The Failure of The Delaware Business Trust Act as the New Corporate Law

Tamar Frankel

Abstract

Business trusts have been around for over one hundred years. . . . Like their ancestor, the private trust, business trusts are established by trust instruments. . . . The Delaware Business Trust Act has addressed [certain prior] uncertainties. . . But the Delaware Act is far more ambitious. It contains highly permissive provisions, allowing promoters of business trusts a staggering degree of freedom to design their relationships with beneficiaries-investors. Moreover, the Act explicitly invites commercial and manufacturing enterprises (C&M Enterprises) to take advantage of this marvelous contract-like organizational form emphasizing its liberal contractarian approach and the freedom to write into or omit from the trust documents anything they wish, or almost anything. . . . Further, the rights of the beneficial owners in trust property, in section 3805, and the management of the trusts, in section 3806, are all couched in permissive terms. . . . One would assume that C&M Enterprises and their lawyers would jump at this golden opportunity. But they do not. Why has the Delaware Act failed to become the new modern corporate law? . . . I offer other [than inertia] answers. . . Essentially, the costs of adopting the Act as a substitute for corporate law exceed the benefits of change. . . . Delaware Act does not support the contractarian interpretation of the Act, unless it means based on consent (but not contract). Contrary to this interpretation, these business trusts cannot be designed in any form, and their promoters cannot apply any law they choose. Even though the Delaware Business Trust Act on its face seems to be a default rule with respect to both form and substance of trust law, the permissive provisions of the Act are far more limited. The Delaware Act has been interpreted by the business and lawyer communities to allow some relaxation of trust law, but not to substitute for it. Business trusts must be organized in trust form and be subject to trust principles (with some relaxation). Further, trust instruments constitute consensual arrangements, but are not governed by contract law, neither under trust law nor under the Delaware Act. In our context “contract” can be used only as a metaphor for consensual relationship, like the Republican Party’s “Contract with America” in the 1990s, but not as a precise legal classification. Any other interpretation of the Delaware Act would lead to unacceptable results. Had the Delaware Act allowed a fully default trust law, which it does not, and had form and substance been emptied of their original meaning, leaving only the image of trust (and perhaps the word “trust”), a serious problem of misrepresentation to investors might arise. . . the form and substance of trust law are not suitable for C&M Enterprises. . . .

Laws offering models for business organizations (corporations, partnerships, limited partnerships, and limited liability corporations) cover relationships between the interested parties within the organizations, and the representation of the organizations in their dealings with the outside world. None of these laws, however, regulates the businesses in which the organizations engage. Those commercial and manufacturing businesses are regulated by other laws, unrelated to the organizational structures of the businesses. . . . One set of laws offers organizational models from which the actors may
choose, and a second set of laws, which are mandatory, regulates the businesses operated by whatever organization. . . . [Trust law is an exception]. Trust law offers an organizational form -- a model of relationship between the actors in the trust arrangement -- and rules that govern the business of trust services. . . . The trust form provides the model of relationship among the trustee and the beneficiaries. That relationship is the business and the purpose of the trust. . . . The dual nature of trust law is also evident in its application. . . . [Besides] there is a sufficient number of known legal forms of organizations that meet the needs of C&M Enterprises: corporations, partnerships, limited partnerships, and limited liability companies. . . . The Delaware Act does not offer any tax advantages. Further, the seemingly breathtaking sweep of the Delaware Act is far narrower in light of federal laws that preempt its application. Hence, this novel organizational form offers no significant benefits over the existing forms. . . .
The Failure of The Delaware Business Trust Act as the New Corporate Law

Essay

Tamar Frankel*

**Introduction**

Business trusts have been around for over one hundred years. They have evolved from private trusts and are used as one form of offering of trust services to the public. Thus, the Supreme Court defined a business trust as “an arrangement whereby property is conveyed to trustees, in accordance with the terms of an instrument of trust, to be held and managed for the benefit of such persons as may, from time to time, be the holders of transferable certificates issued by the trustees, showing the shares into which the beneficial interest in the property is divided.”

Like their ancestor, the private trust, business trusts are established by trust instruments. While some features of business trusts resemble those of corporations, business trusts could be viewed as the epitome of promoters’ freedom, allowing promoters to design their organizations any way they wish subject only to the pressures and judgments of the markets. However, business trusts posed a number of potential legal uncertainties. The Delaware Business Trust Act has addressed these uncertainties.

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2 Trust services can be offered through other forms such as corporations and limited partnerships. *Delaware Law of Corporations and Business Organizations* § 19.2 (2000), available at LEXIS, Del Library, Delcbo File. Historically, business trusts were used “to obtain the advantages of incorporation without complying with the regulatory and tax burdens placed on corporations.”


4 Herbert B. Chernsilde, Jr., Annotation, *Modern Status of the Massachusetts or Business Trust*, 88 A.L.R.3d 704 (1978) (describing in detail Massachusetts business trusts, and problems they raise. Their status as business trusts is not always clear. They are unincorporated associations that look and act like corporations, and may be considered to have violated corporate laws if they do not register as corporations. Their standing to sue and be sued has been challenged in some jurisdictions. Their beneficiaries usually require some control over the trustees and thereby risk losing limited liability and becoming personally liable for the debts as partners. The beneficiaries’ status as creditors entitled to petition for involuntary bankruptcy of the business trusts has been questioned.).

5 Act of June 21, 1988, ch. 279, 66 Del. Laws 514 (1988) (codified as amended at Del. Code Ann. tit. 12, §§ 3801-3824 (1995 & Supp. 1998)) [Delaware Act]; see also Maryland Business Trust Act, ch. 452, 1999 Md. Laws, WL MD LEGIS 452 (codified at Md. Code Ann., Corps. & Ass’ns §§ 12-101 to -810 (Supp. 2000)) (similar statute). Like its ancestor, the private trust, the business trust is based on a trust instrument that the trustee must follow. The business which the trustee has to conduct is embodied in the same instrument on which the form of the trust is based. The private trust instrument has given rise to a large body of judicial decisions. These decisions were intended to protect beneficiaries who did not choose the trustee nor the assets of the trust, and who were precluded from controlling the trustee by the very design of the trust. The danger to the beneficiaries from abuses of trust by a trustee who was not accountable to them (the persons most interested), gave rise to protective measures both in interpreting the nature of the
Therefore, everyone could rejoice when the Delaware Business Trust Act was passed. In fact, a number of mutual funds, have taken advantage of the Act to benefit from its clarifications and the flexibility it offers.

But the Delaware Act is far more ambitious. It contains highly permissive provisions, allowing promoters of business trusts a staggering degree of freedom to design their relationships with beneficiaries-investors. Moreover, the Act explicitly invites commercial and manufacturing enterprises (C&M Enterprises) to take advantage of this marvelous contract-like organizational form emphasizing its liberal contractarian approach and the freedom to write into or omit from the trust documents anything they wish, or almost anything.

The flexibility embodied in the definition of the ‘business trust’ allows the parties forming the business trust to take on such characteristics of traditional inter vivos trusts, business trusts, corporations or partnerships as the parties may desire. This flexibility is consistent with Delaware’s fundamental policy of freedom of contract and may be the greatest advantage of the business trust over alternative forms of business organizations.6

Further, the rights of the beneficial owners in trust property, in section 3805, and the management of the trusts, in section 3806, are all couched in permissive terms: “Except to the extent otherwise provided in the governing instrument of a business trust.” Therefore, it seems that the promoters of these trusts may write their own rules.7

In addition, “[t]he principal purpose of the Act is to recognize expressly the business trust as an alternative form of business association.” The “Act eliminates the requirement imposed by other states that the trust be engaged in the conduct of a trade or business or issue certificates or shares.”8 Any legal business, for-profit or not-for-profit, including presumably commercial business, will do.

Delaware business trusts should look attractive to promoters and their lawyers. As consent-based organizations,9 they offer lawyers opportunities for engagement and innovation. To promoters they offer any organizational form they wish, subject to market acceptance. One would assume that C&M Enterprises and their lawyers would jump at this golden opportunity. But they do not. While the Delaware Business Trust Act is used

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7 DEL. CODE ANN. tit. 12, § 3805(a) (1995); § 3806(a) (Supp. 1998).
9 I call business trusts “organizations” in the social sense, as entities in which many people participate subject to certain rules, even though business trusts are not considered legal entities.
by Public Trustees for traditional trust purposes--managing other people’s money and real estate (Trust Services)--C&M Enterprises have not used it.

Why has the Delaware Act failed to become the new modern corporate law? Why does this Act fail to open the new era of flexible organizations? Every innovation, however brilliant, meets resistance. People simply resist new organizational forms even if they are the best and most efficient. People follow the trodden path. \(^{10}\) Custom and tradition of both businessmen and their lawyers, lead to the adoption of existing forms (especially the corporate form). Viewing the puzzle from a broader perspective I offer other answers, some obvious, and others less so. Essentially, the costs of adopting the Act as a substitute for corporate law exceed the benefits of change.

As discussed in Part One of this Essay, a closer look at the Delaware Act does not support the contractarian interpretation of the Act, unless it means based on consent (but not contract). Contrary to this interpretation, these business trusts cannot be designed in any form, and their promoters cannot apply any law they choose. Even though the Delaware Business Trust Act on its face seems to be a default rule with respect to both form and substance of trust law, the permissive provisions of the Act are far more limited.

The Delaware Act has been interpreted by the business and lawyer communities to allow some relaxation of trust law, but not to substitute for it. Business trusts must be organized in trust form and be subject to trust principles (with some relaxation). Further, trust instruments constitute consensual \(^{11}\) arrangements, but are not governed by contract law, \(^{12}\) neither under trust law nor under the Delaware Act. In our context “contract” can be used only as a metaphor for consensual relationship, like the Republican Party’s “Contract with America” in the 1990s, but not as a precise legal classification. Any other interpretation of the Delaware Act would lead to unacceptable results. Had the Delaware Act allowed a fully default trust law, which it does not, and had form and substance been emptied of their original meaning, leaving only the image of trust (and perhaps the word “trust”), a serious problem of misrepresentation to investors might arise.

Further, as argued in Part Two of this Essay, the form and substance of trust law are not suitable for C&M Enterprises. Therefore, the legal risks and the costs of adopting a business trust under the Act are likely to outweigh the benefits. This conclusion is based in part on a fundamental distinction between legal organizational models--corporation laws, on the one hand, and trust laws, on the other hand.

Laws offering models for business organizations (corporations, partnerships, limited partnerships, and limited liability corporations) cover relationships between the

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\(^{10}\) See HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS § 60, at 120 (3d ed. 1983) (noting that “[a] business trust is an unattractive investment in that it is not a very familiar form of business to most people”) (footnote omitted). However, the author does not agree with the conclusion that familiarity will encourage the use of this form by C&M Enterprises.

\(^{11}\) Some scholars call consensual arrangements “contractarian.” I prefer to use another word so as not to confuse such arrangements with agreements subject to contract law.

interested parties within the organizations, and the representation of the organizations in their dealings with the outside world. None of these laws, however, regulates the businesses in which the organizations engage. Those commercial and manufacturing businesses are regulated by other laws, unrelated to the organizational structures of the businesses. A restaurant can be owned and managed by a partnership, a limited partnership, and a corporation. But all restaurants must comply with laws relating to building structures, protection from fire hazards, and rules governing hygiene. McDonald’s, although an international corporation engaged in the fast-food business, is subject to the same rules on food cleanliness as a fast-food mom-and-pop partnership small restaurant. Moreover, barring few exceptions, businesses are free to choose their organizational forms.¹³ But none can choose the rules that regulate their businesses.¹⁴

This is the legal scheme for organizing businesses and regulating businesses. One set of laws offers organizational models from which the actors may choose, and a second set of laws, which are mandatory, regulates the businesses operated by whatever organization. This scheme makes sense. The organizational form serves the needs of different contributors to the business. The regulation of the businesses applies to all who carry on that business.

The legal scheme described here has one apparent exception, and that is trust law. Trust law offers an organizational form -- a model of relationship between the actors in the trust arrangement -- and rules that govern the business of trust services. The main reason for this combined coverage of the form law and regulating law is not hard to discover. The trust form provides the model of relationship among the trustee and the beneficiaries. That relationship is the business and the purpose of the trust. Hence, the relationship of the trustee with the beneficiaries – the organizational form -- and the regulation of trust business -- the trustee’s services to the beneficiaries -- are one and the same. The nature of trust regulation demonstrates its symbiotic relationship to trust organization. Most trust rules are default rules; prohibited actions become permissible with the consent of the beneficiaries or their representatives.¹⁵ Thus, the regulatory scheme is built on and integrated with the parties’ relationship.

The dual nature of trust law is also evident in its application. The regulatory part of trust law governs any organization engaged in trust business, regardless of its form. And when courts did not adopt this approach but applied corporate organizational laws to

¹³ The laws regulating certain types of businesses, all of which relate to money management, required those businesses to organize in a certain manner. For example, national banks must be organized as corporations. See 12 U.S.C. § 24 (1994) (provides that national banking association is considered a “body corporate”); id. § 21 (requiring national banking association to have at least five incorporators and articles of association). Insurance companies may be organized as mutual companies and as corporations, depending on the state law under which they are organized. See, e.g., N.Y. INS. LAW § 1201 (McKinney 1985 & Supp. 1999) (incorporation of stock of mutual insurance companies). Investment companies may be organized in any form, subject to a superseding organizational model that resembles a corporation. 1,3 TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS §§ 5.01, 21.01[A]-[E] (2d ed. 2001) (discussing form of investment company organization).

¹⁴ They could, however, influence the rule-makers to introduce changes.

Trust Services, federal law stepped in and changed the rules to apply trust principles to these services.\textsuperscript{16} While the trust form is suitable for Trust Services it is far less so for C&M Enterprises. Vesting in a trustee the ownership of trust assets is inconvenient for C&M Enterprises. The right of trustees to indemnification is inappropriate. Some states do not award limited liability to trust beneficiaries. The trust form is unique to the common law legal systems, and is not familiar in countries that have adopted the civil law.

In addition, as Part Three demonstrates, there is a sufficient number of known legal forms of organizations that meet the needs of C&M Enterprises: corporations, partnerships, limited partnerships, and limited liability companies. Because the laws containing these forms are mainly state laws, there are ample states ready to amend the laws to meet the changing needs of such Enterprises. The Delaware Act does not offer any tax advantages. Further, the seemingly breathtaking sweep of the Delaware Act is far narrower in light of federal laws that preempt its application. Hence, this novel organizational form offers no significant benefits over the existing forms.

For these reasons businessmen and their lawyers will not adopt the Delaware Act for C&M Enterprises. The Delaware Act, however, is, and will continue to be, adopted by Public Trustees, because its form and substance fit, subject to federal laws.

**Part One. Notwithstanding Its Permissive Approach, the Delaware Business Trust Act Requires Adherence to Trust Form and Substance**

The Delaware Business Trust Act allows business trusts to engage in any business they choose:\textsuperscript{17} a hotel, a restaurant, a manufacturing enterprise, or an advisory service. Yet this business trust form has not been used for commercial business in the recent past, and is not used for C&M Enterprises today.\textsuperscript{18} It is hard to understand why Delaware’s resolutions of business trusts’ uncertainties and its generous accommodation to promoters of businesses of all sorts was not snapped up.

One explanation to this puzzle is that with all its permissiveness, the Delaware Act does not allow the actors to choose a non-trust form or apply other than substantive

\textsuperscript{16} See McGahan v. United Eng’g Corp., 180 A. 95 (N.J. Ch. 1935) (binding the shareholders to waivers in the articles of association, including lack of voting, and implied consent to indirect conflicts of interest); 1, 3 FRANKEL & SCHWING, supra note 3, §§ 5.01, 21.01[A]-[E] (Investment Company Act of 1940 regulates trust business of mutual funds on all forms of organization). In 1974 Congress passed the Employee Retirement Income Security Act, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of 26, 29 U.S.C.), that regulates pension funds. The Act covers trust business and trust form.

\textsuperscript{17} DEL. CODE ANN. tit. 12, § 3801(a) (Supp. 1998) ("A business trust may be organized to carry on any lawful business or activity, whether or not for profit. . . ").

\textsuperscript{18} It seems that some businesses such as oil and gas and other excavations are organized as trusts. But these lend themselves to this form and to trust law principles applicable to real estate trusts. 16A W ILLIAM MEADE FLETCHER, Cyclopedia of the Law of Private Corporations § 8231, at 496 (Timothy P. Bjur & James Solheim eds. 1995) (citing Helvering v. Combs, 296 U.S. 365, 366 (1935) (trust formed to finance and drill for oil, gas, and other substances); Peoples Bank v. D’Lo Royalties, Inc., 235 So. 2d 257, 259 (Miss. 1970) (trust formed to manage oil property); Wichita Royalty Co. v. City Nat’l Bank, 89 S.W. 2d 394, 396 (Tex. 1935) (trust formed to purchase and sell oil and gas royalties and properties)).
trust law. As discussed in Part Two, neither form nor substance of trust law are suitable for C&M Enterprises.

The Delaware Act is somewhat unclear on the applicability of the appropriate law to business trusts. After inviting C&M Enterprises to take advantage of its trust instrument form, the Act provides a default rule which could be interpreted to offer promoters a contract-like form, and full freedom to design the relationships within the organization. Trust law seems to be a default rule, which the specific provisions of trust instruments can overcome. The Act states that “[t]he document creating the trust is the law of the trust.” Addressing the law applicable to the business trusts, section 3809 states:

§ 3809. Applicability of trust law.

Except to the extent otherwise provided in the governing instrument of a business trust or in this subchapter, the laws of this State pertaining to trusts are hereby made applicable to business trusts; provided however, that for purposes of [taxation] . . . a business trust shall be classified as a corporation . . . .”

This provision may suggest that business trusts can be governed by other branches of the law, depending on the promoters’ choice. There are no authorities on this point. Delaware bar members, however, are clear that the Act does not allow the promoters of a business trust to eliminate the principles of trust law altogether nor to incorporate by reference the laws of other models of organization, such as corporate laws, or other branches of law, such as contract laws.

Thus, it is very unlikely that reference to contract law in its entirety would be enforced in the context of business trusts. Trustees are fiduciaries and not contract parties. And trusts are not contracts. Eliminating all vestiges of fiduciary duties is an unlikely interpretation of an act establishing a business trust. Besides, the Act was designed to address the problems that non-statutory business trusts raised. One of the issues concerning such trusts was the incorporation of other trust laws into the trust documents by reference. That was generally approved by the courts because the choice of the applicable trust laws was in line with some important component of the trust (e.g., the real estate trust property location). There is no precedent, to my knowledge, of an attempt to incorporate an erasure of trust law principles or to incorporate an entirely different branch of the law into business trust documents, let alone an approval of such

20 Delaware Act § 3809 (Supp. 1998).
21 Telephone Interview with Doneen Damon, Esq. and Mark J. Gentile, Esq., Richards, Layton & Fing, One Rodney Square PO Box 551Wilmington, DE 19899 (Feb. 2, 2001).
incorporation by the courts. It should be noted that the new Uniform Trust Code, applicable to private trusts, is more permissive than prior judicial decisions, but does not cover such broad grounds. In sum, the Delaware Business Trust Act applies trust law on business trusts, regardless of their operations, and is not a default rule with respect to the form or substance of the law.

Part Two. Trust Law in Form and Substance Does Not Fit C&M Enterprises

Legal scheme for organizational models and regulatory laws. To understand the difficulties of using trust law for other than Trust Services, it is helpful to examine trust law within the legal scheme. Organizational models and substantive regulation of businesses are generally separate. Further, organizational model laws are for the choosing. In contrast, laws that regulate businesses are mandatory, and apply to the same businesses regardless of how they are organized. The one exception to this scheme is trust law. As elaborated in Part Three, that combination explains why the Delaware Business Trust Act is not suitable for businesses other than Trust Services, both in terms of form and in terms of regulatory law.

The laws providing models of organizational forms, such as partnerships, limited partnerships, corporations, and limited liability corporations, offer standardized internal structure for the relationships among those who control the activities of an organization and those who provide labor and capital. A partnership model is suitable for those who contribute labor and often—capital—to the enterprise, and have control and power of representing the enterprise, with a partial status of a legal entity. A corporation offers an organizational form that constitutes a legal entity, in which labor, capital and control are generally separate roles even when they are exercised by the same individuals. A trust offers a form that is not a legal entity, in which control and title to ownership of the trust property are vested in the trustee, and are separate from beneficial ownership. These models can be adjusted to the parties’ desires to some extent. But the basic features of these organizations must be retained, once the form is chosen.

A quick review of the organizational models laws demonstrates that these laws deal with the relationships among the interest groups within the organizations. None of these laws regulates the businesses in which the organizations engage. The businesses in which organizations engage are regulated by other laws, and these are not usually related to the organizational structures of the businesses. Barring a few exceptions, businesses are free to choose their organizational forms. But none can choose the rules that

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25 The laws regulating certain types of businesses, all of which relate to money management, required those businesses to organize in a certain manner. For example, national banks are organized as corporations. See 12 U.S.C. § 24 (1994) (provides that national banking association is considered a “body corporate”); id. § 21 (requiring national banking association to have at least five incorporators and articles of association). Insurance companies may be organized as mutual companies and as corporations, depending on the state law under which they are organized. See e.g., N.Y. INS. LAW § 1201 (McKinney 1985 & Supp. 1999) (incorporation of stock or mutual insurance companies). Investment companies may be organized in any
regulate their businesses, although some relaxation of the rules governing trust investment services is permissible under the common law. The one exception to this division of form and business regulation is the trust. Traditional trust law governs both form and business of trustees. Business trust laws are like private trust laws on this score; form and substance have not been severed.

Why does trust law include both trust form and regulation of Trust Services?
The most obvious reason for the combined form and substantive regulation in trust law is that the form—relationship between trustees and beneficiaries—and the Trust Services are one and the same. Trust Services are the relationship among the members of the organization: the trustee and the beneficiaries. The main function of trustees involves the same rules as those of the organizational structure as well as the duties of those who control the assets of others. There are no other functions, and the relationships of the trustees with third parties are very limited. Hence, the regulation of the trustee is included in the same body of law that provides the form of the trust.

Trust form and trust law remain closely related even though the Trust Services have expanded to the management of financial assets and to public offering of Trust Services. The public offering of Trust Services has changed the relationship between trustee and beneficiaries, to resemble corporations. Business trusts have more beneficiaries than private trusts do. Business trusts remain intact as an association notwithstanding the change in the identity of their beneficiaries. In contrast to most private trusts, the trustees of business trusts are usually the beneficiaries and not third parties. The beneficiaries of business trusts require a measure of control over the trustee and a voice in changing the trust instruments. In these respects business trusts are different from private trusts and similar to corporations.

Today as in the past, business trust law regulates both form and business as it does in the case of private trusts. The essence of the business has remained Trust Services. Because mass offering of Trust Services is crucial to the stability of the financial system, federal laws have preempted a significant part of state laws. Not surprisingly, federal laws too regulate organizational forms and Trust Services in the same laws.

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26 One of the reasons for these organizational changes was the desire of trustees to offer more streamlined and less custom-made trust services. Arguably this form was also designed to circumvent the limitations on the use of corporate forms. After all, the trust form was hatched and developed to circumvent legal limitations and burdens.

27 The death of business trusts (investment companies) in the beginning of the 1930s and with it the death of the investment management industry ended in federal legislation. The last two of the five acts Congress passed during the thirties addressed the issues of the financial system. The Investment Company Act and Investment Advisers Act both of 1940 provide both overriding organizational form and the rules regulating the business of mass-produced and offered trust services. State legislation has a limited impact; and is operative only to the extent that it does not conflict with state law. Similarly, in 1974 Congress passed the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of 26, 29 U.S.C.), regulating pension funds, which preempted trust law both as a form of organization and as a regulation of trust business. The Comptroller of the Currency has promulgated trust law regulations that apply to bank departments acting as private trustees, and as pension...
Trust law governs Trust Services; trust law will govern C&M Enterprises. Those who view business trusts as corporations suggest that business trusts should be regulated as corporations, even if they offer Trust Services. That means that the corporate form will dictate the duties and liabilities of the trustee-directors to the beneficiaries-shareholders. Yet, the reverse result should govern. If a corporation manages other people’s money and performs Trust Services, it is regulated as a trust, and its duties to the beneficiaries are trustees’ duties. It may be that the corporation will be deemed the trustee and not the corporate directors. But that difference is technical. Directors of a corporation that carries on a trust business must see to it that the corporation will perform its duties under trust law; if they do not, the directors will be liable for violating their duty of care.28 That duty is linked to the type of business that the corporation manages, and not to their status as directors. Directors of a corporation that manages an explosives factory will be remiss in their duty if they do not make sure that the corporation carries insurance against explosions. Directors of a corporation that manages a trust business will be remiss in their duties if they do not ensure that the corporation carries insurance against embezzlement by its employees, or does not segregate the trust assets from its own and does not earmark them, and does not deposit trust liquid assets with a reliable bank.29 A partnership would be subject to the same rules and liabilities. In sum, trust regulation applies to an organization that offers trust services regardless of the form of the organization.30

Moreover, the substance of trust law will apply to those who carry on a non-trust business, if they are organized as business trusts.31 Further, the trustees’ duties to the beneficiaries (shareholders) will be subject to trust law, in addition to the regulation of their non-business. If the two conflict, the trustees have to comply with trust duties. This is an unchartered area because there are no trusts that manage C&M businesses. When trust property is an on-going business, the business is usually organized as a corporation and the trustees are vested with the shares. To be sure, the Delaware Business Trust Act was not available before 1991, but we do not see changes in this area. I maintain that the

trustees. 12 C.F.R. §§ 9.1-.20 (2000) (retaining much of state trust law). The organizational form of this trustee is a department of a bank, and the Comptroller’s rules apply to it. The residual rules relating to organization and trust business are the state laws, and the Delaware Business Trust Act is one of them. The bifurcation of trust law is now dual: it exists as an organizational law and as a regulating law in both state law and federal law.

29 See, e.g., Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981) (a director of a corporation that operated a reinsurance business and held premiums in trust was liable for misappropriation of the trust funds. The court emphasized that the corporation was a trustee and that the director had high duties of care which she did not meet). See also, McGlynn v. Schultz, 90 N.J. Super. 505 (Ch. Div. 1966), aff’d 95 N.J. Super. 412, cert. denied, 50 N.J. 409 (1967) (finding directors liable for not insisting on segregation of trust funds held by the corporation).
30 See Uniform Trust Code §802g.
31 But see, e.g., Spinoso v. Heilman (In re Heilman), 241 B.R. 137, 159 (Bankr. D. Md. 1999) (in determining the relationship between the parties in the context of the Bankruptcy Code the parties’ use of the word trust was not determinative) (citing Upshur v. Briscoe, 138 U.S. 365 (1891)); Gunter v. Janes, 9 Cal. 643, 658 (1858) (a trustee who is also a creditor is bound by his obligations as trustee).
trust structure is not used for C&M enterprises because in trust law one cannot separate form and substance. The literal language of the Delaware Act may be interpreted to allow a business trust that is a trust neither in form nor in substance. Yet, as discussed, that was not the intent of the legislation. Besides, this interpretation leads to a problematic result. An organization that has eliminated in the trust instrument its trust duties and has adopted another internal relationship with the shareholders may mislead the shareholders and investors if it implies that the form of organization also carries with it trust regulation, which is stricter than the actual regulation that applies to the C&M Enterprise. While there is a law that prohibits the use of the term “bank” except for approved banks, there is no specific law that prohibits the use of the term “trust.” But the general law of fraudulent misrepresentation applies to all names and may apply to such a name under these circumstances.

**Trust Services and C&M Enterprises are fundamentally different.** This is the opinion of those who offer Trust Services and those who manage C&M Enterprises. C&M Enterprises are not using the Delaware Act because they are not offering Trust Services. Investment managers, the Public Trustees offering Trust Services, reject the role of Enterprise managers. They did not accept the suggestion of a number of scholars that mutual funds and pension funds become active shareholders involved in the operations of Enterprises. Investment managers, even of state pension funds that are the most active funds, declined to appoint representative directors to the boards of corporations in which the funds held a significant number of shares. When dissatisfied with the corporate management of their investments, these trustees-investment managers sell the shares. They “exit” rather than exercise “voice.” When they are required to vote; for example, when corporations propose merger or are targets of takeovers, investment managers prefer to follow their shareholders’ directives on how to vote rather than use their discretion. When there is no escape, they act as creditors but not as business managers. Investment managers have justified their abstention from activism on the ground, among others, that investment management is different and distinct from corporate management. Monitoring is not operating. And their expertise is in

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32 Once the beneficiaries sign off, they have presumably agreed to the terms. Not only that; the terms need not be specified in the instrument. They can be mentioned by reference. Delaware Act § 3801(f)(2):

A governing instrument:

(1) May provide that a person shall become a beneficial owner and shall become bound by the governing instrument if such person (or a representative authorized by such person orally, in writing or by other action such as payment for a beneficial interest) complies with the conditions for becoming a beneficial owner set forth in the governing instrument or any other writing and acquires a beneficial interest; and

(2) May consist of 1 or more agreements, instruments or other writings and may include or incorporate bylaws containing provisions relating to the business of the business trust, the conduct of its affairs and its rights or powers or the rights or powers of its trustees, beneficial owners, agents or employees.

33 See, e.g., N.Y. BANKING LAW § 669 (McKinney 1971).
monitoring. But I believe they know their business quite well, and would become activists if this were part of their business. Furthermore, private trustees that manage inherited businesses usually hold the shares of the businesses rather than the position of directors. However, this pattern may be due to the fact that most such trusts were established before the Delaware Act was passed. The future will tell whether businesses given in trust will be reorganized as Delaware Business Trusts.

Part Three. The Delaware Business Trust Act Does Not Offer Advantages to C&M Enterprises

C&M Enterprises do not use the Delaware Business Trust Act because there are sufficient known legal forms of organizations that meet their needs: corporations, partnerships, limited partnerships, and limited liability companies. These models are contained in state laws, and there are states that meet the changing needs of such Enterprises by amending their laws. Therefore, a novel organizational form, especially a form that poses uncertainties and has not been used before for C&M Enterprises, must offer significant benefits over the existing available forms, which current forms do not offer, or remedy serious flaws in existing forms.

While the Act recognizes the inescapable fact that business trusts are organizations, and clarifies their ambiguous position (e.g., recognizing them as legal entities), the Delaware Act entitles promoters to design the constitutive instruments of this legal entity as they wish. The implications of this distinction will be discussed later.

I searched for basic flaws of the current legal models of C&M Enterprises, organizations, looking for expressions by bar and businesses of dissatisfactions with the existing organizational models, or the desire for more freedom to shape them. I found none. I note amendments of corporate laws and partnership laws that relax the fiduciary duties of the managers of the enterprises, converting mandatory rules into default rules, especially in relationship to the duty of care. I note a relaxation of requirement for annual shareholder meetings, which are costly for publicly held corporations and cause

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36 See Del. Code Ann. tit. 8, §211(a)(Supp. 2000) (allowing board to authorize stockholders’ meetings by remote communication); id. §211(b) (allowing stockholders to elect directors by written consent unless certificate of incorporation otherwise provides) John Nuveen & Co., SEC No-Action Letter (Nov. 18, 1986) (interpreting section 32(a) of the Investment Company Act of 1940 to generally not required investment companies to hold annual shareholder meetings, unless the Act specifically requires a shareholder action); Md. Code Ann., Corps. & Ass’ns § 2-501(b) (1999) (allowing charter or bylaws of registered investment company to provide that corporation need not hold annual meetings in a year when election of director is not required).


38 Telephone Interview With Mark Gentile, Esq. Richards, Layton & Fing, I Rodney Square, PO Box 551. Wilmington Delaware,19899 (Jan. 29, 2001). Mr. Gentile notes that the limited liability company acts meet the tax needs with which many businesses are concerned.

problems of acquiring quorums. I note the limited liability company acts which allow the parties to design their relationships, and thereby take advantage of pass-through tax treatment. The literature does not demonstrate any problems either. Of course it is difficult to prove the negative. All that can be said here is that there are no signs of complaints about existing organizational forms. I conclude that there is no shortage of available legal forms to accommodate the needs of C&M Enterprises.

Possible advantages. What about a self-perpetuating board? Assume that promoters of C&M Enterprises may be enticed to use of the business trust if the form would allow them to establish a self-perpetuating board. After all, the private trust is in fact an organization that precludes the beneficiaries’ control, and most not-for-profit organizations have self-perpetuating boards. Such boards exist when there are no voters. Promoters of C&M Enterprises may follow suit and eliminate voting, which is costly, and acquire greater control over the Enterprises. So long as shareholders are able to exit the organization by selling their shares they will not exercise “voice” unless they have a significant stake in the Enterprise. In such a case they may negotiate the right to place their choice on the board. The trust instrument may permit directors to sell directorships without investments in the Delaware business trusts. On its face, there is nothing in the Act to prohibit such contractarian trust instruments.

I do not know what the reaction of the market would be to such an innovation. I suspect that few can anticipate whether other Enterprises will follow this structure or whether shareholders will reject the innovation, or whether state or federal legislators will negate these structures. I do believe that such a step may cause some reaction. The trend in recent years has been to strengthen the boards’ independence of management, and at the same time to require from them a higher degree of accountability. Thus, the risk of taking this step and its effects on share prices and the ability to raise capital seems quite high. Promoters have sufficient means to maintain control through management

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40 See Del. Code Ann. tit. 8, §211(a) (Supp. 2000) (allowing board to authorize stockholders’ meetings by remote communication); id. §211(b) (allowing stockholders to elect directors by written consent unless certificate of incorporation otherwise provides); John Nuveen & Co., SEC No-Action Letter (Nov. 18, 1986) (interpreting section 32(a) of the Investment Company Act of 1940 to generally not required investment companies to hold annual shareholder meetings, unless the Act specifically requires a shareholder action); Md. Code Ann., Corps. & Ass’ns § 2-501(b) (1999) (allowing charter or bylaws of registered investment company to provide that corporation need not hold annual meetings in a year when election of director is not required).

41 See Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24,816 (Jan. 2, 2001), 66 Fed. Reg. 3734 (Jan. 16, 2001) (to be codified in scattered sections of 17 C.F.R.) (requiring investment companies relying on certain exemptive rules to have a majority of independent directors on their boards; requiring independent directors of these companies to select and nominate other independent directors; requiring legal counsel for independent directors to be independent; requiring further disclosure about directors); Charles M. Elson, Director Compensation and the Management Captured Board—The History of a Symptom and a Cure, 50 SMU L. Rev. 127 (1996) (advocating equity-based director compensation to encourage active management); Charles M. Elson, Executive Overcompensation—A Broad-Based Solution, 34 B.C. L. Rev. 937 (1993) (advocating stock ownership and lengthened board terms to encourage active shareholder input).

42 See Harry G. Henn & John R. Alexander, Laws of Corporations § 60, at 120 (3d ed. 1983) (noting that “[a] business trust is an unattractive investment in that it is not a very familiar form of business to most people, and there can be little or no control in the certificate holders (beneficiaries) over the affairs of the
positions and the choice of the initial board members. Thus, they need not maintain their control in a way that runs counter to the general trend today, and is quite risky. Therefore, I doubt whether the possibility of self-perpetuating control or even the conversion of office into property for sale is sufficiently beneficial for promoters to take the risk.

What about reducing liabilities on management and the directors? Another benefit which promoters may reap from adopting a business trust form is the reduction or elimination of the liabilities of directors and management to shareholders. Even though corporate laws, including Delaware corporation law, have converted the duty of care from a mandatory duty to a default rule, in which level of directors’ duty of care can be lowered, corporate laws have maintained the duty of loyalty as mandatory. So has the new Uniform Trust Code. The Delaware Act does not seem to limit the promoters’ ability to erase the duty of loyalty and care altogether. That does not mean that the promoters can do that in reality.

For a starter the Delaware bar does not accept this interpretation and the courts are also unlikely to accept it. Most likely, the courts will interpret the Act as limiting the ability of the promoters to seek or rely on such a waiver on the ground that the shareholders’ consent by definition is uninformed. The waiver can cover future broad conflicts of interest or embezzlement that may result in serious losses to shareholders. Shareholders will not be presumed to have anticipated such losses by waiver. My doubt persists notwithstanding the provision of the Act that the purchase of the shares of the business trust constitutes consent to the provisions of the trust instrument.

In addition, the Delaware legislature or federal legislators may overrule the waivers. Further, it is unclear that shareholders will accept such a waiver. A provision that drastically reduces the management’s and director-trustees’ liabilities sends a signal to shareholders that the people who control the Enterprises are concerned about liability for acts that may injure shareholders. To be sure, the desire for protection against litigation is understandable. But it is doubtful whether protection from judicial scrutiny that leaves accountability entirely to the markets will be lightly used or accepted. Thus, it may be that the trust instrument will contain a somewhat increased protection for managements and directors, but not a very extreme one. The speculative benefits must be weighed against the speculative costs.

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43 This conversion negates the very essence of directors’ fiduciary duties. See Tamar Frankel, Fiduciary Law, 71 Cal. L. Rev. 795, 803 n.24 (1983).

44 DEL CODE ANN. tit. 8, § 102(b)(7)(I) Supp. 2000); MD. CTS & JUD. PROC. § 5-418(a)(1) (providing that charter may not restrict or limit liabilities of directors or officers to extent that they received “improper benefits.”).


46 Delaware Act § 3801(f)(1) (1995) (stating that governing instrument may provide that person who complies with conditions for becoming beneficial owner and acquires beneficial interest becomes bound by governing instrument). Cf UNIF. TRUST CODE § 1008 (limiting waivers to good faith actions).
How about imposing fiduciary duties of the management and directors towards debt security holders? The arguments for and against imposing fiduciary duties towards debt security holders on corporate directors have raged for a number of years. The courts have declined to impose such duties except when the enterprise has become insolvent or close to becoming insolvent. Generally debt security holders must specify their rights and gain their protection from the terms of their debt obligations (and the trust indenture). An enterprise that is highly leveraged may desire to provide beneficial rights for its debt security holders, and arguably, the business trust form will enable it to do so. I am not sure whether and under what circumstances such a desire would rise. Assuming it does, the question is whether existing organizational structures and form models would not allow for the establishment of such rights; for example, by allotting common shares or voting rights to debt security holders. Most corporate laws are sufficiently broad and permissive to allow the issuance of such instruments. If they are not issued, I believe the reasons are business reasons, not legal limits. Other mechanisms exist as well. To the extent that banks, for example, desire to have insider information about the affairs of the enterprise in order to protect their interests, the banks bargain for a directorship to the board. Thus, one can achieve this purpose without embarking on a risky legal venture of a business trust.

The scope of the Delaware Act is narrower than it seems. The Act promises far more than it can deliver. That is because some of its permissive provisions are preempted fully or partially by federal laws. For example, the Act provides relief from the costs of obtaining investors’ consent to the trust instruments. Section 3801(f)(1) of the Delaware statute states:

A governing instrument:
(1) May provide that a person shall become a beneficial owner and shall become bound by the governing instrument if such person (or a representative authorized by such person orally, in writing or by other action such as payment for a beneficial interest) complies with the conditions for becoming a beneficial owner set forth in the governing instrument or any other writing and acquires a beneficial interest. . .

Therefore, the purchase of a trust share signifies an agreement to the trust instrument. An oral authority signifies an acceptance. If an investor says to the sales person: “If you think that the trust instrument is OK, then I will buy the shares offered by the trust,” that is sufficient to bind the investors.

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But if investors wish to read the trust instrument, especially if the instrument does not represent a form contract but the creation of the promoter-trustee, and if investors ask to see the instrument, then the following provision in section 3801(f)(2) could be used:

A governing instrument . . .

(2) [may consist of 1 or more agreements, instruments or other writings and may include or incorporate by laws containing provisions relating to the business of the business trust, the conduct of its affairs and its rights or powers or the rights or powers of its trustees, beneficial owners, agents or employees.\(^{50}\)

Investors may receive a trust instrument that either is comprised of many agreements, or better still, contains these agreements by reference. Unless the investors are investing significant amounts of money and are prepared to invest significant amounts of time (or their lawyers’ time), they will not read the instrument but may buy the trust shares.\(^{51}\)

**The Securities Act of 1933 and the Securities Exchange Act of 1934 preempt most of these generous provisions.** First, public offerings are subject to the requirement of extensive disclosure documents that must be filed with the Securities and Exchange Commission. Second, even non-public offerings must be accompanied by more than the requirements of the Delaware Act.\(^{52}\) In private trusts it is likely that the trustor and the trustee will negotiate the terms of the trust on a one-to-one basis. In a public trust no such negotiation takes place. That is why the securities acts fill in the void. Thus, by buying a security an investor should not be deemed to have agreed to the terms of the security or be bound to other trust instrument provisions without full disclosure. In fact, it seems that these provisions of the Delaware Act have little if any effect on both Public Trustees and C&M Enterprises.

**Even Public Trustees cannot take advantage of many permissions offered in the Delaware Act.** Investment companies are governed by the Investment Company Act of 1940 which regulates their form, financial structure, operations, and some of their investments as well as conflict of interest of their affiliates.\(^{53}\) The scope of the Delaware Act is therefore limited to those situations in which the federal laws do not apply expressly or impliedly. For example, shareholders’ meetings need not be held annually if there are not elections of new directors.\(^{54}\) Similarly, insurance companies, regulated under state laws, cannot escape their form and substantive regulation by organizing as a

\(^{50}\) Id. § 3801(f)(2).

\(^{51}\) For public trust forms that conduct trust business, however, these provisions would rarely apply. In most cases they would conflict with the federal securities acts, and especially the Investment Company Act and Investment Advisers Act of 1940. These acts require far more explicit disclosure and approvals of shareholders and clients as well as the boards of directors of investment companies to various changes. Hence, the business trusts that could take advantage of these provisions must be non-public.

\(^{52}\) See also Unif. Trust Code § 813 (duty to inform); §105(8),(9) (duty is mandatory).


business trust. The Employee Retirement Income Security Act of 1974 has preempted all trust state laws. 55 Since trust law includes both form and substantive regulation the Delaware Act is preempted as well, and federal banking laws will continue to trump the Act.

Further, C&M Enterprises cannot take advantage of the Delaware Act to overcome the substantive regulation of their businesses, even if this regulation is contained in state laws. Any change that C&M Enterprises make in the business trust will pertain to form only. No other outcome seems possible.

The Delaware Act does not offer tax relief or advantages. For both Public Trustees and C&M Enterprises the Delaware Act does not offer any relief from tax burdens. The Act expressly provides that Delaware business trusts will be taxed as corporations.56 To be sure, under the Tax Code investment companies, banks, and insurance companies are afforded pass-through tax treatment. C&M Enterprises that organize as partnerships, limited partnerships or some types of limited liability companies benefit from pass-through tax treatment, subject to certain conditions. The Delaware Act does not relieve business trusts from these conditions.57

Some states, such as Texas, do not recognize the limited liability status of beneficiaries of business trusts.58 This posture renders the business trust form disadvantageous and risky for businesses that operate nationally, depending on the forum state choice of law. Since the trust is a common law institution, lawyers, business persons, and courts in countries with code-based legal systems are not familiar with trust law and concepts. Thus, Delaware business trusts are unattractive for Enterprises that operate interstate and internationally.

Raising Capital It has long been suggested that the business trust form is not conducive to obtaining credit or raising new capital, which C&M Enterprises, especially developing Enterprises, might need.59 Further, a holding company in the form of a trust

55 Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of 26, 29 U.S.C.), regulating pension funds, which preempted trust law both as a form of organization and as a regulation of trust business. The Comptroller of the Currency has promulgated trust law regulations that apply to bank departments acting as private trustees, and as pension trustees. 12 C.F.R. §§ 9.1-.20 (2000). The organizational form of this trustee is a department of a bank, and the Comptroller’s rules apply to it. The residual rules relating to organization and trust business are the state laws, and the Delaware Business Trust Act is one of them. The bifurcation of trust law is now dual: it exists as an organizational law and as a regulating law in both state law and federal law.


57 But if, hypothetically, the Act is interpreted to require a corporate classification for tax treatment, then C&M Enterprises that could use other forms of organization will avoid resorting to Delaware business trust for this reason.


59 See Harry G. Henn & John R. Alexander, Laws of Corporations § 60, at 120 (3d ed. 1983) (noting that “[a] business trust is an unattractive investment in that it is not a very familiar form of business to most people, and there can be little or no control in the certificate holders (beneficiaries) over the affairs of the trust” and that “[t]he amount of credit obtainable is limited by the solvency of the trust since the beneficiaries usually are not personally liable”) (footnote omitted).
may raise problems under the antitrust statutes. The trust form is used as a tool for the business of investment management and, until it was outlawed, to maintain monopolies and to overcome the prohibition on creating holding companies.\textsuperscript{60} These difficulties, however, may be remedied by a sympathetic and accommodating state legislature. Trusts that are used for the process of securitizing debt prove the point. These trusts are not used to raise funds for other business but rather to hold financial assets and protect them from the bankruptcy and risk of the transferor of the assets. In sum, the trusts serve in a classic role of trustees.\textsuperscript{61}

\textbf{Notwithstanding its “contractarian” image, Delaware Act business trusts are not endowed with contract privileges.} Trust instruments, whether in a private trust or a Public Trust, do not belong to the contract category,\textsuperscript{62} trust remedies cover more than contract remedies.\textsuperscript{63} Presumably, trust instruments are not contracts for purposes of the Contract Clause of the United States Constitution.\textsuperscript{64} Therefore, the constraints of the Contract Clause do not apply to their regulation.\textsuperscript{65} In addition, the interpretation of contracts differs from that of legislation, and the trust instruments must give way to the legislation.\textsuperscript{66} The seeming freedom of the promoter in designing the trust instruments is subject to statutory regulation.


\textsuperscript{61} See 1 Tamar Frankel, \textit{Securitization Structured Financing, Financial Assets Pools, and Asset-Backed Securities} Ch. 8 (1991)

\textsuperscript{62} 3 Austin Wakeman Scott & William Franklin Fratcher, \textit{The Law of Trusts} § 197.2, at 192 (4\textsuperscript{th} ed. 1988) (“[T]he creation of a trust, although it may involve the elements usually found in a contract, is not treated as a contract.”); 2A id. § 169, at 311 (1987) (“[The trustee’s] duty to administer the trust is not a contractual duty. . . .”). However, the trustee may enter into a contract with the settlor in connection with the trust, if the trustee agrees to do something other than perform Trust Services. See, e.g., if the trustee promises to replace property lost without its fault. 3 id. § 197.2, at 192 (1988).

\textsuperscript{63} See 3 id. § 197.2, at 191 (1988) (stating that beneficiary has no action at law for breach of contract).

\textsuperscript{64} U.S. Const. art. I, § 10, cl. 1 (“No State shall . . . pass any . . . Law impairing the Obligation of Contracts.”).

\textsuperscript{65} Courts have adopted a two-part test to determine whether legislation violates the Contract Clause. First, (1) there must be a contractual relationship, (2) the legislation must impair that relationship, and (3) the impairment must be substantial. Second, if there is substantial impairment, the court determines whether it is “reasonable and necessary to achieve a valid state interest.” \textit{In re Seltzer}, 159 B.R. 329 (Bankr. D. Nev. 1993).

Conclusion

The Delaware Business Trust Act is extremely helpful to Public Trustees; it solves most of the problems facing unincorporated business trusts. Therefore, investment companies have reincorporated under the Delaware Act. Similarly, Special Purpose Vehicles, a unique type of passive investment companies that are used to convert illiquid debt and loans into liquid and tradable securities, make use of the Delaware Act. But the Act has not relaxed the regulation of the Public Trustees, such as pension funds and mutual funds. Most of these Public Trustees are regulated by federal law, covering their financial structure, nature and terms of the beneficial interests, disclosure requirements, and fiduciary duties. In addition, federal law provides government preventive enforcement and imposes self-enforcement on Public Trustees. Federal laws have been stricter than the private trust laws.

To C&M Enterprises the Delaware Business Trust Act promised more than it delivered. Enterprises have not used business trusts and are unlikely to use them in the future. The reason is that notwithstanding its permissive provisions the Delaware Act requires that business trusts remain trusts in form and substantive law. Business trusts are not corporations; trust instruments are not contracts. Trust law is neither corporate law not contract law, and its form and substance are not suitable for C&M Enterprises.

Some readers may conclude that the Delaware Act can be emptied of its trust form and substance. They may hope that business trusts will emerge as novel organizations that are contract-based and contract-regulated. This Essay demonstrates that the conclusion is wrong, and the hope is illusory.