protection afforded third parties interested in dealing with the trustee. For without adequate protection, third parties would be deterred from transacting with a trustee, thereby undermining the efficient and effective administration of the trust. \textit{Id.} at 662. Given that the premise of the U.T.P.A. is to maximize the efficient administration of the trust, the logical standard of liability for third parties dealing with a trustee then would be complete immunity, even when there is actual knowledge that the transaction constitutes a breach of trust. Complete immunity is necessary because as long as there is any liability exposure, the third party may hesitate and even decide not to transact with a trustee. Any obstacle to transacting with a trustee hurts trust administration efficiency. Therefore, the logical standard of liability for third parties dealing with a trustee is complete immunity. Yet, why did Professor Fratcher nonetheless recommend the actual knowledge standard and not complete immunity?

There is no evidence, direct or circumstantial, that indicates why Professor Fratcher settled on the actual knowledge standard instead of complete immunity. The most logical explanation is that the actual knowledge standard may have been a political compromise based on the realization that the Uniform Law Commission would never adopt the complete immunity standard, but the Commission might adopt the actual knowledge standard without realizing the significance of the standard. Complete immunity, even when there is actual knowledge that the transaction constitutes a breach of trust, is not just a significant departure from prevailing law, it is revolutionary. Complete immunity for third parties dealing with a trustee would have been a controversial proposal which would have stood out like a red flag. A complete immunity proposal would have attracted widespread attention and no doubt criticism, thereby providing extra ammunition for those critics who already thought Professor Fratcher was going too far on the issue of the trustees' powers. \textit{See} Hallgring, \textit{The Uniform Trustees' Powers Act and the Basic Principles of Fiduciary Responsibility}, 41 \textit{WASH. L. REV.} 801, 801-02 (1966); Haskell, \textit{Some Problems with the Uniform Trustees' Powers Act}, 32 \textit{LAW \\& CONTEMP. PROBS.} 168, 168 (1967). The complete immunity standard would have jeopardized the principal part of Fratcher's proposal: the prudent man standard with respect to trustees' powers. Rather than risking jeopardizing the whole concept, Professor Fratcher may have decided to compromise a bit on the issue of the standard of liability for third parties dealing with a trustee.

Accordingly, instead of proposing complete immunity, Professor Fratcher may have opted for the actual knowledge standard since in practice the actual knowledge standard is very close to complete immunity. "It will rarely happen that a knowledge of the fraud, or other fatal vice, can be brought home to the purchaser by positive evidence . . . ." Pringle v. Phillips, 7 N.Y. Super. Ct. (5 Sandf.) 157, 172 (1851), \textit{quoted in} G. BOGERT, \textit{supra} note 2, § 894. As between complete immunity and the good faith standard adopted by the other uniform laws addressing the liability of third parties dealing with a fiduciary, the actual knowledge standard is closer to the complete immunity standard than it is to the good faith standard. Under the good faith
standard of liability, there is always the risk that while there may be no direct evidence that the purchaser had actual knowledge that the trustee was acting improperly, the circumstantial evidence may be strong enough that the jury may be convinced that the purchaser's failure to inquire could not have been the result of negligence but rather only the result of a bad faith desire to avoid potentially damaging information. *Id.*

On the other hand, under the actual knowledge standard with absolutely no duty of inquiry, in the absence of direct evidence of actual knowledge on the part of the third party, evidence which is rarely present, there is no possibility of second guessing by the jury. Therefore, the actual knowledge with absolutely no duty of inquiry does provide substantially greater security to a third party dealing with a trustee, thereby facilitating transactions between third parties and trustees, which in turn promotes the basic premise underlying the U.T.P.A.—to maximize the efficient and effective administration of the modern day investment oriented trust. Although the actual knowledge standard is still a significant departure from common law and the other prevailing uniform laws, on its face the actual knowledge proposal does not stand out as a departure from the other prevailing uniform laws.

It should be noted that the theory that Professor Fratcher wanted complete immunity for third parties dealing with a trustee but compromised on actual knowledge when he proposed the trustees' powers legislation is complete speculation based upon lack of a more reasonable explanation for the actual knowledge standard. There is no direct evidence that at the time Professor Fratcher proposed the prudent man standard for the scope of the trustees' powers he wanted complete immunity for third parties dealing with a trustee and that he compromised on the actual knowledge standard. Moreover, there is no direct evidence that he intentionally downplayed the significance of the actual knowledge standard. There is, however, direct evidence that not too long after the Uniform Law Commissioners adopted and promulgated the U.T.P.A., Professor Fratcher wished and argued for complete immunity for third parties dealing with a trustee.

In 1974, Professor Fratcher adhered the chapter on Trusts in the INT'L ENCYCLOPEDIA OF COMPARATIVE LAW. W. FRATCHER, Trusts, in IV INT'L ENCYCLOPEDIA OF COMPARATIVE LAW (F. Lawson ed. 1972). In contrast to his 1962 article which downplays the significance of his no duty of inquiry and actual knowledge proposal, the 1974 work highlights that the no duty of inquiry constitutes a significant break with and improvement over other legislation and uniform laws protecting third parties dealing with trustees. In particular, Professor Fratcher clearly points out that while the other legislation protecting third parties retains a duty of inquiry where the third party has "knowledge that the transaction is for the individual benefit of the trustee or otherwise in breach of the trust.... [T]he Uniform Trustees' Powers Act... abolishes altogether the duty of third persons to inquire into trustees' powers and the propriety of their exercise." *Id.* at 82-83. That Professor Fratcher considers § 7 unique and important is brought home by the fact that Professor Fratcher then sets forth the entire § 7 of the U.T.P.A. verbatim. *Id.* at 83. In his eighty-three-page discussion of the common law origins of and statutory modifications to the Anglo-American law of trusts, with hundreds of citations to over one hundred different statutory modifications to the common law of trusts, § 7 of the U.T.P.A. is one of only a handful of historic statutory provisions which he deemed worth setting forth in full.

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Just after singing the praises of § 7 with respect to its abolition of the duty of inquiry, however, Professor Fratcher implicitly attacks § 7 and its actual knowledge standard of liability by arguing rhetorically for complete immunity for third parties dealing with a trustee:

It should be noted that the legislation just discussed, both BRITISH and AMERICAN [the latter including cites to the Uniform Fiduciaries Act, the Uniform Commercial Code, the Uniform Act for the Simplification of Fiduciary Security Transfers, and the Uniform Trustees’ Powers Act], relieves third persons of the duty of inquiry but preserves the rule that a third person who participates with or assists a trustee in a transaction involving a breach of trust, with notice of the breach, incurs virtually the same liability to the beneficiary which the trustee is subject . . . .

We are still left with the rule that a third person who deals with or assists a trustee in a transaction with notice that it involves a breach of trust incurs substantially the same liability for the breach as the trustee himself. Is this a desirable rule? Liability (sic) is not imposed on one who sells a mink coat to a married man merely because he has notice that the purchaser intends to give it to his mistress. Liability is not imposed on one who buys a house from a corporation merely because he has notice that the corporation plans to pay excessive salaries to its officers. Liability is not imposed on one who buys an automobile from a dealer merely because he has notice that the seller does not plan to pay his income tax. If persons who deal with trustees are subject to liabilities which would not arise in the absence of a trust, the ability of trustees to persuade others to deal with them on advantageous terms and, hence, to manage the trust property as a prudent man would his own, is impaired. To the extent that this ability is impaired, all trust beneficiaries are injured. The settlor of a trust entrusts the trustee with legal ownership of the trust property because he considers him trustworthy. In most cases he is. Is the protection afforded trust beneficiaries by the rule that third persons who deal with a trustee are, in effect, guarantors of the trustees' prudence and fidelity, worth its cost in terms of impairing the efficiency of trust administration?

Id. at 83 (emphasis added).

The quoted material is significant for two reasons. First, the opening sentence of the quoted material implicitly lumps together the broad common law notice standard with both the other uniform laws’ good faith standard and the U.T.P.A.’s actual knowledge standard. Could it be that Professor Fratcher viewed the increased protection afforded the third parties by the respective uniform laws, be it the good faith standard or the actual knowledge standard, as indistinguishable from the common law notice standard? While Professor Fratcher specifically notes and emphasizes that the other uniform laws have relieved third parties of the broad common law duty of inquiry and impose the duty of inquiry only in limited circumstances, he fails specifically even to note the fact that the other uniform laws have rejected the broad notice component of the common law bona fide purchaser requirement in favor of a...
Moreover, the manner in which Professor Fratcher's article presents the no duty of inquiry and actual knowledge proposal minimizes the chances that one reading the proposal would realize that the no duty of inquiry and actual knowledge standard is a departure from the other prevailing uniform laws. The no duty of inquiry and actual knowledge proposal is juxtaposed with: (1) Professor Fratcher's discussion of the evils of the broad common law duty of inquiry based simply upon notice that one is dealing with a trustee, and (2) Professor Fratcher's discussion of the Uniform Fiduciaries Act and the Uniform Commercial Code. The juxtaposition implies: (1) that the complete termination of the duty of inquiry logically flows from the repudiation of the broad common law duty of inquiry, and (2) that the Uniform Fiduciaries Act and the Uniform Commercial Code have adopted the actual knowledge standard. There are problems, however, with respect to both implications.

more limited good faith standard. This treatment of the other uniform laws is particularly confusing in light of the fact that in discussing the English statutes which grant protection to third parties dealing with a trustee, Professor Fratcher repeatedly notes that the English statutes require the third party to be acting in good faith. Id. at 81-82. Why Professor Fratcher fails to distinguish among the broad common law notice standard, the prevailing uniform law good faith standard, and the U.T.P.A.'s actual knowledge standard is unclear.

If Professor Fratcher actually believed that there is no significant difference among the standards, that may explain his failure to discuss his actual knowledge standard in his 1962 proposal. This explanation, however, creates only greater confusion with respect to how § 7 of the U.T.P.A. should be interpreted, and further supports the position that the Special Committee responsible for drafting § 7 may have believed that it contained the good faith and limited duty of inquiry requirements.

In the alternative, Professor Fratcher may not have distinguished among the different standards because he believed that there is no reason to distinguish among them. Any standard of liability short of complete immunity is inefficient in terms of trust administration and therefore is unacceptable if one accepts maximizing trust administration efficiency as the ultimate goal. Just as the trustee should be free to deal with the trust property as he or she would their own—as if there were no trust or trust beneficiaries at all—third parties should be free to deal with the trustee and trust property as if there were no trust or trust beneficiaries at all. If Professor Fratcher did not hold this position in 1962 when he proposed the trustees' powers legislation, he certainly held it not too long thereafter. On the other hand, if Professor Fratcher held this position in 1962, one can assume only that his actual knowledge proposal constituted a compromise which he thought would be more acceptable than the more controversial and noticeable complete immunity standard.

95. While the proposal's presentation implies these conclusions, the proposal does not to state that such is the case.
In particular, with respect to the duty of inquiry, the proposal focuses the reader's attention on the apparent inconsistency between abolishing the duty of inquiry for one who purchases a million dollars in corporate bonds from a trustee while imposing the duty of inquiry where one purchases a pig or rocking chair at a trustee’s auction. The article then asks the obvious question: "Might it not be better to eliminate the duty of inquiry in all transactions...?" That both situations should be treated the same follows logically from the apparent inconsistency in the two transactions with respect to the duty of inquiry; the problem is that the apparent inconsistency is not a completely accurate statement of the law. Although a third party purchasing corporate bonds from a trustee need not inquire into the trustees’ powers simply because the third party is dealing with a trustee, a third party purchasing corporate bonds must inquire into the trustees’ powers if the third party has knowledge that the transaction is for the personal benefit of the trustee or otherwise in breach of trust. Moreover, one purchasing corporate bonds from a trustee must be acting in good faith, with good faith defined as the absence of bad faith. Although bad faith is not expressly defined in terms of the duty of inquiry, bad faith evolved out of the notice component of the common law bona fide purchaser requirement and inherently contains

96. Fratcher, supra note 75, at 662.
97. Id. at 662-63.
98. Although one could argue there is a meaningful difference in the transactions in the nature of the transactions, the commercial paper and investment securities covered by the U.C.C. are unique commodities that require special treatment. The same is true of the negotiable instruments covered by the U.F.A. A modern investment-oriented society needs to be able to act quickly and dependably with respect to such commodities. The same is not necessarily true, or at least not to the same degree, with respect to the purchase of a pig or rocking chair at a trustee’s auction.
99. The transfer of corporate bonds is regulated by the U.C.C. Which provision of the Code governs depends on the circumstances surrounding the sale of the bond. "[A] bond in bearer form which is a negotiable instrument and governed by Article 3 could become an investment security [governed by Article 8] if it is one of a series and is traded on an exchange." E.F. Hutton & Co. v. Manufacturers Nat'l Bank, 259 F. Supp. 513, 517 (E.D. Mich. 1966). Regardless of which article governs, both articles require a limited duty of inquiry where the party "has knowledge that a fiduciary has negotiated the instrument in payment of or as security for his own debt or in any transaction for his own benefit or otherwise in breach of duty." U.C.C. § 3-304 (1977); accord U.C.C. § 8-304 (1977).
an inquiry component. Accordingly, to say that one purchasing corporate bonds from a trustee need not inquire into the trustees' powers overstates the standard of protection accorded third parties under the Uniform Commercial Code. Therefore, the question, "Might it not be better to eliminate the duty of inquiry in all transactions with trustees . . .?" really does not follow at all from the discussion preceding it. Although the unsuspecting reader interprets the foregoing question to mean: "Might it not be better to treat both of these situations the same . . .?", in fact the proposal asks a completely different question: "Might it not be better to eliminate the duty of inquiry in

102. Bad faith is tantamount to the common law's bad faith constructive knowledge. See Scarsdale Nat'l Bank & Trust Co. v. Toronto-Dominion Band, 533 F. Supp. 378 (S.D.N.Y. 1982); see also supra note 69. The official comments to the U.F.A. make it clear that the concept of bad faith relates directly to the issue of a third party's duty to inquire as to the propriety of the transaction. The official comments provide that absent knowledge that the transaction if for the personal benefit of the fiduciary, the

 presumption should be that the transaction is proper and the presumption should be rebutted only by proof of actual knowledge that it is improper, or proof of bad faith. The taker should be liable not only where he has actual knowledge that the fiduciary is acting improperly but also where he acts in bad faith, as for example, where he suspects that the fiduciary is acting improperly and deliberately refrains from investigating in order that he may avoid knowledge that the fiduciary is acting improperly. The test however should not be the objective test of negligence but the subjective test of bad faith.


103. Although the proposal does not expressly cite the Uniform Act for Simplification of Fiduciary Security Transfer, it could also apply to the purchase of corporate bonds. The Uniform Act for Simplification of Fiduciary Security Transfer provides expressly for complete protection and for no duty of inquiry under any circumstances for a corporation and transfer agent involved in the transfer of stock held by a fiduciary. The Act also affects third parties who participate in the transfer. The Act provides expressly that these third parties are not liable for participation in a breach of fiduciary duty by reason of failure to inquire into whether the transaction involves a breach unless it is shown that he acted with actual knowledge that the proceeds of the transaction were being used for the individual benefit of the fiduciary or that the transaction was otherwise in breach of duty.


The prefatory notes and history to the Act indicate that the Act was intended to protect the parties involved in the process necessary to transfer the security, but not the ultimate purchaser of the security. See UNIFORM ACT FOR SIMPLIFICATION OF FIDUCIARY SECURITY TRANSFER PREFATORY NOTE, 7B U.L.A. 690-93; A. SCOTT, Participation in Breach of Trust, in 1958 TRUSTS AND ESTATES 1114, 1114-16 (1958).
all transactions . . . ?" Despite the impression created that the elimination of the duty in all transactions follows logically from the fact that the duty had already been eliminated in some transactions, in reality the duty of inquiry had not been completely eliminated in any transaction for any third party dealing with a trustee.104 The complete elimination of the duty of inquiry for all third parties dealing with a trustee constituted a completely new and significant development in the law of trusts. Inasmuch as Professor Fratcher himself carefully noted that the Uniform Fiduciaries Act and the Uniform Commercial Code had not completely eliminated the duty of inquiry in all transactions concerning negotiable instruments and investment securities,105 one would have expected more of an explanation of why he proposed the complete elimination of the duty in all other transactions involving a trustee.

Just as juxtaposing the discussion of the Uniform Fiduciaries Act and the Uniform Commercial Code with the proposal for no duty of inquiry implies that these other uniform laws had adopted the no duty of inquiry standard, juxtaposing the actual knowledge standard right after the no duty of inquiry proposal likewise implies that these other uniform laws had adopted the actual knowledge standard. This implication is reinforced by Professor Fratcher's earlier discussion of the general common law rules governing third parties transacting with trustees, and by his discussion of the other legislative measures which had modified the common law rules and accorded greater protection to third parties dealing with a trustee. In defining and discussing the common law bona fide purchaser rule, Professor Fratcher does not expressly include a reference to the requirement that the third party be acting in good faith.106 In discussing the other statutory modifications of the common law bona fide purchaser rule, Professor Fratcher discusses a number of changes effected by the different state and uniform laws, but conspicuously absent is any discussion of the good faith requirement.107 Despite repeated references and citations to the Uniform Fiduciaries Act and the Uniform Commercial Code, not once does the article acknowledge the good faith requirement of these other uniform laws.108 Accordingly, when the actual knowledge proposal follows the discussion of the Uniform Fiduciaries Act and the Uniform Commercial Code, the implication is that these uniform laws adopt the actual knowledge standard. As noted above, however, this is not the case. Both the Uniform Fiduciaries Act and the Uniform Commercial Code require good faith.109 Inasmuch as both the Uniform Fiduciaries Act and the

104. See UNIFORM PREFATORY NOTE, supra note 103, at 690-93.
105. Fratcher, supra note 75, at 662.
106. Id. at 645.
107. Id. at 647-49.
108. Id. at 648-49.
109. Supra note 6.
Uniform Commercial Code retain the good faith requirement, one would expect more of an explanation of why Professor Fratcher rejected the good faith requirement in favor of the actual knowledge standard.

This historical examination of section seven of the Uniform Trustees’ Powers Act produces a rather interesting conclusion: although the express language of section seven is clear and unambiguous, when evaluated in light of its legislative background section seven is anything but clear and unambiguous. While the Uniform Law Commission clearly intended to reject the broad common law duty of inquiry and *bona fide* purchaser requirements, there is no evidence that the Commission intended to reject the limited duty of inquiry and good faith requirements prevailing in the other uniform laws addressing the liability of third parties dealing with a fiduciary. Moreover, the only comments attributable to the Commission indicate that the Commission thought that section seven contained the limited duty of inquiry and good faith requirements. The latent ambiguity in section seven apparently stems from the Commission’s blind acceptance of Professor Fratcher’s 1962 proposal that the appropriate standard of liability for third parties dealing with a trustee should be an actual knowledge with absolutely no duty of inquiry standard. The Commission’s blind acceptance of this proposal would be forgivable if Professor Fratcher’s proposal contained a thorough analysis and justification for this standard of liability. Unfortunately, Professor Fratcher’s proposal contained no such analysis. The Commission’s blind acceptance of Professor Fratcher’s proposal may be forgivable, however, for another reason: Professor Fratcher’s third party liability proposal is presented so cryptically, one may forgive the Commission for not realizing the significance of the actual knowledge with no duty of inquiry standard. Why Professor Fratcher presented his proposal so cryptically is unclear, but the conclusion that the Commission failed to realize the significance of the proposal is clear. There is no evidence that the Uniform Law Commission knowingly and consciously rejected the prevailing limited duty of inquiry and good faith standard contained in the other uniform laws addressing the liability of third parties dealing with a fiduciary.

The historical background of section seven is not only interesting in its own right, but it also has current relevance. At first glance, this claim of current relevance may seem a bit strange. The Uniform Law Commission adopted and promulgated the Uniform Trustees’ Powers Act in 1964. The Act has been adopted in 16 states and there is no evidence that the actual


111. As of July 1, 1990 the following states had adopted the U.T.P.A.: Arizona, *ARIZ. REV. STAT. ANN.* §§ 14-7231 to -7237 (1989); California, *CAL. PROB. CODE* § 18,100 (West 1990); Florida, *FLA. STAT. ANN.* §§ 737.401-.407 (West 1990); Hawaii, *HAW. REV. STAT.* § 554A-7 (1985); Idaho, *IDAHO CODE* §§ 68-104 to -113 (1989);
knowledge with no duty of inquiry standard has been problematic; there has been no outcry for revision of the provision. But just as the apparent clarity of section seven belies its latent ambiguity, the apparent success of section seven belies its latent ineffectiveness.

III. ANALYTICAL CRITIQUE OF SECTION SEVEN OF THE UNIFORM TRUSTEES' POWERS ACT

A. The Conflict Between Section Seven of the Uniform Trustees' Powers Act and the Corresponding Provisions of the Other Uniform Laws Renders Section Seven Ineffective

The latent ineffectiveness of section seven of the Uniform Trustees' Powers Act stems from the fact that section seven not only differs from the corresponding provisions of the other uniform laws, but also overlaps with the conflicting corresponding provisions to a degree. Faced with this conflict and the resulting uncertainty over which standard governs, third parties interested in dealing with a trustee no doubt conform their conduct to the higher standard of the other uniform laws. The net result is that section seven of the Uniform Trustees' Powers Act is ineffective in terms of affecting the dealings between third parties and trustees.

By way of example, what if a third party is interested in purchasing a negotiable instrument from a trustee, but the third party has actual knowledge of facts which raise a strong suspicion in the third party's mind that the sale is in breach of the trustee's fiduciary obligations. The trustee, however, is offering the negotiable instrument at such an attractive price, the third party decides not to inquire further into the propriety of the transaction for fear of


California has modified § 7 of the U.T.P.A. to include a requirement that the third party act in good faith. See Cal. Prob. Code § 18,100 (West 1990).

112. To date there are no cases addressing or even acknowledging either the latent ambiguity in § 7 of the U.T.P.A. or the conflict between § 7 and the corresponding provisions of the U.C.C. and the U.F.A.
acquiring actual knowledge that the transaction constitutes a breach of trust. If the third party purchases the instrument, and the transaction in fact constitutes a breach of trust by the trustee, which uniform law governs the liability of the third party: the Uniform Trustees’ Powers Act, because the third party is dealing with a trustee, or the Uniform Commercial Code, article 3, because the transaction involves the transfer of a negotiable instrument?

What if a bank has actual knowledge of facts which raise a strong suspicion in the bank's mind that a trustee may be misappropriating trust funds in breach of the trustee's fiduciary obligations. The bank does not want to inquire into the propriety of the trustee's use of the withdrawn funds, however, because the bank also suspects that the trustee is using the withdrawn funds to repay a personal debt of the trustee to the bank. If it turns out that in fact the trustee was misappropriating the trust funds in breach of trustee's obligations, which uniform law governs the liability of the bank: the Uniform Trustees' Powers Act, because the bank is dealing with a trustee, or the Uniform Fiduciaries Act, because the transaction involves a deposit account in the name of a fiduciary as such?

What if a third party is interested in purchasing an investment security from a trustee, but the third party has actual knowledge of facts which raise a strong suspicion in the third party's mind that the sale is in breach of the trustee's fiduciary obligations. The trustee, however, is offering the investment security at such an attractive price, the third party decides not to inquire further into the propriety of the transaction for fear of acquiring actual knowledge that the transaction constitutes a breach of trust. If the third party purchases the security, and the transaction in fact constitutes a breach of trust by the trustee, which uniform law governs the liability of the third party: the Uniform Trustees' Powers Act, because the third party is dealing with a trustee, or the Uniform Fiduciaries Act, because the transaction involves the transfer of an investment security?

At common law, there is no doubt that in each of the above hypotheticals the third party dealing with the trustee is liable for participating in the breach of trust. In each hypothetical the third party knows it is dealing with a trustee and the broad common law duty of inquiry charges the third party with knowledge of the information that it would have obtained if it had conducted a reasonably diligent inquiry into the trustee's powers. Assuming that such an inquiry would reveal that the proposed transaction

113. The three hypotheticals will be dealt with collectively. Accordingly, the subsequent references to the "third party" refers to the third party interested in purchasing the negotiable instrument, the bank interested in paying trust funds to the trustee, and the third party interested in purchasing the investment security.

114. See supra notes 18-20 and accompanying text.
constituted a breach of trust, the third party is liable for participating in the breach of trust.

Under the Uniform Fiduciaries Act and the Uniform Commercial Code, the third party in each of the above hypotheticals would still be liable for participating in the breach of trust. Under both the Uniform Fiduciaries Act and the Uniform Commercial Code, the third party’s suspicions about the transaction in each hypothetical coupled with the party’s conscious decision not to inquire further in the hope of avoiding actual knowledge that the transaction constituted a breach of trust constitute bad faith.\textsuperscript{115} Based upon the good faith requirement contained in both the Uniform Fiduciaries Act and the Uniform Commercial Code, the third party would be liable for participating in the breach of trust.\textsuperscript{116} Moreover, although neither the Uniform Fiduciaries Act nor the Uniform Commercial Code contains a general duty of inquiry simply because the third party knows it is dealing with a trustee, the third party has a limited duty of inquiry if the transaction is \textit{prima facie} wrongful.\textsuperscript{117} Under the limited duty of inquiry retained by both the Uniform Fiduciaries Act and the Uniform Commercial Code, the third party may have a duty to inquire, and, if so, the third party, is chargeable with knowledge of the information that the third party would have obtained if it had conducted a reasonably diligent inquiry into the trustees’ powers.\textsuperscript{118} Assuming that the inquiry would reveal that the proposed transaction constitutes a breach of trust, the third party failure to inquire may provide an additional basis upon which to impose liability for participating in the breach of trust.

Under the Uniform Trustees’ Powers Act, however, the third party in each of the hypotheticals would not be liable for participating in the breach of trust. Even if the third party knows that the trustee is benefitting individually from the transaction, the Uniform Trustees’ Powers Act imposes absolutely no duty of inquiry under any circumstances.\textsuperscript{119} Even though in each hypothetical the third party strongly suspects that there is something wrong with the transaction and consciously shields its eyes to avoid acquiring damaging information, the third party does not have actual knowledge that the transaction constitutes a breach of trust. Absent actual knowledge, the third party can go through with the transaction with confidence that it has no liability exposure.\textsuperscript{120}

\textsuperscript{115} See supra notes 31-32 and accompanying text.

\textsuperscript{116} Id.


\textsuperscript{118} Id.


\textsuperscript{120} Id.
This confidence, however, is undermined by the fact that every state which has adopted the Uniform Trustees’ Powers Act has adopted the Uniform Commercial Code, and a number of the states which have adopted the Uniform Trustees’ Powers Act have adopted both the Uniform Commercial Code and the Uniform Fiduciaries Act. Inasmuch as the conflicting statutory provisions overlap and apply to the same situation, a third party interested in dealing with a trustee is faced with the dilemma of trying to figure out which of the conflicting standards of liability controls. In the


122. It should be noted that there are a number of transactions (those not involving commercial paper, negotiable instruments or investment securities) which do not fall within the scope of all three uniform laws. By way of example, in the hypothetical which opened this Article (the trustee of a charitable foundation offered to make two $1,000,000 donations to a not-for-profit organization if the organization would use one of the donations to purchase a residence and deed it back to the foundation), if the trustee were to use cash, only the U.T.P.A. would apply. The use of cash, however, would only heighten one’s suspicions that the trustee may be breaching its fiduciary obligations, increasing the probability that any failure to inquire would be a bad faith failure to inquire. Under the U.T.P.A., however, bad faith is irrelevant. This variation on the opening example shows (1) the obvious inequities of protecting third parties who act in bad faith, and (2) how the U.T.P.A.’s ‘actual knowledge’ standard facilitates breaches of trust.

123. Arguments over which statutory provision should control can be advanced on both sides of the issue. On the one hand, the not-for-profit organization could argue that the U.T.P.A. should control. The Act specifically addresses that issue of the liability of third parties dealing with a trustee, while the other uniform laws address the liability of third parties dealing with a fiduciary generally. The Act was drafted
face of clear conflict between the traditional good faith standard and the unusually broad actual knowledge standard contained in section seven, the lack of a clear legislative explanation behind section seven creates sufficient uncertainty to undermine the effectiveness of section seven. Faced with the conflict and uncertainty over which standard of liability governs third parties dealing with a trustee, the prudent and honest third parties no doubt adhere to the higher standard imposed by the other uniform laws, thereby minimizing the risks of liability and the costs associated with resolving the uncertainty over the governing standard of liability. Accordingly, for the vast majority of third parties, and hence for the vast majority of trustees' transactions, section seven is completely ineffective.

Therefore, even if the Special Committee responsible for drafting section seven actually intended to terminate completely the duty of inquiry and good faith requirements, absent a stronger legislative statement that the Committee actually intended that result, the vast majority of third parties will still adhere to the good faith and limited duty of inquiry requirements. If, on the other hand, the Special Committee actually thought that section seven contained the good faith and limited duty of inquiry requirements, then section seven should be amended to express clearly those requirements.

As matters currently stand then, section seven silently cries out for clarification. Although section seven appears to be clear and straightforward when read in isolation, when read in light of the corresponding provisions of the other uniform laws addressing the liability of third parties dealing with a fiduciary and in light of the realization that such provisions overlap, the conflict among the laws is obvious. Such conflict within the uniform law and adopted against the backdrop of the other uniform laws and the language of § 7 clearly and unambiguously rejects any duty of inquiry and imposes liability only if the third party has actual knowledge that the transaction constitutes a breach of trust. It should be assumed that the Uniform Law Commission knew the standard of liability imposed by the other uniform laws and implicitly rejected them in adopting § 7. Moreover, application of § 7's actual knowledge standard furthers the purpose of the U.T.P.A.—to maximize trust administration efficiency. On the other hand, inasmuch as the legislative history behind § 7 is at best confusing, and arguably indicates that the Special Committee responsible for drafting the section thought the section contained a limited duty of inquiry and good faith requirement, it is doubtful that any court would apply § 7 over one of the other uniform law provisions governing third party liability for participating in a breach of trust. Application of § 7 over the other the other uniform law provisions governing the liability of third parties dealing with a trustee would result in the death of the long standing principles of equity that third parties have at least a limited duty of inquiry and duty to act in good faith when dealing with a trustee. Such a significant change in the law should not be enforced without greater evidence that such a change was actually intended by the drafters of § 7.
system and the uncertainty the conflict creates is the antithesis of the uniform law philosophy. In resolving the conflict, the obvious question is which standard of liability should govern third parties dealing with a trustee: (1) the limited duty of inquiry coupled with a good faith standard; (2) the actual knowledge with absolutely no duty of inquiry standard; or (3) the complete immunity standard?

B. Any Re-Examination of the Appropriate Standard of Liability for Third Parties Interested in Dealing with a Trustee Should Begin with the Presumption that the Appropriate Standard is the Good Faith and Limited Duty of Inquiry Standard

Although a thorough analysis of the issue of the appropriate standard of liability for third parties dealing with a trustee exceeds the scope of this article, a few preliminary observations are in order. First of all, of the three possible standards, the most logical choice is the limited duty of inquiry and good faith standard.

Professor Fratcher was not the first to realize the tension between the conservative common law rules governing the liability of third parties dealing with a fiduciary and the economic necessities of the modern day investment-oriented society, nor was the Uniform Trustees' Powers Act the first statutory modification of the conservative common law rules governing the liability of third parties dealing with a fiduciary. A plethora of other uniform laws have rejected the broad common law duty of inquiry and bona fide purchaser concept, and the broad liability which flowed from these requirements, yet these laws have retained the good faith and limited duty of inquiry requirements. One of the earliest of such uniform laws, the Uniform Fiduciaries Act, evolved out of Professor Scott's 1921 comprehensive and famous article, Participation in a Breach of Trust. In that article, Professor Scott thoroughly examines the inequities and economic inefficiencies of the


125. See supra note 94.

126. UNIF. NEGOTIABLE INSTRUMENTS ACT §§ 52, 26 (1896) (superseded by the Uniform Commercial Code); U.F.A. §§ 4-9, 7A U.L.A. 405-17 (1990); U.C.C. §§ 3-302, 3-304 (1977); U.C.C. §§ 8-302, 8-304 (1977); UNIF. FRAUDULENT CONVEYANCES ACT §§ 3, 4, 7A U.L.A. 448, 474 (1990); UNIF. FRAUDULENT TRANSFER ACT § 8(a), 7A U.L.A. 662 (1984); BANKRUPTCY CODE § 548 (1990) (all of these acts requiring that the party give valuable consideration).

common law rules governing the liability of third parties dealing with a fiduciary and the economic necessities of the modern day negotiable instruments and commercial paper.\textsuperscript{128} Professor Scott not only acknowledges but expressly endorses the limited duty of inquiry where the transaction is \textit{prima facie} wrongful.\textsuperscript{129} Moreover, Professor Scott implicitly argues for a good faith requirement when he repeatedly argues for no liability "in the absence of actual knowledge of the breach of trust or conduct amounting to bad faith."\textsuperscript{130}

The good faith and limited duty of inquiry requirements are well-accepted because they accord with one’s sense of what is equitable and fair. Where a party suspects a transaction is wrongful, the party should not be able to intentionally shield its eyes and cover its ears to avoid actual knowledge that the transaction is wrongful. Where a transaction is \textit{prima facie} wrongful, and a third party goes through with the transaction without investigating its propriety, the innocent third party’s position is equitably inferior to that of the damaged party.\textsuperscript{131} Moreover, where a transaction is not \textit{prima facie} wrongful, but the third party has actual notice that the transaction is potentially wrongful and intentionally fails to investigate in hopes of avoiding actual knowledge that the transaction is wrongful, the third party’s position is equitably inferior to that of the damaged party.\textsuperscript{132} These principles were well-accepted at common law and are expressed in the good faith and limited duty of inquiry requirements which are the statutory norm even where economic considerations have mandated revision of the common law rules. In light of these equitable principles, and for the sake of consistency and uniformity, any analysis of the appropriate standard of liability for third parties dealing with a trustee should begin with the presumption that the good faith and limited duty of inquiry standard is the appropriate standard.\textsuperscript{133}

No doubt Professor Fratcher knew that the prevailing statutory norm was the good faith and limited duty of inquiry standard, yet he first rejected it in favor of the actual knowledge with no duty of inquiry standard, and later the complete immunity with no duty of inquiry standard. Why he rejected the

\begin{itemize}
\item \textsuperscript{128} Id.
\item \textsuperscript{129} Id. at 456-57, 481.
\item \textsuperscript{130} Id. at 482.
\item \textsuperscript{131} This conclusion flows from the equitable principle that "he who comes into equity must come with clean hands" and is based upon the third parties’ lack of good faith. \textit{See} 2 J. POMEROY, \textit{supra} note 15, §§ 397-404, 687-88.
\item \textsuperscript{132} Id.
\item \textsuperscript{133} Although beyond the scope of this Article, a strong argument can be made that any analysis of the appropriate standard of liability for third parties dealing with a trustee should also begin with the presumption that the third party should be required to give value. \textit{See supra} notes 4, 13, 126.
\end{itemize}
good faith and limited duty of inquiry requirements is unclear, but he appears to have rejected them for two reasons: (1) to maximize trust administration efficiency, and (2) to avoid the unfair holding in *King v. Richardson.* King held a third party acting in good faith liable for participating in a breach of trust because the third party had actual knowledge of the terms of the trust. The court held the correct interpretation of the terms was a question of law to which the good faith conduct of the third party was irrelevant. Both of these concerns, however, are adequately addressed under the good faith and limited duty of inquiry standard.

**C. The Good Faith and Limited Duty of Inquiry Standard of Liability Maximizes Trust Administration Efficiency While Protecting the Interests of the Trust Beneficiaries**

Professor Fratcher has persuasively argued that in selecting the standard of liability for third parties dealing with a trustee, one has to remember that the standard of liability directly affects a third party's willingness to transact with a trustee, which directly affects trust administration efficiency. In particular, Professor Fratcher asks: "Is the protection afforded trust beneficiaries by the rule that third persons who deal with a trustee are, in effect, guarantors of the trustees' prudence and fidelity, worth its cost in terms of impairing the efficiency of trust administration?" Professor Fratcher's question implicitly asserts two points: (1) that the rules of liability for third parties dealing with a trustee make the third parties "guarantors of the trustees' prudence and fidelity;" and (2) that the rules of liability for third parties dealing with a trustee are not "worth their costs in terms of impairing the efficiency of trust administration." While both of these points are true with respect to the common law rules of liability, these points do not apply to the good faith and limited duty of inquiry standard of liability.

It is true that at common law third parties are "in effect, guarantors of the trustees' prudence and fidelity" and the common law rules of liability are not "worth their costs in terms of impairing the efficiency of trust administration." The broad common law duty of inquiry imposes upon third parties the duty to inquire diligently into the trustees' powers to enter into the proposed transaction. No doubt such an inquiry usually should reveal whether the trustee has the requisite authority. Accordingly, in the event the transaction

135. Fratcher, *supra* note 75, at 658 (citing *King v. Richardson*, 136 F.2d 849 (4th Cir. 1943), *cert. denied*, 320 U.S. 777 (1943)).
136. Id.
constitutes a breach of trust, for all practical purposes the broad common law duty of inquiry imputes knowledge of the breach to the third party simply because the third party is dealing with a trustee. At common law, then, the third parties are "in effect, guarantors of the trustees' prudence and fidelity." Moreover, this guarantee arguably is not worth its cost in terms of administration efficiency. The guarantee's broad liability exposure applies to all transactions where the third party knows or should know that it is dealing with a trustee, not just those where the third party suspects that the transaction may be in breach of trust. This broad exposure no doubt deters some third parties from transacting with trustees, and for those remaining third parties who are willing to transact with trustees, the duty of diligent inquiry significantly increases the transaction costs. The reduced market and increased transaction costs significantly impair trust administration efficiency by depressing the prices trustees can obtain for trust property and by increasing the transaction costs third parties pass on to trustees. As between the broad common law rules of liability and Professor Fratcher's complete immunity standard, a strong case can be made that the broad common law standard is not worth its cost in terms of trust administration efficiency. But an equally strong case can be made that as between the complete immunity standard and the good faith and limited duty of inquiry standard, the complete immunity standard is not worth its cost.

Unlike the broad common law rules, the good faith and limited duty of inquiry standard does not make third parties dealing with a trustee "guarantors of the trustees' prudence and fidelity." In the event the transaction constitutes a breach of trust, the third parties are liable only in very limited circumstances: (1) where the third parties know that the transaction is for the personal benefit of the trustee or is otherwise in breach of the trustee's obligations and fail to inquire as to the propriety of the transaction, or (2) where the third parties act in bad faith (that is, intentionally fail to ask questions in the hope of avoiding knowledge that the transaction constitutes a breach of trust). In both of these limited instances, the third parties are not guarantors of the trustees' prudence and fidelity, but rather only of their own prudence and fidelity.

Nor does the good faith and limited duty of inquiry standard impair trust administration efficiency. While any standard of liability short of complete immunity obviously will result in some degree of "cost" to trust administration, there is no way of measuring the exact cost. Rather the process is one of evaluating the assumed magnitude of the cost. While the magnitude of the cost of the broad common law duty of inquiry is relatively high, the cost of the good faith and limited duty of inquiry standard is relatively low. The

138. See supra notes 3-4, 19-21.

139. See supra notes 23-32 and accompanying text.
relatively low cost of the good faith and limited duty of inquiry standard is evidenced by the fact that both the Uniform Fiduciaries Act and the Uniform Commercial Code adopted the good faith and limited duty of inquiry standard as their low cost alternative to the unduly burdensome costs associated with the common law rules.\textsuperscript{140} The limited duty of inquiry and good faith requirements have worked well in these other uniform laws; there is no evidence that the good faith and limited duty of inquiry standard imposes any appreciable cost on the regulated transactions.\textsuperscript{141} That the good faith and limited duty of inquiry standard would likewise impose no appreciable costs on trust administration efficiency is evidenced by the fact that for all practical purposes the good faith and limited duty of inquiry standard has in practice been the governing standard for the vast majority of trust transactions\textsuperscript{142} and there is no evidence that this standard has in any way impaired trust administration efficiency.

Furthermore, the good faith and limited duty of inquiry standard passes Professor Fratcher's own test for evaluating trust administration efficiency. Professor Fratcher argued that

\begin{quote}
[i]f persons who deal with trustees are subjected to liabilities which would not arise in the absence of a trust, the ability of the trustees to persuade others to deal with them on advantageous terms, and, hence, to manage the trust property as a prudent man would his own, is impaired.\textsuperscript{143}
\end{quote}

Again, while this argument is true as applied to the broad common law duty of inquiry, the argument does not apply to the good faith and limited duty of inquiry standard. At common law, the broad duty of inquiry requires third parties dealing with a trustee to inquire into the trustees' power to engage in the transaction simply because the third parties' knowledge that they were dealing with a trustee puts them on notice of the trust relationship and hence the potentially adverse interest of the trust beneficiaries.\textsuperscript{144} The duty to inquire applies even in the absence of any facts indicating that the transaction may be wrongful.\textsuperscript{145} To that degree, at common law third parties dealing with a trustee are subject to liabilities which do not apply in the absence of the trust situation. But the good faith and limited duty of inquiry standard

\begin{itemize}
  \item \textsuperscript{140} See id.; see also Scott, supra note 127, at 454.
  \item \textsuperscript{141} Moreover, a strong case can be made that the need for transaction protection and efficiency is even greater in the negotiable instruments and commercial paper areas than in the area of trust administration. See supra note 98.
  \item \textsuperscript{142} See supra note 112.
  \item \textsuperscript{143} Fratcher, supra note 94, at 83.
  \item \textsuperscript{144} Supra notes 18-19.
  \item \textsuperscript{145} Id.; see also Scott, supra note 127, at 458.
\end{itemize}
rejects the broad common law duty of inquiry. The good faith and limited duty of inquiry standard does not subject third parties to "liabilities which would not arise in the absence of a trust." The Uniform Fiduciaries Act applies the good faith and limited duty of inquiry standard not only to trusts but to other fiduciary relationships.\footnote{146} The Uniform Commercial Code applies the good faith and limited duty of inquiry standard to all transactions involving negotiable instruments and investment securities, not just those involving fiduciaries.\footnote{147} Moreover, although the limited duty of inquiry is not always an express requirement, the good faith requirement is applied across the board to a whole host of transactions without regard to the presence of a trust relationship by a number of other uniform laws.\footnote{148} Subjecting third parties to liabilities based upon the third parties' bad faith is not subjecting the third parties to liabilities which would not arise in the absence of a trust. On the other hand, granting third parties who deal with a trustee complete immunity (or even immunity absent actual knowledge) would be providing third parties with a degree of protection which would not be available but for the presence of the trust. Such protection is unnecessary.

Professor Fratcher also argues that trust beneficiaries can be adequately protected under the complete immunity with no duty of inquiry standard by requiring trustees to be bonded. The bond requirement is itself an expense that trustees will pass back to the trust in the form of greater trustees' fees. Moreover, inasmuch as the complete immunity standard facilitates breaches of trust by trustees,\footnote{149} one would have to anticipate an increase in breaches of trust, which in turn will result in an increase in claims by trust beneficiaries, which in turn will result in an increase in the cost of requiring trustees to be bonded. The cost of posting bond will only increase as claims against the trustees rise. Obviously there is a cost associated with requiring each trustee to post bond, and it is far from clear, as Professor Fratcher apparently assumes, that, in terms of impairing trust efficiency, the cost of bonding is lower than the cost of the good faith and limited duty of inquiry standard.

Finally, the complete immunity standard for which Professor Fratcher argues is contrary to most people's notion of ethical conduct. Even Professor Scott himself endorsed the general principles that where a transaction is \textit{prima facie} wrongful the third party has a duty to investigate the propriety of the

\footnote{147} U.C.C. arts. 3, 8 (1977).
\footnote{148} \textit{Supra} note 126.
\footnote{149} The complete immunity standard, and for that matter, the actual knowledge standard, facilitate breaches of trusts by trustees because it will be easier for the trustees to find third parties willing to enter into transactions which constitute a breach of trust. \textit{See supra} note 122. This is particularly true of trustees of charitable trusts, inasmuch as supervision of such trusts and trustees is already difficult enough.
transaction, and where the third party has actual knowledge that the transaction constitutes a breach of trust or acts in bad faith, the third party should be subject to liability. Such parties are not innocent third parties acting honestly but rather culpable third parties who in essence have decided to join in the breach of trust. It is well accepted that such parties should be held liable for their culpable conduct. Repudiating rules which are well accepted as inherently fair and equitable has a cost to a legal system, and such cost should be factored into the cost-benefit analysis. Absent strong evidence that the cost of imposing liability upon third parties who breach the good faith and limited duty of inquiry standard far outweighs its worth in terms of the efficiency of trust administration, such a rule should be preserved because of its worth to the integrity of a legal system as a whole.

Considering all of the above factors, as between the complete immunity with no duty of inquiry standard and the good faith and limited duty of inquiry standard, the good faith and limited duty of inquiry standard provides greater protection to trust beneficiaries without appreciably affecting trust administration efficiency.


The other principal reason Professor Fratcher apparently supports the complete immunity standard is that such a standard is necessary to protect innocent third persons who deal with a trustee with actual knowledge of the terms of the trust. In particular, Professor Fratcher’s concern is based on the case of King v. Richardson.

In King, the testator established a testamentary trust funded with 8/100 interest of the stock of a chemical corporation. The testator gave the 8/100 interest to his wife for life, and upon her death, a remainder interest of 3/100 of the stock in the corporation to the Trustees of the First Presbyterian Church, with the restriction that "the profits or dividends arising therefrom be used by said Trustees for the benefit of Home and Foreign Missions and the benevolent causes of the church, in such proportion as the trustees deem best." Shortly after the death of the testator, and while his widow was still alive, the First Presbyterian Church undertook a campaign to raise funds to erect a new church. Unfortunately, the church was unable to raise the

150. Supra note 127.
151. 136 F.2d 849 (4th Cir. 1943), cert. denied, 320 U.S. 777 (1943).
152. Id. at 853-54.
153. Id. at 854.
154. Id. at 855.
necessary funds. The widow, who was anxious that the church raise the necessary funds, proposed that the church sell its remainder interest in the stock to her children, along with her life estate interest, with the proceeds from the sale devoted to the campaign. These proceeds would give the church sufficient assets to build the new church.

The sale went through as proposed, and the chemical corporation transferred the shares in question from the trustees to the children. Both the children and the chemical corporation had actual knowledge of the terms of the trust and claimed that they believed in good faith that the sale of the stock to raise funds to build the new church was an authorized benevolent cause within the directions of the trust. The widow died 17 years later, and at that time the officers of the Home and Foreign Missions began inquiring into the status of the trust.

When they learned of the sale and prior use of the proceeds, the officers claimed that the sale of the stock and the use of the proceeds to erect the new church constituted a breach of trust and demanded that the trustees sue the purchasers of the stock, the children and the corporation, as participants in the breach of trust.

The court imposed the common law *bona fide* purchaser requirement and held the corporation and purchasers of the stock liable for participating in the trustees' breach of trust. To be a *bona fide* purchaser, the third party had to be acting in good faith and have no notice that the transaction constituted a breach of trust. The court reasoned that even though the third parties were acting in good faith, their good faith was irrelevant. Inasmuch as the third parties had notice of the terms of the trust, at common law they were held to a proper interpretation of the terms of the trust.

Professor Fratcher takes issue with the fairness of the court’s ruling, and rightfully so. In criticizing the court’s opinion, Professor Fratcher states:

They [the purchasers and the corporation] thought, honestly and in good faith, that this was an authorized use of trust funds but liability was imposed on them under a theory that, in contemplation of law, they *knew*
the proposed use was a breach of trust. This theory assumes, (1) because, in Common Law litigation, the meaning of the language is determined by the judge rather than the jury, it is a matter of law; (2) all persons are bound to know the law and treated as if they did know it; (3) therefore, the chemical corporation and the purchasers of the stock were liable as if they had known that the trustees intended to divert the proceeds of the sale to a purpose not authorized by the terms of the trust.166

Fratcher uses the inequity of holding the honest third parties acting in good faith liable to argue for the complete immunity standard:

It should be noted that the legislation just discussed, both British and American [the Uniform Fiduciaries Act, the Uniform Commercial Code, the Uniform Act for Simplification of Fiduciary Security Transfers and the Uniform Trustees’ Powers Act], relieves third parties of the duty of inquiry but preserves the rule that a third person who participates with or assists a trustee in a transaction involving a breach of trust, with notice of the breach, incurs virtually the same liability to the beneficiary to which the trustee is subject . . . Hence, it would not protect the innocent third persons who were defendants in King v. Richardson.167

Professor Fratcher’s argument in favor of complete immunity is logical enough: (1) it is inequitable and unfair to impose liability upon innocent third parties dealing in good faith with a trustee but who have actual knowledge of the terms of the trust; (2) none of the legislative acts protecting third parties dealing with a fiduciary protect such innocent third parties;168 therefore, (3) the only way to protect such third parties is to accord all third parties dealing with a trustee complete immunity. The problem with Professor Fratcher’s argument, however, is that the good faith and limited duty of inquiry standard does protect such third parties.

The innocent stock purchasers in King v. Richardson are protected under the good faith and limited duty of inquiry standard contained in the Uniform Commercial Code.169 At common law, for the third party to receive

166. Fratcher, supra note 94, at 83.
167. Id.
168. It should be noted that in King, the court applied the common laws rules in finding the defendants liability, and did not even address the issue of whether any legislative provisions may have protected the purchasers.
169. In addition to the protection available under the U.C.C., the Uniform Act for Simplification of Fiduciary Security Transfers provides complete immunity to corporations like the chemical corporation in King which are not per se parties to the transaction but are rather simply transferring ownership of the securities sold by the fiduciary. UNIF. ACT FOR SIMPLIFICATION OF FIDUCIARY SECURITY TRANSFERS § 6, 7B U.L.A. 700 (1990). In King, the Fourth Circuit held the corporate defendant liable
property from the trustee free of trust and free of liability to the trust beneficiaries, the third party had to be a *bona fide* purchaser.\(^{170}\) To be a *bona fide* purchaser, the third party had to be acting in good faith *and* have no notice of an adverse claim in the property.\(^{171}\) At common law, good faith alone was not enough to protect the third party because of the additional requirement that the third party have no notice of any adverse claims. Because the common law absence of notice requirement included absence of *negligent* constructive notice, *negligent* third parties acting in good faith could still be held liable for participating in a breach of trust. The Uniform Commercial Code, however, expressly rejects the broad common law notice concept in favor of the more limited duty of inquiry.\(^{172}\) Moreover, the Uniform Commercial Code expressly rejects the common law imposition of liability based upon mere *negligent* constructive notice of the breach of trust and instead requires actual knowledge of the breach of trust or bad faith.\(^{173}\)

In criticizing the Fourth Circuit's holding in *King* imposing liability on the stock purchaser, Professor Fratcher notes that liability was imposed "under a theory that, in contemplation of law, they knew the proposed use was a
What Professor Fratcher fails to indicate is whether this knowledge is actual knowledge or constructive knowledge. If actual knowledge, then Professor Fratcher’s claim that the protective legislation does not protect the innocent purchasers in King is correct. If, on the other hand, the imposition of liability on the purchasers in the King case is based upon negligent constructive knowledge, then the protective legislation’s requirement that the third party dealing with the trustee must have actual knowledge or bad faith that the transaction constitutes breach of trust would accord the purchasers in King protection against liability.

At common law, the generally accepted difference between actual knowledge and constructive knowledge turned on whether the knowledge was imputed to the party. If the party had first-hand conscious knowledge of the matter, and the knowledge did not have to be imputed to the party, then the knowledge was actual. If, on the other hand, the knowledge had to be imputed to the party, the knowledge was constructive knowledge. In King, the Fourth Circuit implicitly acknowledged that the defendants did not have actual knowledge that the transaction constituted a breach of trust when it noted that the fact that the purchasers "had no fraudulent intent and honestly believed that they were acting lawfully does not affect the matter." If the purchasers had actual knowledge that the transaction constituted a breach, there is no way the purchasers could honestly believe they were acting lawfully. In addition, Professor Fratcher himself implicitly admits that the purchasers of the stock were held liable because they had constructive knowledge, not actual knowledge, that the transaction constituted a breach of trust:

[L]iability was imposed upon them under a theory that, in contemplation of law, they knew the proposed use was a breach of trust. This theory assumes, (1) because, in Common Law litigation, the meaning of the language used in a written instrument is determined by the judge rather than a jury, it is a matter of law; (2) all persons are bound to know the law and treated as if they did know it; and (3) therefore, the chemical corporation and the purchasers of the stock were liable as if they had known that the trustees intended to divert the proceeds of the sale to a purpose not authorized by the terms of the trust.

Both the King opinion and Professor Fratcher implicitly acknowledge that the knowledge that the transaction constituted a breach of trust was imputed to the

174. Fratcher, supra note 94, at 83 (emphasis added).
175. Supra note 17.
177. Fratcher, supra note 94, at 83 (emphasis added).
purchasers of the stock, and as such constitutes constructive knowledge of the breach of trust.

Having established that the purchaser's knowledge that the transaction constituted a breach of trust was constructive knowledge, the question becomes whether this constructive knowledge is negligent constructive knowledge or bad faith constructive knowledge. While negligent constructive knowledge of the breach of trust was sufficient to impose liability at common law, negligent constructive knowledge is not enough under the Uniform Commercial Code. Under the protective legislation, the third party takes free of the trust and free of liability to the trust beneficiaries absent actual knowledge that the transaction constitutes a breach of trust or bad faith, which in essence is bad faith constructive knowledge. The Fourth Circuit's statement that the purchasers "had no fraudulent intent and honestly believed that they were acting lawfully" indicates that at most the purchasers were guilty of negligent constructive knowledge, not bad faith constructive knowledge, of the breach. Hence, the Uniform Commercial Code protects innocent good faith purchasers, like the purchasers in the King case, who have actual knowledge of the terms of the trust and in good faith believe the terms authorize the transaction.

Assuming that Professor Fratcher advocates complete immunity for third parties dealing with a trustee to maximize trust administration efficiency and to protect innocent third parties who have actual knowledge of the terms of the trust, the good faith and limited duty of inquiry standard protects such third parties and ensures trust efficiency without protecting culpable third parties who knowingly participate in a breach of trust or who in essence knowingly participate by their bad faith.

178. Supra note 32.
179. Supra notes 32-33.
180. King, 136 F.2d at 859.
181. This conclusion is further supported by the case law which limits judicial review of a trustee's interpretation of a trust instrument to the issue of whether the trustee acted arbitrarily, capriciously or in bad faith. See Rehmar v. Smith, 555 F.2d 1362, 1371-72 (9th Cir. 1976) (citations omitted). The trustee shall not be liable for simple acts of negligence, but rather the trustee is liable only where the trustee's conduct constitutes bad faith. If the trustee's negligent but good faith misinterpretation of the trust provisions is protected under the good faith standard, certainly third parties dealing with a trustee who misinterpret the trust provisions in good faith should be protected under the good faith standard.
V. CONCLUSION

Section seven of the Uniform Trustees' Powers Act inexplicably provides unusually broad protection to third parties dealing with a trustee. A thorough examination of the legislative history behind section seven indicates that the reason the unusually broad protection is inexplicable is that the unusually broad protection was unintentional. The Special Committee responsible for drafting section seven apparently believed that section seven tracked the corresponding provisions of the other uniform laws addressing the liability of third parties dealing with a trustee; the Special Committee apparently believed that section seven contained the good faith and limited duty of inquiry requirements. This mistake apparently stems from the cryptic manner in which the no duty of inquiry and actual knowledge standard was proposed. There is no evidence that the Uniform Law Commission realized that section seven provides unusually broad protection to third parties dealing with a trustee.

Although in theory section seven provides unusually broad protection to third parties dealing with a trustee, in practice section seven is ineffective. The unusually broad protective provisions of section seven conflict with the corresponding provisions of the Uniform Fiduciaries Act and the Uniform Commercial Code. The vast majority of transactions covered by section seven of the Uniform Trustees' Powers Act are also covered by one or more of the corresponding provisions of the Uniform Fiduciaries Act or the Uniform Commercial Code. Faced with the conflict between the governing standards, and no clear legislative statement that the unusually broad actual knowledge standard of section seven was intentional, third parties interested in dealing with a trustee conform to the higher good faith and limited duty of inquiry standard contained in the Uniform Fiduciaries Act and the Uniform Commercial Code. Accordingly, section seven creates needless confusion in the law of trusts which quietly calls out for clarification. Any efforts at clarifying section seven should begin with the presumption that the most logical standard of liability for third parties dealing with a trustee is the traditional good faith and limited duty of inquiry standard. The good faith and limited duty of inquiry standard imposes minimal costs on trust administration, provides adequate protection to third parties dealing with a trustee, and provides consistency and uniformity within the uniform law system.